Annual Report 2005/06

Treasury Management and Actual Prudential Indicators

1. Introduction

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

- The Local Government in Scotland 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 Scottish Ministers 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 2005/06);
- Statutory Instrument (SSI) 29 2004, requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities, and therefore to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services;

1.2 This Council has adopted the CIPFA Code of Practice for Treasury Management in the Public Sector 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 in a prudent, affordable and sustainable basis.

1.3 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).

1.4 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 activity during 2005/06;
- Performance indicators set for 2005/06;
- Risk and Performance.

2. A Summary of the Strategy Agreed for 2005/06

2.1 The treasury strategy expected long term interest rates to increase slightly and short term interest rates to remain relatively steady during 2005/6. As a result, the Council chose to take a cautious approach to its strategy and take necessary actions on borrowings, investments and reschedulings, in conjunction with market conditions at that time.

3. The Council's Treasury Position at 31 March 2006

3.1 During 2005/06, the Head of Finance managed the debt position with the use of internal funds as well as external borrowing, and the treasury position at the 31 March 2006 compared with the previous year was:

Table 1

Treasury position	**31 March 2006**		**31 March 2005**	
	Principal	**Average Rate**	**Principal**	**Average Rate**
Fixed Interest Rate Debt	£202.532m	5.56%	£197.946m	5.67%
Variable Interest Rate Debt	£1.084m	4.62%	£0.559m	5.12%
Total Debt	**£203.616m**	**5.55%**	**£198.505m**	**5.67%**
Total Investments	**£4.419m**	**4.40%**	**£10.730m**	**4.54%**
Net borrowing position	**£199.197m**		**£187.775m**	

3.2 From the above table, it can be seen that the average interest rate on long term debt held on 31 March has decreased from 5.67% in 2005 to 5.55% in 2006. At the same time – in line with market conditions - the average interest rate has also fallen on the investments held on 31 March 2005 to 2006 – from 4.54% to 4.4%.

3.3 There are four treasury prudential indicators which contain the activity of the treasury function within certain limits, thereby reducing the risk of an adverse movement in interest rates impacting negatively on the Council's overall position:

- Upper limits on variable rate exposure.
- Upper limits on fixed rate exposure.
- Maturity structures of borrowing.
- Total principal funds invested for greater than 364 days. The use of investments greater than 364 days is currently prohibited in Scotland, so this indicator is set at nil.

3.4 The indicators within the table below show that the upper and lower limits set for debt type and maturity were not breached.

Table 2

	2005/06 Actual	2005/06 Original Indicator	
Upper limits on fixed interest rates *(against maximum position)*	99.47%	100%	
Upper limits on variable interest rates *(against maximum position)*	0.53%	30%	
Maturity structure fixed rate borrowing *(%)*	**Year end Position**	**Max**	**Min**
Under 12 months	0.49%	0%	10%
12 months to 2 years	0.04%	0%	10%
2 years to 5 years	0.08%	0%	30%
5 years to 10 years	7.29%	0%	50%
10 years and above	92.10%	0%	100%
Maximum principal funds invested *>364 days*	£15.600m	No set Limit	

4. The Main Prudential Indicators and Compliance with Limits

4.1 The Council is required by the Prudential Code to report the actual prudential indicators after the year end.

4.2 **Capital Expenditure and its Financing -** This forms one of the required prudential indicators and shows total capital expenditure for the year and how this was financed.

Table 3

	2005/06 Actual	2005/06 Estimate
Total capital expenditure	£33.945m	£31.613m
Resourced by:		
Capital receipts and grants	£16.232m	£17.026m
Revenue	£0.112m	£0.000m
Unfinanced capital expenditure (additional need to borrow)	**£17.601m**	**£14.587m**

4.3 **Net Borrowing and the Capital Financing Requirement (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, exceed the CFR for 2005/06 plus the expected changes to the CFR over 2006/07 and 2007/08. It is recognised within the Code (page 24: para 85) that if a Council holds premiums on their Balance Sheet, these could cause external borrowing to exceed the CFR limit. In this case, this will not be considered a breach of the Code. *The Head of Finance reports that this Council has complied with the requirement to keep borrowing below the relevant adjusted CFR in 2005/06.*

Table 4

	2005/06 Actual	2005/06 Original Indicator
Net borrowing position	**£199.197m**	**£206.473m**
Capital Financing Requirement (excluding CFR movement in 2006/07 and 2007/08)	**£198.068m**	**£196.115m**
Capital Financing Requirement plus premiums	**£220.776m**	**£218.636m**

4.4 **The Authorised Limit** - The Authorised Limit is the "Affordable Borrowing Limit" required by s35 of the Local Government in Scotland Act 2003. The Council does not have the power to borrow above this level. The table below demonstrates that during 2005/06 the Council has maintained gross borrowing within its Authorised Limit.

4.5 **The Operational Boundary** – The Operational Boundary is the borrowing position that the Council expects to work around during the year, and periods where the actual position is either below or over the Boundary is acceptable subject to the Authorised Limit not being breached.

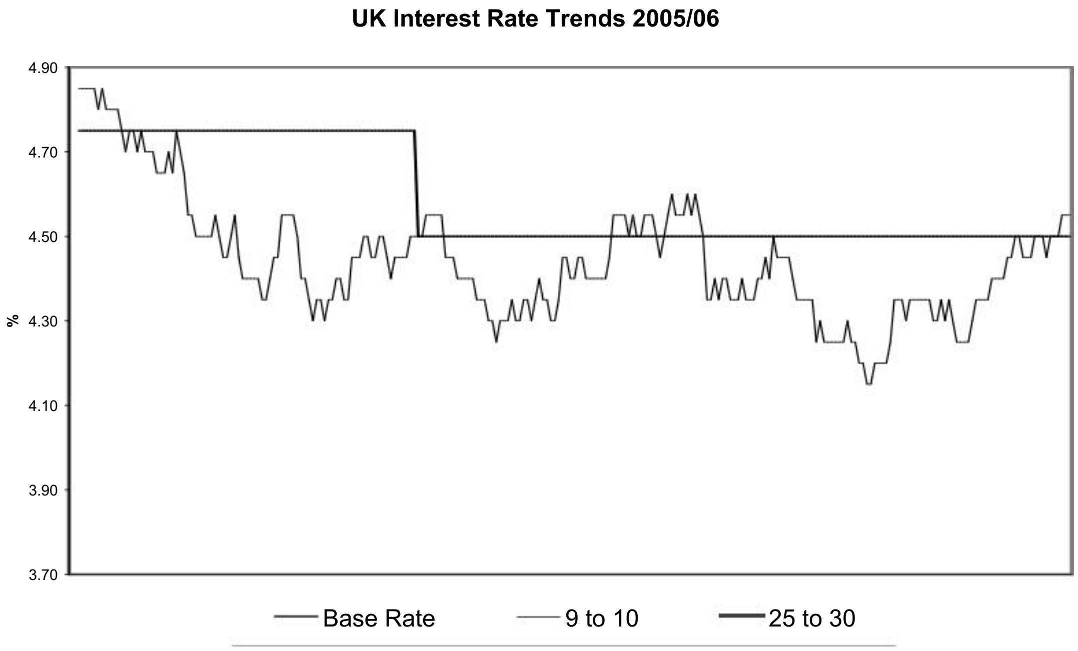
4.6 **Incremental Impact of capital investment decisions** - This indicator identifies the trend of the proposed changes in the capital programmes compared to existing commitments and current plans, measured against Band D council tax and weekly housing rents.

4.7 **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.

Table 5

	2005/06	
Original Indicator - Authorised Limit	**£246.380m**	
Original Indicator - Operational Boundary	**£225.265m**	
Maximum gross borrowing position during 2005/06	**£203.732m**	
Minimum gross borrowing position during 2005/06	**£198.732m**	
	Estimated	**Actual**
Incremental Impact of capital investment decisions:		
Council Tax (excluding year-end flexibility)	£5.46	£5.47
Rent	£0.99	£0.99
Financing costs as a proportion of net revenue stream:		
Housing	37.47%	38.74%
Non housing	6.47%	6.57%

5. Summary of the Economic Factors affecting the Strategy over 2005/06



5.1 UK interest rates remained within a tight range during 2005/06. Base rates opened the year at 4.75% and ended 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.

5.2 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 base rate rises, supported suggestions that base rates had further to rise before peaking in the later stages of 2005.

5.3 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, this did not happen.

5.4 Long-term (PWLB) fixed interest rates followed an erratic path. Some declines were seen in the first half of the year. However, the main driving force behind movement in long-term fixed interest rates was caused by movements from international funds to bonds and very heavy UK pension fund demand for fixed income assets.

5.5 **In** late 2005 and early 2006, the new bond supply to the UK market was insufficient 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%.

5.6 The downward trend did not continue. Long-term interest rates rebounded in February and March but still ended the year 0.25% below where they had started.

6. Treasury Activity during 2005/06

6.1 **Borrowing** – One loan was drawn to finance the net capital spend and naturally maturing debt. Details of the loan drawn are:

Table 6

Lender	Principal	Type	Interest Rate	Maturity
PWLB	£5.000m	Fixed interest rate	3.70%	50 years

6.2 This compares with a budget assumption of borrowing at an interest rate of 4.00%. The timing and the maturity of this borrowing was considered to best benefit the Council over a longer period.

6.3 **Rescheduling** – During 2005/06, the Council repaid £39.100m at an average interest rate of 4.12%, with no breakage costs. These loans were replaced with £39.100m at an average rate of 3.68%. As a result interest savings of £0.460m will be shared between the General Fund and the HRA over the next 10 years.

6.4 **Repayment** – Other than for debt rescheduling purposes, during the year, only naturally maturing debt was repaid. The Council repaid £0.350m.

6.5 **Summary of Debt Transactions** – The overall position of the debt activity resulted in a fall in the average interest rate by 0.12% for loans held at the year end.

6.6 **Investment Policy –** Unlike the rest of Britain, councils in Scotland do not currently have guidance or regulations to assist with the investment strategy they undertake.

6.7 The Council's investment policy is therefore governed by best practice, covered predominantly by the CIPFA Code of Practice on Treasury Management.

6.8 The Council's policy was included in the annual treasury strategy approved by Council on 30 March 2005. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

6.9 The Council maintained an average balance of £6.550m and received an average return of 4.57%.

7. Performance Indicators set for 2005/06

7.1 This service has set the following performance indicators:

- Debt – Average interest rate at 31 March year on year has reduced from 5.67% to 5.55%.
- Debt – Average rate of new borrowing (excluding debt rescheduling) for the year was 3.7% over 45-50 year, compared to the average available over the same period of 4.0% (4.2% highest and 3.7% lowest available)
- Investments – Average rate was 4.57%, compared to the average 7-day LIBID rate of 4.54% and a budgeted rate of 4.5%

8. Risk and Performance

8.1 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 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.

8.2 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 to utilise historically low borrowing costs and has complied with its internal and external procedural requirements. There is little risk of volatility of costs in the current debt portfolio as the interest rates are predominantly fixed, utilising long-term loans.

8.3 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.