Report to the Cabinet

Report reference: C/045/2007-08.
Date of meeting: 3 September 2007.

Epping Forest
District Council

Portfolio: **Finance, Performance Management and Corporate Support Services.**

Subject: **Prudential Indicators Outturn 2006-07 and Treasury Management Stewardship Report.**

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Recommendations:

(1) That the Prudential Indicators Outturn for 2006-07 be approved;

(2) That the Treasury Management Stewardship Report for 2006-07 be noted, including the minor breaches of the internal dealing limits; and

(3) That the clarification of counterparty criteria be approved.

Introduction and Background:

1. The annual treasury report is a requirement of the CIPFA Code of Practice on Treasury Management and covers the treasury activity for 2006-07.

2. An integral part of the report is the outturn of the Prudential Indicators for 2006-07 in accordance with the requirements of 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.

3. The 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.

4. This report summarises:

(a) Capital expenditure, finance and indebtedness for the year;

(b) The potential impact of capital financing and investment on the Council's expenditure;

(c) The economic background for the year;

(d) The Council's treasury activities during the year; and

(e) A recommendation for the clarification of the current counterparty criteria relating to building societies.

5. The outturn of the Council's prudential indicators is summarised in Appendix 1.

Capital Expenditure and Financing 2006-07:

6. The Council undertakes capital expenditure on long-term assets, which may be either:

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

(b) Financed wholly or partly by borrowing.

7. Actual capital expenditure is the first required Prudential Indicator. Capital expenditure for 2006-07 is shown in Table 1 below, together with details of how this was financed.

Table 1: Capital Expenditure and Financing			
Capital Expenditure	**2005-06 Actual £'000**	**2006-07 Revised Estimate £'000**	**2006-07 Actual £'000**
General Fund	2,923	7,611	4,813
HRA	6,614	7,869	5,687
Total Expenditure	**9,537**	**15,480**	**10,500**
Financed by:			
Borrowing	0	0	0
Capital Receipts: Transitional Relief	1,620	1,722	987
Capital Receipts: Other	2,455	5,270	3,751
Capital Grants	727	1,271	1,190
Revenue	4,735	7,217	4,572
Total Financed	9,537	15,480	10,500
Total Unfinanced brought forward	0	0	0
Total Spend	**9,537**	**15,480**	**10,500**
Capital Financing Requirements			
CFR – General Fund	**23,844**	**23,844**	**23,844**
CFR – Housing	**-24,629**	**-24,629**	**-24,629**
Total CFR	**- 784**	**- 784**	**- 784**
Net Movement in CFR	0	0	0
External Debt			
Borrowing (PWLB)	0	0	0
Other Long Term Liabilities	0	0	0
Total Debt as at 31 March	0	0	0
Less debt transferred to other LAs	-610	-584	-584
Borrowing less Transferred Debt	**-610**	**-584**	**-584**

8. The outturn of the capital monitoring indicators differs from the revised estimates. The decrease of £4.98m for 2006-07 was chiefly due to the funding for some capital projects being carried forward from 2006-07 to 2007-08. The amount of revenue used to finance capital expenditure for the HRA increased from the original estimate by £238,000.

9. The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). The CFR is a measure of the Council's capital debt position; as the Council has fully financed its past and current capital expenditure, it has no debt requirement.

The Potential Impact of Capital Financing on Council Expenditure:

10. The Council is required to report the estimated and actual ratios of net capital financing costs to the net revenue stream for both the General Fund and HRA. This is shown in Table 2 below.

Table 2: Ratios of capital financing costs to net revenue stream		
	2006-07 Revised estimate %	2006-07 Outturn %
General Fund	-8.51	-7.14
HRA	-8.79	-7.38

11. The ratios above were influenced by an increase in interest income beyond the revised estimate and a change in accounting requirements.

12. It is recognised that decisions taken on additional capital expenditure funded from revenue sources could potentially have an impact on the Council Tax and housing rents charged by the Council. The potential impact is shown in Table 3 below.

Table 3: Potential impact of incremental capital expenditure decisions		
	Estimate 2006-07 £	Actual 2006-07 £
Council Tax – Band D	0.00	0.00
Weekly Housing Rents	0.43	0.43

13. Neither the Council Tax nor the levels of housing rents have been affected by capital expenditure decisions. No revenue resources have been committed to capital expenditure for General Fund purposes, while the level of housing rents is outside the Council's control, as it is determined by a rigid formula set by central government.

Treasury Activity during 2006-07:

14. The treasury position at the 31 March 2007 compared with the previous year is shown in Table 4 below.

Table 4: Treasury Position on the final day of the financial year.				
	31 March 2007		31 March 2006	
	Principal	Average Rate	Principal	Average Rate
Total Investments	£ 53.00 m	5.35%	£ 43.00 m	4.58%
Total Debt	£ 0.00 m		£ 0.00 m	
7 Day LIBID rate		5.26%		4.54%

15. The increase in the level of investments was similar to that experienced during 2005-06. The major factor in this year's increase was the receipt for the sale of the Parade Ground at North Weald Airfield. Although the sale of council houses under the Right to Buy scheme continues, with an increased number of houses sold (46 in 2006-07, compared 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 50% during 2005/06 to 25% in 2006-07, only £2.5m of the sales receipts was retained. The relief will cease altogether from 2007-08.

16. During 2006-07 the Council opened a Special Interest Bearing Account (SIBA) with Nat West Bank PLC. Although the initial intention was to earn interest immediately on the receipt for the sale of the Parade Ground, the account has since been used as a complement to the Bank of Scotland account. Both earn interest at Bank of England Base Rate; however, the SIBA can be managed through the Council's treasury software, transferring late-arriving funds up to 3.30 pm and saving the cost of an external CHAPS charge.

17. The Bank of Scotland remains a valuable part of the treasury function. In addition to the instant access account, 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.

Benchmarking Information:

18. Epping Forest District Council contributes to the CIPFA Treasury Management Benchmarking Club, submitting data on its investments and costs directly attributable to its Treasury services. In return, the Council receives reports comparing its performance to other Club members. The results are shown in Table 5.

Table 5: CIPFA Benchmarking Club Results 2006-07			
	Epping Forest District Council	**All Club members**	**Closest comparators**
Number of respondents	1	150	7
Return on all investments and call accounts	4.92%	4.80%	4.80%
Return on short-term investments	4.88%	4.87%	4.87%
Return on callable investments	5.13%	5.15%	4.96%
Return on externally managed funds	None placed	4.20%	4.30%
Return on call accounts	4.86%	4.82%	4.79%
Direct cost of in-house Treasury service (per £m managed)	£370	£450	£500

19. Comparison with all other members' results is encouraging this year. The Council's average rate of return on investments of 4.92% compares very favourably with the average of 4.80% achieved across the whole club, while the cost of the Treasury function per million pounds managed was lower - £370 per million for Epping, against £450 per million on average.

20. In addition, the Council has chosen seven authorities of a similar financial size to itself in terms of budget and investment portfolio to benchmark against. The average return across the eight contributors is again 4.80%, against the Council's 4.92%, and the average cost per million managed is £500 against the Council's £370.

21. As four of the seven comparators have part or all of their funds given over to external fund management, this provides a useful insight into the performance of external managers. As a whole, external managers performed poorly during the year, returning 4.20% average over the year (4.30% for the four closest comparators) and decreasing the overall return of the authorities that used them.

Treasury Prudential Indicators:

22. Certain of the Prudential Indicators provide either an overview or a limit on treasury activity, and the first of these are shown in Table 6:

Table 6: Net Debt compared to Capital Financing Requirement		
Net borrowing position:	**2006-07 Actual**	**2005-06 Actual**
(minimum investment)	**(£ 43.0 m)**	**(£ 42.0 m)**
(maximum investment)	**(£ 60.5 m)**	**(£ 54.9 m)**
Capital Financing Requirement	**(£ 0.78 m)**	**(£ 0.78m)**

23. 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 2006-07 plus the expected changes to the CFR over 2007-08 and 2008/09. Table 6 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.

Table 7: Maximum Debt compared to the Authorised and Operational Boundaries	
	£ m
Indicator Agreed – Authorised Limit	5.00
Indicator Agreed – Operational Boundary	3.00
Maximum gross borrowing position during the year	0.00
Capital Financing Requirement	(0.78)

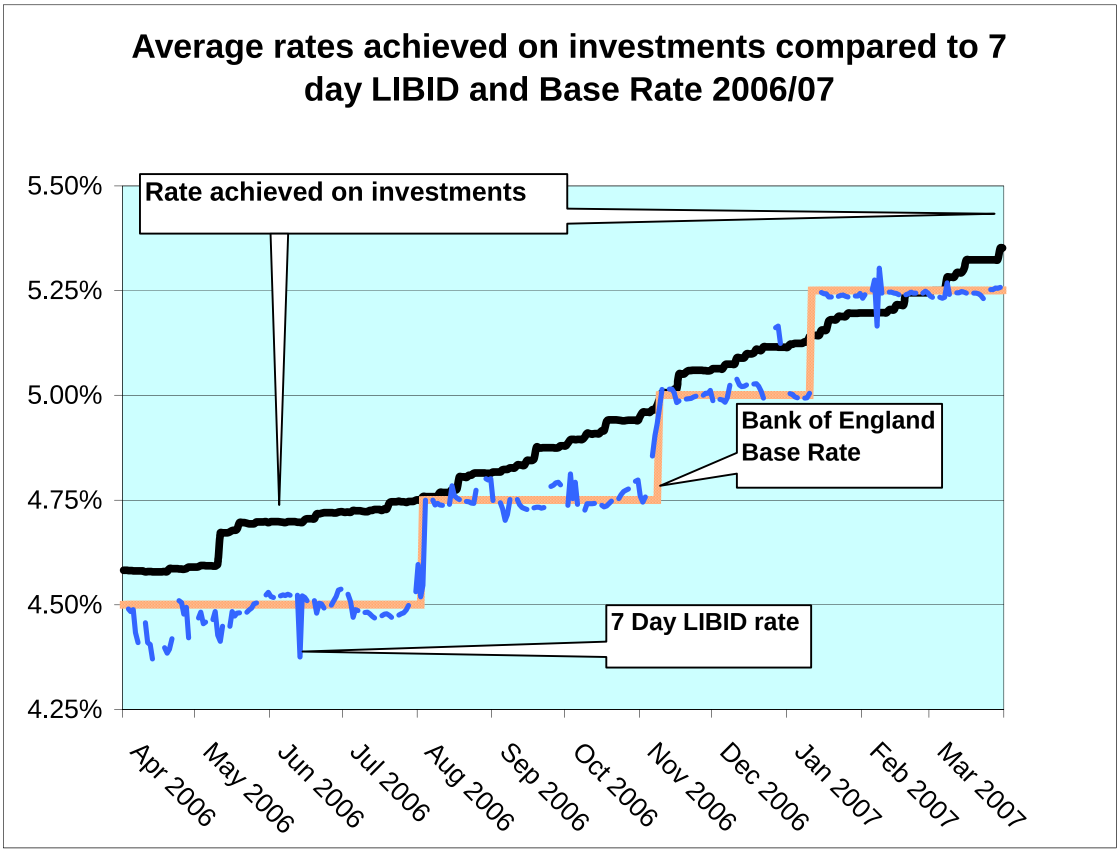
24. Table 7 shows the Authorised and Operational Boundaries compared to the maximum debt position and the CFR. The Authorised Limit is the "Affordable Borrowing Limit" required by s3 of the Local Government Act 2003. The table demonstrates that during 2006-07 the Council has maintained gross borrowing within its Authorised Limit.

25. 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.

26. The indicators set to regulate the fixed and variable interest rate exposure and the maturity structure of the Council's debt portfolio were set to match the Council's policy of remaining debt-free. The maximum exposure to both fixed and variable rates is set at 75%, while 100% of the Council's debt portfolio is required to be repaid within twelve months. The Council has remained debt-free throughout 2006-07, and intends to remain so.

27. The final Treasury indicator, the maximum limit on the total principal sum invested for periods of one year or more, was set at £15m in February 2006. The total amount invested through deals for terms in excess of 364 days reached a maximum of £13m during 2006-07. This indicator was revised to £30m in February 2007, in anticipation of longer-term investment potentially following the sale of further land in 2007-08.

Economic Background for 2006-07:



28. The Council's treasury activity is directed by both the current market interest rates and expectations of future movements, for instance longer term investment rates for one and two years will reflect anticipated movements in the MPC Bank Rate (UK Repo Rate). Longer-term borrowing rates are influenced by inflation and demand and supply considerations.

29. The 2006-07 financial year featured a rising trend in short term interest rates as policy makers and financial markets responded to the twin effects of strengthening economic activity and rising inflation.

30. The optimism that prevailed in the first few months of 2006 had evaporated by the beginning of the new financial year. The rebound in economic activity since 2005 proved more robust than had been generally expected. In addition, external pressures on consumer price inflation had continued to escalate. While short-term interest rates remained steady in the first few months of the year, there were growing expectations of an eventual rise in official interest rates.

31. The first rise in the Base Rate (from 4.5% to 4.75%) was announced in August 2006, as the Bank of England responded to the deteriorating inflation outlook. The economy's slow response to monetary policy tightening, a less than favourable international backdrop and concerns that deteriorating inflation expectations at home would drive prices higher prompted additional rate rises. Two quarter point increases in Bank Rate were announced, in November 2006 to 5% and in January 2007 to 5.25%. The market anticipated further tightening measures, and attractive investment opportunities prevailed to year-end.

32. Deteriorating inflation expectations on the domestic and international fronts, in reaction to strong growth on a global basis, was the principal force driving yields higher. Strong technical demand for bonds, courtesy of the rebalancing of pension fund portfolios in favour of fixed income assets, was insufficiently strong to counter the rise in yields. Occasional rallies in the gilt-edged market caused dips in rates and presented favourable borrowing opportunities. But these were short-lived and by the close of the year, yields were trading close to the highest levels seen since early 2005.

The Strategy Agreed for 2006-07:

33. The strategy agreed for Treasury activities during 2006-07 was to:

(a) Maintain the Council's debt-free status;

(b) Maintain core investment balances of at least £25m, by maintaining at least £25m as short term or specified investments; and

(c) 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 Strategy During 2006-07:

34. **Borrowing** - Capital expenditure for the year was £10.5m. The Council's 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.

35. **Investment Policy –** The Council's investment policy is governed by guidance issued by the DCLG, which is implemented in the annual investment strategy. The investment strategy for 2006-07 was approved by Council as part of the council tax setting procedure on 21 February 2006. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

36. **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 may 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.

37. The Council maintained an average investment balance of £53.4m and received an average return of 4.93% on fixed term investments (4.92% on investments and call accounts combined), compared to an average net return of 4.29% for money market funds. The performance indicator used as a standard benchmark of local authority treasury performance is the 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). The average 7-day LIBID rate for 2006-07 was 4.82%. By exceeding this benchmark, the Council earned an additional £53,000 in interest. By comparison, the average 7-day LIBID rate for 2005/06 was 4.53% and the average return on Council investments was 4.73%, earning an additional £92,000 in interest on the average investment balance of £46.7m.

Risk and Performance:

38. The Council has complied with all 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.

39. With regard to performance limitations, there were three minor breaches of the counterparty limits during the year, as shown in Table 8 below. In each case the mistake was discovered within hours and reported to the Head of Finance immediately. In view of the very low level of risk involved, it was decided that the Council would not attempt to recall any of the investments concerned prematurely.

Table 8: Breaches of Maximum Cumulative Investment Totals			
	Deal 1	Deal 2	Deal 3
Counterparty name	Stroud & Swindon Building Society	Saffron Walden, Herts & Essex Building Society	Nottingham Building Society
Cumulative limit	£3,000,000	£2,000,000	£3,000,000
Total invested	£4,000,000	£3,000,000	£3,500,000
Excess exposure	£1,000,000	£1,000,000	£ 500,000
Length of excess	96 days	1 day	96 days

40. In addition to the above, there were two occasions when the restrictions on maximum terms on building society investments were breached, compared to four in the preceding financial year.

41. The members of the Treasury dealing team were reminded of the need to check the counterparty list restrictions very carefully before committing the Council to a deal, in order to prevent further breaches of counterparty limits or term limits.

42. 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 at a cost of £8,500 per annum, has proactively managed the investments over the year. The Council has complied with its internal and external procedural requirements, apart from the breaches of total cumulative investment limits mentioned above.

43. 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.

Investments over £5,000,000:

44. In March 2006 the Council extended the maximum limits from £5m to £8m for any counterparty on the councils approved list with a credit rating of F1+ (short-term) and AA- or greater (long-term). This limit was raised to £12m in February 2007. During 2006-07, this higher limit was used on three occasions:

(i) Nat West Bank PLC (8 to 11 May 2006). Following the sale of the Parade Ground, 77% of the capital receipt was placed into the Council's interest bearing account until a suitable long-term deal could be arranged. The remainder was transferred to the interest bearing account with the Bank of Scotland, to ensure that activity on the Council's current accounts did not breach the £8m investment limit placed on NatWest at the time;

(ii) Bank of Scotland (8 to 15 May 2006). As a result of the sale of the Parade Ground, the remaining 23% of the capital receipt was placed in the Bank of Scotland interest bearing account, taking the total balance to £5,000,915.78 for one week; and

(iii) Royal Bank of Scotland (30 March 2007; ongoing). A three-year investment with the Royal Bank of Scotland, struck on 30 March 2007, took the cumulative investment total to £8m, against the newly agreed limit of £12m.

Proposed changes to the investment criteria:

45. The Council currently applies different criteria to banks and building societies, considering banks on the basis of their credit ratings and building societies on their asset base. This has been normal practice, as the majority of building societies were not rated.

46. However, in recent years an increasing number of building societies have acquired credit ratings, providing an independent means of comparing them to banks. In order to ensure a consistent approach, it is proposed that the counterparty criteria is modified to treat rated building societies on the basis of their credit rating.

47. As part of the same review, it is requested that building societies without credit ratings be treated on the basis of their asset size alone. The current policy is based on a minimum asset size and the society's place in the Butler's annual list of rank by asset size. A society with the required minimum asset size (£500m) will be excluded from the Council's list if it is ranked below the arbitrary top 30, while societies with almost identical asset bases are subject to different limits if one is ranked 20th, the second 21st.

48. To put the listing on a logical basis, it is proposed that:

(i) Building societies based in either the United Kingdom or the Republic of Ireland will be included;

(ii) Irish societies base their accounts on the Euro (€); however, all deals will be made in pounds sterling and will not be converted out of sterling at any stage;

(iii) Unrated societies with assets in excess of £1bn (€1.5 bn) are subject to cumulative investment limits of £3m and maximum terms of 9 months;

(iv) Unrated building societies with asset bases in excess of £500m (€ 750m) are subject to cumulative investment limits of £2m and maximum terms of 6 months; and

(v) Unrated building societies with asset bases of less than £500m (€ 750m) are excluded from the counterparty listing.

49. The current system uses the society's ranking to determine the cumulative investment limit and its asset base to determine the maximum term allowed.

Statement in Support of Recommended Action:

50. The outturn figure for each Prudential Indicator has been compared to its estimate (see Appendix 1) and any significant differences have been analysed. There were no breaches of limiting indicators during the year.

51. The Treasury Management Stewardship Report for 2006-07 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. Details of these breaches have been given in the "Risk and Performance" section above.

52. The clarification of the treatment of building society counterparties with credit ratings corrects an inconsistency in previous treatment. The credit rating ensures that there is the same level of risk to the Council's investment, regardless of whether the rating is held by a bank or a building society, and the approval of restrictions based on asset base and credit rating rather than business stream allows greater flexibility in investment.

Other Options for Action:

53. To continue with the same building society criteria of the top 30 subject to a minimum capital asset base of £500m. This is causing some inconsistency between credit rated bodies, as credit rated building societies are rated according to their ranking in the list (which changes arbitrarily when two higher-ranked societies merge) while banks are judged on their rating.

Consultations Undertaken:

54. Our external Treasury advisors, Butlers, gave detailed advice on the new counterparty limits to be adopted in respect of the building societies with and without credit ratings. The CIPFA Benchmarking Club provided reports and information on other authorities' investment statistics in comparison to our own.

Resource implications:

Budget provision: £53,000 additional interest income implied by exceeding the 7-day LIBID benchmark.
Personnel: No extra personnel required.
Land: Nil.

Council Plan/BVPP ref: N/A.
Relevant Statutory Powers: Local Government Act 2003 and associated regulations.

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

Appendix 1

PRUDENTIAL INDICATORS 2006-07	Actual outturn	Revised indicator
Capital expenditure: General Fund	**£ 4.81 m**	**£ 7.61 m**
HRA	**£ 5.69 m**	**£ 7.87 m**
Total	**£ 10.50 m**	**£ 15.48 m**
Capital Financing Requirement (CFR) at 31 March		
Housing	**(£ 24.63 m)**	**(£ 24.63 m)**
Non-Housing	**£ 23.84 m**	**£ 23.84 m**
Total	**(£ 0.79 m)**	**(£ 0.79 m)**
Treasury Position at 31 March		
Borrowing	**(£ 0.58 m)**	
Other long term liabilities	**£ 0.00 m**	
Total Debt	**(£ 0.58 m)**	
Investments	**(£ 53.00 m)**	
Net Borrowing (negative; net investment)	**(£ 53.58 m)**	
Authorised Limit (against maximum debt)	**£ 0.00 m**	**£ 5.00 m**
Operational Boundary (against maximum debt)	**£ 0.00 m**	**£ 3.00 m**
Ratio of financing costs to net revenue stream		
HRA	**(7.14 %)**	**(8.79 %)**
General Fund	**(7.38 %)**	**(8.51 %)**
Incremental impact of capital investment decisions on the annual Band D Council Tax	**(£ 0.00)**	**(£ 0.00)**
Incremental impact of capital investment decisions on the weekly housing rent levels	**£ 0.43**	**£ 0.43**
Upper limits on fixed interest rate debt	**Debt-free**	**75%**
Upper limits on variable rate debt	**Debt-free**	**75%**
Maturity structure of fixed rate debt (actual shows maximum fixed rate debt during the year)		
Maturing in less than 12 months	£ 0.00 m	100%
Maturing in the next 12 months to 2 years	£ 0.00 m	0%
Maturing in the next 2 to 5 years	£ 0.00 m	0%
Maturing in the next 5 to 10 years	£ 0.00 m	0%
Maturing after 10 years	£ 0.00 m	0%
Maximum principal funds invested for terms greater than 364 days Indicator revised to £30m in February 2007	**£ 13.00 m**	**£ 15.00 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.