Report to the Cabinet

Report reference: C/039/2006-07.
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Epping Forest District Council

Portfolio: Finance, Performance Management and Corporate Support Services.

Subject: Treasury Management Policies and Investment Practices.

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Recommendations:

(1) That, as shown within the report, the 2005/06 outturn for Prudential Indicators be approved; and

(2) That the Treasury Management Stewardship Report for 2005/06 be noted.

Annual Report on the Treasury Management Service and Prudential Indicators 2005/06:

Purpose:

1. The annual treasury report is a requirement of the CIPFA Treasury Management Code and covers the treasury activity for 2005/06. The report also covers the actual Prudential Indicators for 2005/06 in accordance with the requirements of the Prudential Code.

Introduction and Background:

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

- 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.
- The Act permits the Secretary of State to set limits either on the Council as an individual entity or nationally on all local authorities, restricting the amount of borrowing which may be undertaken. No restrictions were made in 2005/06.
- Under the Act the ODPM has issued Investment Guidance to structure and regulate the Council's investment activities.
- The Local Government Finance Act 1992, section 32, requires all billing authorities to set a balanced budget, and this Council has complied with this requirement.
- Statutory Instrument 3146 2003 (SI 3146 2003), as amended, develops the controls and powers within the Act.
- SI 3146 2003 requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities.
- SI 3146 2003 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.

3. This Council adopted the CIPFA Code of Practice for Treasury Management in the Public Sector on 16 April 2002, and operates its treasury management service in compliance with this Code and the above requirements. These require that the prime

objective of the treasury management activity is the effective management of risk, and that its borrowing activities are undertaken on a prudent, affordable and sustainable basis.

Reporting Requirements:

4. The Code requires as a minimum the regular reporting of treasury management activities to:

- Forecast the likely activity for the forthcoming year (in the Annual Treasury Strategy Report); and
- Review actual activity for the proceeding year (this report).

5. This report sets out:

- A summary of the strategy agreed for 2005/06;
- The Council's treasury position at 31 March 2006;
- The main Prudential Indicators and compliance with limits;
- A summary of the economic factors affecting the strategy over 2005/06;
- The treasury decisions taken and their revenue effects;
- The associated risks of any of these decisions; and
- The performance of these decisions.

The Strategy Agreed for 2005/06:

6. The original strategy for 2005/06 was formulated in February 2005 and outlined a cautious approach in response to advice provided by Butlers, our treasury advisors. In November 2004, Butlers' reported that the general economic forecast had changed from mild optimism to caution over the course of autumn 2004.

7. The main change in treasury dealing in 2005/06 was in that part of the portfolio is kept available for instant access. A change was made from individual call deals on the money market to investment in an instant access deposit account with the Bank of Scotland. This account was opened in mid March 2005, and accrued interest on credit balances at the Bank of England base rate (currently 4.50%), which is 0.25% to 0.35% better than the average call deal struck on the open market in the months before the change of practice. Balances over £5m attract interest at 0.10% over the Bank of England base rate.

8. This approach was further modified in January 2006. The Bank of Scotland informed us that they could not maintain the current rates of interest, and that they would be decreasing the rates slightly from January 1st 2006. After comparing similar products offered by our main bankers, NatWest, the Council has opened a seven day notice account with the Bank of Scotland, to run alongside the instant access account. The seven day notice account offers a rate based on 3 month LIBOR, which is expected to be slightly above the base rate. Funds will be kept in this account to the highest level possible while still maintaining the required level of "instant access" funds for short notice withdrawals such as BACS payment runs.

Treasury Position at 31 March 2006:

9. The treasury position at 31 March 2006 compared with the previous year was:

	31 March 2006		31 March 2005	
	Principal	**Average Rate**	**Principal**	**Average Rate**
Fixed Interest Rate Debt	£ 0.00 m		£ 0.00 m	
Variable Interest Rate	£ 0.00 m		£ 0.00 m	
Total Debt	**£ 0.00 m**		**£ 0.00 m**	
Fixed Interest	£ 43.0 m	4.58%	£ 44.60 m	4.92%
Variable Interest	£ 1.52 m	4.51%	£ 1.45 m	4.75%
Total Investments	**£ 44.52 m**	**4.58%**	**£ 46.05 m**	**4.92%**

10. The change in the level of investments was less than experienced in previous years. Although the sale of council houses under the Right to Buy scheme continues, the number of houses sold in 2005/06 has reduced from 61 in 2004/05 to 40 in 2005/06. The proportion of capital receipts retained has reduced considerably, as the transitional relief allowances on the capital receipts pooling scheme has decreased from 75% during 2004/05 to 50% in 2005/06. The relief will reduce further to 25% in 2006/07 and cease altogether from 2007/08.

11. In March 2005 the call investments were recalled and placed in the instant access deposit account with the Bank of Scotland described above. Under the previous system, surplus funds to be placed on call were offered to the money market. The brokers required a minimum offering of £100,000 and on some occasions the scarcity of takers for funds offered meant that there were no suitable deals available. The new arrangement allowed the deposit or withdrawal of any amount required and guaranteed interest at a rate equal to the Bank of England base rate. In addition, the Council's seven day notice account with the Bank of Scotland forms part of its flexible, short notice recall funds, which offers a rate slightly above Bank of England base rate.

Prudential Indicators and Compliance Issues:

12. The Council is required by the Prudential Code to report the outturn of the actual Prudential Indicators after the end of the financial year. Appendix A provides a schedule of all the mandatory Prudential Indicators.

13. The outturn of the capital monitoring indicators differ from their original estimates. The decrease of £4.86m in capital expenditure during 2005/06 (Indicator 2) was chiefly due to the funding for some capital projects being carried forward from 2005/06 to 2006/07. There was an underspend of £925,000 on housing-related capital expenditure for 2005/06 and one of £278,000 on non-housing related capital. The amount of revenue used to finance capital expenditure for the HRA decreased from the original estimate by £149,000.

14. Certain of the Prudential Indicators provide either an overview or a limit on treasury activity, and these are shown below:

	31 March 2006 Actual	31 March 2005 Original Indicator
Net borrowing position	**(£ 46.70 m)**	**(£ 44.60 m)**
Capital Financing Requirement	**£ 0.00m**	**£ 1.45 m**

15. The Capital Financing Requirement (CFR) shows the Council's underlying need to borrow for capital purposes. In order to ensure that over the medium term borrowing net of investments will be solely for capital purposes, net borrowing should not, except in the short term, exceed the CFR for 2005/06 plus the expected changes to the CFR over 2006/07 and 2007/08. The table above highlights the fact that, by remaining debt-free, the Council has complied with this requirement: the net borrowing position

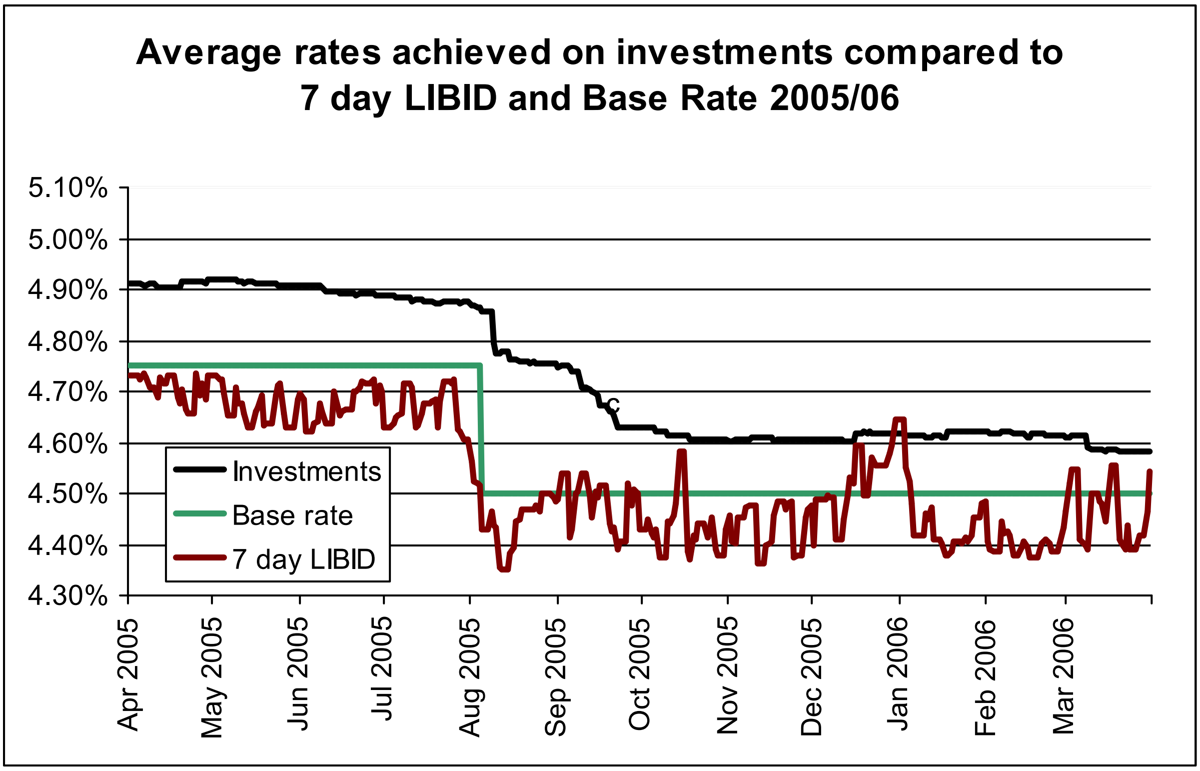
is negative, as the Council is debt-free and is an investor.

	2005/06
Original Indicator – Authorised Limit	£ 5.00 m
Original indicator – Operational Boundary	£ 3.00 m
Maximum gross borrowing position during the year	£ 0.00 m
Capital Financing Requirement	£ 0.00 m

16. The Authorised Limit is the "Affordable Borrowing Limit" required by s3 of the Local Government Act 2003. The table demonstrates that during 2005/06 the Council has maintained gross borrowing within its Authorised Limit.

17. The Operational Boundary is the expected borrowing position of the Council during the year. It would be acceptable for the actual position to be either below or above this boundary for short periods, subject to the Authorised Limit not being breached.

Economic Background for 2005/06:



18. UK interest rates remained within a tight range during the 2005/06 financial year. Base rates opened the period at 4.75% and ended a quarter-point lower at 4.5%. In spite of this, longer-dated fixed interest rates fluctuated more, rising and falling in response to notable shifts in market expectations.

19. The year started on a pessimistic note. The apparent failure of consumer spending and the housing market to respond to the Bank of England's policy base rate rises – in train since November 2003 – supported suggestions that base rates had further to rise before peaking in the later stages of 2005.

20. These concerns faded quickly, in spite of an unfavourable international background where the rise in US interest rates showed no signs of abating. UK economic data suggested the economy was slowing down faster than had been assumed just a few months earlier. As evidence of this slowdown gathered, expectations of a return to a more stable monetary policy strengthened.

21. Base rates were finally cut by 0.25% to 4.5% in August and hopes of further reductions in the autumn and spring 2006 were widespread. However optimism faded as signs of a recovery in UK activity increased whilst the international interest rate backdrop deteriorated.

22. Long-term (PWLB) fixed interest rates followed an erratic path. Some declines were seen in the first half of the year as concerns about the combination of economic activity and inflation faded. However, it was technical factors that proved to be the main driving force behind long-term fixed interest rates. These comprised strong flows of international funds to bonds and very heavy UK pension fund demand for fixed income assets.

23. Technical demand came to a head in late 2005 and early 2006. New bond supply to the UK market was insufficient to satisfy this and long-term fixed interest rates were driven to historic lows. This trend was seen most clearly for very long interest rates and the rate on the new 45-50 year PWLB loan (introduced in early December 2005) reached a low of 3.7%.

24. The downward trend did not continue. Strong demand associated with international fund inflows and UK pension fund investment weakened as investors chose not to chase yields to yet lower levels. In addition to this, fears that overseas interest rates had a good deal further to rise in the face of strengthening activity in the US, Japan and the Euro-zone encouraged a switch away from bond investments. As a result, long-term interest rates rebounded in February and March but still ended the year some 0.25% below where they had started.

Actual Strategy During 2005/06:

25. **Borrowing** - Capital expenditure for the year was £9.54m. The Council became debt free at the end of 2003/04. The current Treasury strategy is based on the determination to maintain debt free status, and accordingly no external loans were drawn to fund capital expenditure. Future capital expenditure is planned on the basis that no external debt will be incurred.

26. **Investment Policy –** The Council's investment policy is governed by ODPM Guidance, which is implemented in the annual investment strategy. The investment strategy for 2005/06 was approved by Council as part of the Council Tax setting procedure on 2 February 2005. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

27. **Investments Held by The Council** - The Council's current policy is to manage funds in-house with the assistance of professional advice from Butlers, avoiding the more volatile investment instruments that require professional expertise and constant attention. Performance tends to be slightly lower over the longer term than for professionally managed funds, but does not suffer from high professional management fees or from undue volatility.

28. The Council maintained an average investment balance of £46.7m and received an average return of 4.73%, compared to an average net return of 4.51% for money market funds. The performance indicator used as a standard benchmark of local authority treasury performance is the average 7-day LIBID rate (London Interbank Bid rate, the average rate at which UK banks are willing to borrow from other banks for a term of seven days), which was 4.53% in 2005/06. By exceeding this benchmark, the Council earned an additional £92,000 in interest. In comparison, the average 7-day LIBID rate for 2004/05 was 4.52% and the average return on Council investments was 4.67%, earning an additional £68,000 in interest on the average investment balance of £45.5m. The majority of the improved performance for 2005/06 was due to a full year of operating according to the revised Treasury policy approved in December

2004.

Risk and Performance:

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

30. With regard to performance limitations, there was one breach of the rules during the year. On 23 February 2006, an investment of £1m was made with Northern Rock PLC, taking the total of funds invested to £6m against a counterparty limit of £5m. The breach was discovered on the following day and reported to the Head of Finance immediately. In accordance with the Treasury Management policy it was decided that the Council would not attempt to recall any of Northern Rock's investments prematurely. At the time of the breach occurring, Northern Rock PLC was rated as F1 short term and was not expected to cause concern. The excess exposure lasted until 7 April 2006, when an investment of £2m matured with Northern Rock.

31. To prevent further breaches of counterparty limits, a table showing the names, maximum limits and current investment totals of the Council's counterparties is now left in the Treasury cashbook each night for the information of the dealer on duty the following morning.

32. The Council is aware of the risks of passive management of the treasury portfolio and, with the support of Butlers, the Council's professional treasury advisers, has proactively managed the debt and investments over the year. The Council has complied with its internal and external procedural requirements, apart from the total cumulative investment limit mentioned above.

33. Shorter-term variable 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.

Change to maximum investment limits:

34. In March 2006 the Council implemented the proposed change agreed in the 2005/06 strategy and extended the maximum limits to £8 m for any counterparty on the councils approved list with a credit rating of F1+ (short-term) and AA- or greater (long-term). Since that time, investments in excess of £5m have been placed with only one counterparty, the Bank of Scotland. This has been done by placing additional funds in the deposit accounts held with the Bank of Scotland, and has been exercised only on two occasions, when large outgoing payments were required to be paid on immediate demand.

Changes to the Treasury Management Manual:

35. In May 2006, CIPFA published revised guidance notes to its Code of Practice in the Public Services, suggesting improved standards and additional information to be displayed in each authority's Manual. These were minor changes – for example, reference to the authority's money laundering policies and specific mention of the legislation relied on in carrying out the Treasury function. These have been incorporated into the Treasury Management Manual, a copy of which can be requested from Accountancy.

Statement in Support of Recommended Action:

36. The outturn figure for each Prudential Indicator has been compared to its estimate (see Appendix A) and any significant differences have been analysed. There were no breaches of limiting indicators during the year.

37. The Treasury Management Stewardship Report for 2005/06 demonstrates that the Council has complied with all limits placed on its Treasury operations, with the exception of the limits placed on maximum total cumulative investment limit. Explanations of this breach has been given in the “Risk and Performance” section above.

38. The increase in maximum total investment with each counterparty at any one time represents a reasonable balance between risk management and increased flexibility following the change of maximum investment term.

Options Considered and Rejected:

39. To continue with the same maximum limit of investment per counterparty, regardless of the potential effect on longer-term investment decisions and loss of flexibility.

Resource implications:

Budget provision: £92,000 additional income implied by exceeding the 7-day LIBID benchmark. Total investment income for 2005/06 exceeded budget by £71,000.
Personnel: No extra personnel required.
Land: Nil.

Community Plan/BVPP ref: N/A.
Relevant Statutory Powers: Local Government Act 2003.

Background papers: Held within Finance Department.
Environmental/Human Rights Act/Crime and Disorder Act Implications: None.
Key Decision reference (if required): N/A.

Appendix A

	PRUDENTIAL INDICATORS 2005/06	**Actual outturn**	**Original indicator**
1	**Capital expenditure**	**£ 9.54 m**	**£ 14.4 m**
2	**Capital Financing Requirement (CFR) as at 31 March**		
	Housing	**(£ 24.63 m)**	**(£ 21.97m)**
	Non-Housing	**£ 23.84 m**	**£ 21.57m**
	Total	**(£ 0.79 m)**	**(£ 0.40m)**
3	**Treasury Position as at 31 March**		
	Borrowing	**(£ 0.61 m)**	**(£ 0.61 m)**
	Other long term liabilities	**£ 0.00 m**	**£ 0.00 m**
	Total Debt	**£ 0.00 m**	**(£ 0.61 m)**
	Investments	**(£43.00m)**	**(£ 48.00m)**
	Net Borrowing	**(£43.61m)**	**(£ 48.61m)**
4	**Authorised Limit (actual shows maximum debt position)**	**£ 0.00 m**	**£ 5.00 m**
5	**Operational Boundary**	**£ 0.00 m**	**£ 3.00 m**
6	**Ratio of financing costs to net revenue stream**		
	HRA	**(7.41 %)**	**(6.53 %)**
	Non-HRA	**(7.47 %)**	**(6.65 %)**
7	**Incremental impact of capital investment decisions on the annual Band D Council Tax**	**(£ 0.00)**	**(£ 0.00)**
8	**Incremental impact of capital investment decisions on the weekly housing rent levels**	**£ 3.41**	**£ 3.48**
10	**Upper limits on fixed interest rates**	**Debt-free**	**75%**
11	**Maturity structure of fixed rate debt (actual shows maximum fixed rate debt during the year)**		
	Maturing in less than 12 months	£ 0.00 m	0 to 20%
	Maturing in the next 12 months to 2 years	£ 0.00 m	0 to 20%
	Maturing in the next 2 to 5 years	£ 0.00 m	0 to 50%
	Maturing in the next 5 to 10 years	£ 0.00 m	0 to 75%
	Maturing after 10 years	£ 0.00 m	25 to 90%
12	**Maximum principal funds invested for terms greater than 364 days**	**£ 5.00 m**	**£ 10.00 m**

In addition to the above indicators, the Council is required to;

- Adopt the CIPFA Code of Practice
- Ensure that over the medium term, borrowing will be only for capital purposes (i.e., net external debt is less than the CFR).

The Council has complied with both of these indicators.