Report to the Cabinet

Report reference: C-025-2008/09
Date of meeting: 1 September 2008

Epping Forest District Council

Portfolio: **Finance & Performance Management.**

Subject: **Treasury Management Service and Actual Prudential Indicators Annual Report 2007/08.**

Responsible Officer: **Bob Palmer** **(01992–564279)**

Democratic Services Officer: **Gary Woodhall** **(01992–564470)**

Recommendations/Decisions Required:

(1) That Members approve the 2007/08 outturn for Prudential Indicators shown within the report; and

(2) That Members note the Treasury Management Stewardship Report for 2007/08.

Executive Summary:

The annual treasury report is a requirement of the Council's reporting procedures. It covers the treasury activity for 2007/08, and the actual Prudential Indicators for 2007/08.

The report meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003.

During 2007/08 the Council complied with its legislative and regulatory requirements. The actual prudential indicators for the year, with comparators, are as follows:

Actual Prudential Indicators	**2006/07**	**2007/08**
Actual Capital Expenditure	10,500,000	10,597,000
Capital Financing Requirement		
Non-HRA	23,844,000	23,844,000
HRA	-24,628,000	-24,628,000
Total	-784,000	-784,000
Financing Costs as a proportion of Net Revenue Stream		
Non-HRA	-8.78%	-9.27%
HRA	-9.07%	-9.57%

It is also confirmed that no borrowing was undertaken during the year and the Statutory borrowing limit, the Authorised Limit, was not breached.

At 31 March 2008, the Council's external debt was nil (nil at 31 March 2007) and its investments totalled £57.25m (£53m).

Reasons for Proposed Decision:

The proposed decision is necessary in order to comply with the requirements of the CIPFA Code of Practice on Treasury management and the CIPFA Prudential Code for capital Finance in Local Authorities. The Council is required to comply with both codes in accordance with regulations issued under the Local Government Act 2003.

Other Options for Action:

Members could ask for additional information about the CIPFA Codes or the Prudential Indicators, but in order to comply with the regulations there are few options for action.

Report

1. This report summarises:

- the capital activity for the year;
- how this activity was financed;
- the impact on the Council's indebtedness for capital purposes;
- the Council's overall treasury position;
- the reporting of the required prudential indicators;
- a summary of interest rate movements in the year;
- debt activity; and
- investment activity.

<u>The Council's Capital Expenditure and Financing 2007/08</u>

2. The Council undertakes capital expenditure on long-term assets. These activities may either be:

(a) financed immediately through capital receipts, capital grants etc; or

(b) If insufficient financing is available, or a decision is taken not to apply capital resources, the expenditure will give rise to a borrowing need.

3. The Council has previously fully financed its capital expenditure and does not therefore have a current borrowing need.

4. The wider treasury activities also include managing the Council's cash flows and the investment of surplus funds. These activities are structured to manage risk foremost, and then optimise performance. Wider information on the regulatory requirements is shown in Section 11.

5. The actual capital expenditure forms one of the required prudential indicators. The table below also shows how this was financed:

	2006/07 Actual £'000	2007/08 Revised Estimate £'000	2007/08 Actual £'000
Non-HRA capital expenditure	4,813	6,185	4,949
HRA capital expenditure	5,687	6,139	5,648
Total Capital Expenditure	**10,500**	**12,324**	**10,597**
Resourced by:			
Capital receipts	4,738	5,080	4,064
Capital grants	1,190	1,185	937
Revenue	4,572	6,059	5,596
Total Resources Applied	**10,500**	**12,324**	**10,597**

The Council's Overall Borrowing Need

6. The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). This figure is a gauge for the Council's debt position. This Council currently does not have an overall positive CFR (HRA and Non-HRA), and so has no underlying need to borrow for a capital purpose.

7. With effect from 1 April 2008 the CLG introduced new Minimum Revenue provision (MRP) Guidance, which requires an MRP Policy to be approved by Members. The MRP is the mechanism for the reduction of the borrowing need by a revenue charge. In anticipation of this guidance, Council approved the following MRP Statement on 19 February 2008 as part of the Council Tax setting report:

> *"As the Council is currently debt-free and intends to remain so for the foreseeable future, there is no requirement to make a provision for external debt repayment. If the Council identifies a need to borrow externally, the Council will draw up a minimum revenue provision policy in accordance with proper accounting practice, and will present this to members for approval."*

8. The Council's CFR for the year is shown below:

	31 March 2007 Actual £'000	31 March 2008 Revised Estimate £'000	31 March 2008 Actual £'000
Closing balance	**-784**	**-784**	**-784**

Treasury Position at 31 March 2008

9. Whilst the Council's gauge of its underlying need to borrow is the CFR, the treasury function can manage the Council's actual borrowing position by either:

(a) borrowing to the CFR;

(b) choosing to utilise some temporary internal cash flow funds instead of borrowing (under-borrowing); or

(c) borrowing for future increases in the CFR (borrowing in advance of need).

10. It should be noted that the accounting practice required to be followed by the Council (the Statement of Recommended Practice or SoRP), changed in 2007/8 accounts, and required financial instruments in the accounts (debt and investments etc.) to be measured in a method compliant with national Financial Reporting Standards. The figures in this report are based on the amounts borrowed and invested and so may differ form those in the final accounts by items such as accrued interest.

11. During 2007/08 the treasury function managed the debt position to remain debt free, in accordance with established Council policy. Although the Council is debt-free and expects to remain so for the foreseeable future, there is a reducing element of debt taken out on behalf of other local authorities. This Council has repaid the underlying external debt in full from its own resources; the authorities concerned are paying the Council their share of the debt plus interest in instalments. This is shown as negative debt, as it represents income to the Council.

12. The treasury position at the 31 March 2008 compared with the previous year was:

Treasury position	**31 March 2007**		**31 March 2008**	
	Principal	**Average Rate**	**Principal**	**Average Rate**
Total Debt	**-£0.585m**		**-£0.559m**	
Fixed Interest Investments	-£53.0m	4.93%	-£56.25m	5.85%
Variable Interest Investments	£0.0m		-£1.0m	6.01%
Total Investments	**-£53.0m**	**4.93%**	**-£57.25m**	**5.85%**
Net borrowing/ (Investment) position	**-£53.585m**		**-£57.809m**	

Prudential Indicators and Compliance Issues

13. Some of the prudential indicators provide either an overview or specific limits on treasury activity. These are shown below.

14. Net Borrowing and the CFR - In order to ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2007/08 plus the expected changes to the CFR over 2008/09 and 2009/10. Since the Council does not have a positive CFR, the Council's net investment position must be lower than the CFR. The Council has complied with this prudential indicator.

	31 March 2007 Actual	**31 March 2008 Revised Estimate**	**31 March 2008 Actual**
Net borrowing/ Investment position	**-£53.585m**	**-£58.559m**	**-£57.809m**
CFR	**-£0.784m**	**-£0.784m**	**-£0.784m**

15. The Authorised Limit - The Authorised Limit is the "Affordable Borrowing Limit" required by s3 of the Local Government Act 2003. The Council does not have the power to borrow above this level once set. The table below demonstrates that during 2007/08 the Council has maintained gross borrowing within its Authorised Limit.

16. The Operational Boundary – The Operational Boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the Boundary is acceptable subject to the Authorised Limit not being breached.

17. Actual financing costs as a proportion of net revenue stream - This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	2007/08
Original Indicator - Authorised Limit	**£5.0m**
Maximum gross borrowing position	**£0.00m**
Original Indicator - Operational Boundary	**£0.5m**
Average gross borrowing position	**£0.00m**
Financing costs as a proportion of net revenue stream **Non-HRA** **HRA**	 **-9.27%** **-9.57%**

Economic Background for 2007/08

18. The rising trend in UK interest rates continued in the first half of the 2007/08 financial year. The domestic economic backdrop continued to present problems for the Monetary Policy Committee, notably in the early summer. CPI inflation breached the 3% upper limit of the Government's target range in April (reported in May), consumer spending growth remained buoyant and an expanding number of companies expressed intentions to raise prices.

19. Official Bank Rate was raised to 5.5% in May and 5.75% in July in response to the deteriorating inflation outlook. In addition, the Bank of England's May and August Inflation Reports hinted that more hikes might be necessary.

Interest Rates:

End Qtr	Bank Rate	LIBOR			PWLB Rates		
		3mth	6mth	1yr	5yr	20yr	50yr
2007 Mar	5.25	5.6	5.8	5.9	5.35	4.80	4.45
Jun	5.50	6.0	6.1	6.3	5.80	5.20	4.80
Sep	5.75	6.3	6.3	6.2	5.25	5.00	4.75
Dec	5.50	6.0	6.0	5.8	4.64	4.63	4.47
2008 Mar	5.25	6.0	6.0	5.8	4.14	4.70	4.43

20. The market was plunged into chaos in late August as the tightening of credit conditions, triggered initially by the failure of a selection of US mortgage lending institutions, undermined investor confidence. LIBOR rates rose to well over 6.5% as financial organisations' reluctance to lend money to counterparties sparked a severe shortage of funds in the market. In the UK, the crisis came to a head with the failure of the Northern Rock Bank (September) and while the danger of potential meltdown was defused by the Government's decision to guarantee all deposits with this institution, this failed to prevent a prolonged tightening of credit conditions.

21. Central banks strove to boost market liquidity via the injection of funds to the banking system and there were signs that this might be working in January. But a series of disappointing financial results and a persistent undercurrent of mistrust ensured a wide margin between official and market rates continued to year-end.

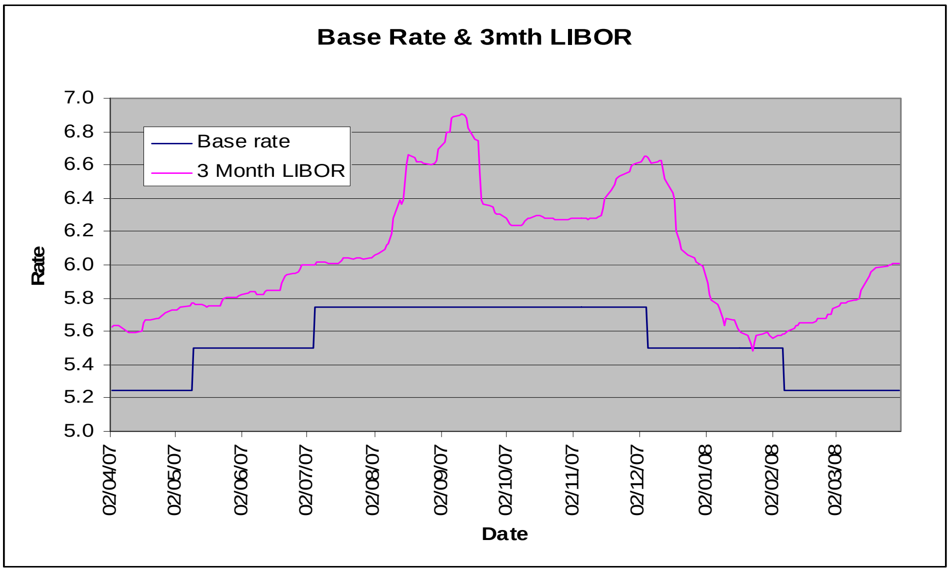
22. The credit crisis provoked a significant change in the Bank of England's assessment of UK economic prospects over the medium term. It was clearly concerned that the tightening of liquidity and the consequent rise in borrowing rates across the entire

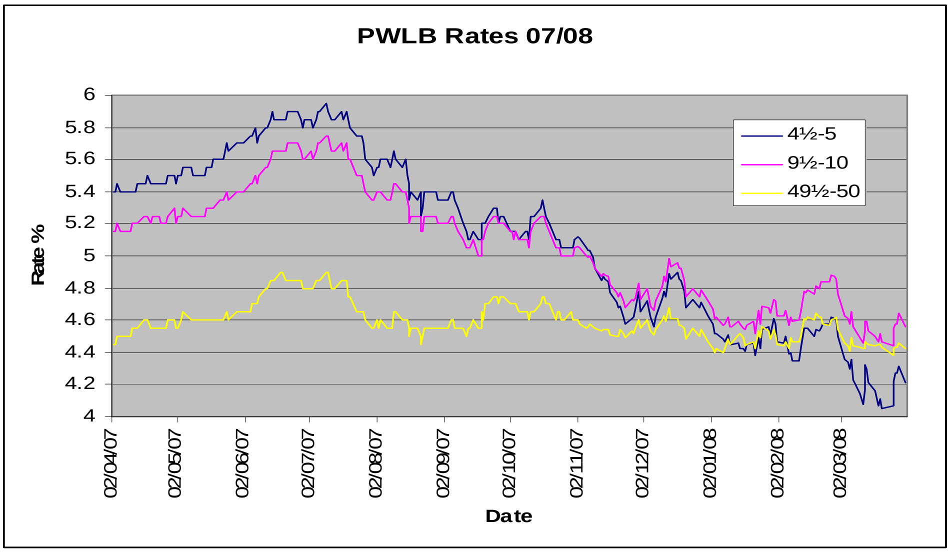
economy could lead to a rapid slowdown in activity. This would help to contain inflation pressures. Bank Rate was cut by 0.25% on two occasions, December and February, to end the year at 5.25%.

23. Long-term rates (gilt yields & PWLB rates) charted an erratic course. The upward pressure on rates in evidence in the closing stages of 2006/07 continued into the new year as concerns persisted that international interest rates would need to rise further to combat mounting inflation pressures.

24. Gilt yields peaked in late June and started to slip lower in the summer months. The flight to safe investments triggered by the financial crisis placed strong downward pressure upon gilt-edged yields in August/September notably at the short end of the maturity range and the rally in this part of the market gained momentum as the year drew on.

25. Progress to lower levels was erratic and limited in the early months of 2008, but the general trend in yields was to lower levels. The most notable development was the reversion of the yield curve to a strongly positive incline.





The Strategy Agreed for 2007/08

26. The strategy agreed for Treasury activities during 2007/08 was to:

(i) maintain the Council's debt-free status; and

(ii) undertake the most appropriate form of investments depending on the prevailing interest rates at the time and the Council's professional advisors' view on forecast rate movements. All investments were to be made in accordance with the Council's investment policies and prevailing legislation and regulations.

Actual Debt Management Activity during 2007/08

27. Borrowing – no borrowing was required during 2007/08.

Investment Position

28. Investment Policy – The Council's investment policy is governed by ODPM (now DCLG) Guidance, which has been implemented in the annual investment strategy approved by Council on 20 February 2007. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

29. Resources – The Council's longer-term cash balances comprise primarily revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources comprised as follows, and meet the expectations of the budget:

Balance Sheet Resources (£m)	**31 March 2007 £'000**	**31 March 2008 £'000**
Revenue balances	12,444	13,699
Earmarked reserves	8,648	10,311
Major repairs reserve	5,655	7,290
Usable capital receipts	26,425	26,823
Total	53,172	58,123

30. Investments Held by The Council - The Council's investment policy does not allow the use of a wide range of higher risk investment products and therefore performance tends to be stable. In recent years performance has exceeded that of professionally managed funds, whose performance tends to fluctuate more. The Council maintained an average balance of £61.2m and received an average return of 5.84%. The comparable performance indicator is the average 7-day LIBID rate, which was 5.60%. Thus interest earnings were some £150,000 above the benchmark and more than £70,000 above the revised estimate.

Benchmarking Information for 2007/08

31. A draft return has been received from the CIPFA Treasury Management Benchmarking Club. This information indicates that in addition to beating the 7-day LIBID rate the rate achieved of 5.84% is above average for the club members. The average rate achieved by club members managing their own funds was 5.80%, whilst those using external fund managers reported earnings of only 5.60%.

32. Data is also provided on costs, with a figure being derived for the cost per £m managed. This Council has a cost of £410 per £m managed which is slightly above the

club average of £390 per £m managed. However, the average investment per club member is above £100m and so far in excess of the EFDC average of £61m. It is therefore likely that a majority of club members are benefiting from economies of scale that are not available to EFDC. The average figure reported for the cost of external fund managers is £1,090 per £m managed.

Regulatory Framework, Risk and Performance

33. The Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance:

(a) The Local Government Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity;

(b) The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (although no restrictions were made in 2007/08);

(c) Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act;

(d) The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities;

(e) The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services;

(f) Under the Act the ODPM (now DCLG) has issued Investment Guidance to structure and regulate the Council's investment activities; and

(g) Under section 238(2) of the Local Government and Public Involvement in Health Act 2007 the Secretary of State has taken powers to issue guidance on accounting practices. Guidance on Minimum Revenue Provision was issued under this section on 8 November 2007.

34. The Council has complied with all of the above relevant statutory and regulatory requirements that limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means both that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

35. The Council is aware of the risks of passive management of the treasury portfolio and, with the support of Butlers, the Council's advisers, has proactively managed its treasury position. The Council has continued with the established policy of remaining debt free and so no borrowing has been undertaken.

36. Shorter-term rates and likely future movements in these rates predominantly determine the Council's investment return. These returns can therefore be volatile and, whilst the risk of loss of principal is minimised through the annual investment strategy, accurately forecasting future returns can be difficult.

Resource Implications:

The credit to the General Fund from interest earnings in 2007/08 was £72,000 more than had been anticipated in the revised estimates.

Legal and Governance Implications:

The regulatory framework is as set out under section 11 above.

Safer, Cleaner and Greener Implications:

There are no environmental implications.

Consultation Undertaken:

The Council's external Treasury advisors provided the framework for this report and have confirmed that the content satisfies all regulatory requirements.

Background Papers:

None.

Impact Assessments:

There are no equalities impacts.

As detailed above, a risk averse position is adopted to ensure no loss of the capital invested by the Council.