CABINET – 4 JULY 2005 **PORTFOLIO : FINANCE AND SUPPORT**

ANNUAL REPORT ON THE TREASURY MANAGEMENT SERVICE AND ACTUAL PRUDENTIAL INDICATORS 2004/05

1. INTRODUCTION

1.1 The annual treasury report is a requirement of the Council's reporting procedures and covers the treasury activity for 2004/05. The report also covers the actual Prudential Indicators for 2004/05 in accordance with the requirements of the Prudential Code.

2. BACKGROUND

2.1 The Council's treasury management activities are regulated by a variety of professional codes and 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 or nationally on all local authorities restricting the amount of borrowing which may be undertaken (although no restrictions were made in 2004/05);
- Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act;
- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities;
- 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;
- Under the Act the ODPM has issued Investment Guidance to structure and regulate the Council's investment activities.

2.2 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.

2.3 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).

2.4 This report sets out the information in the following appendices: -

Appendix 1

- A summary of the treasury strategy agreed for 2004/05;
- A summary of the economic factors affecting the strategy over 2004/05;
- The decisions taken and performance of the treasury service and their revenue effects;
- The Council's treasury position at 31 March 2005;

Appendix 2

- The main Prudential Indicators and compliance with limits;
- Performance indicators set for 2004/05;
- Risk and performance.

3. CRIME AND DISORDER AND ENVIRONMENTAL IMPLICATIONS

3.1 None arising directly from this report.

4. PORTFOLIO HOLDER COMMENTS

4.1 The Portfolio Holder, Finance recognises the careful day to day cash management that is an essential element of ensuring that interest-earning opportunities are not missed and notes that both the outside managed fund and the in-house fund turned in performances which exceeded the industry average.

4.2 He supports the recommendations.

5. RECOMMENDATIONS

Members are recommended to:

5.1 Approve the actual 2004/05 prudential indicators within the report.

5.2 Note the treasury management stewardship report for 2004/05.

For Further Information Contact:	**Background Papers:**
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APPENDIX 1

TREASURY MANAGEMENT PERFORMANCE - 1 APRIL 2004 TO 31 MARCH 2005

1. INTRODUCTION

1.1 This appendix sets out the performance for the Council's own treasury management activities and those of the managed funds.

2. TREASURY STRATEGY SUMMARY FOR 2004/05

2.1 Borrowing Strategy

The borrowing strategy for 2004/05 estimated that: -

- Bank base rates would average 4.40% for the year;
- No long-term borrowing would be undertaken;
- The Council would borrow temporarily for cash flow purposes only;
- No interest payments on borrowing were estimated.

2.2 Investment Strategy

The investment strategy for 2004/05 estimated that: -

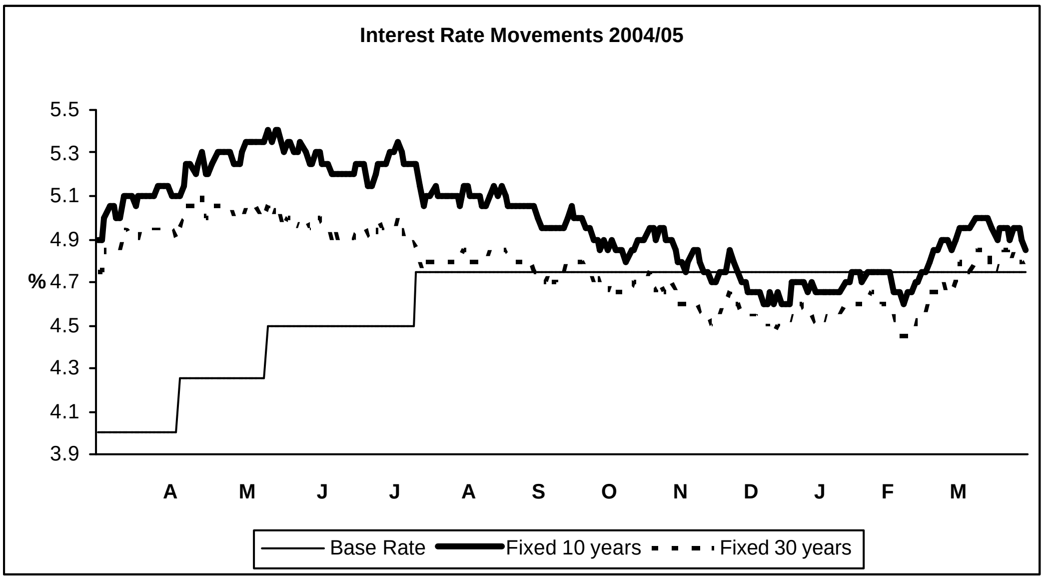
- Investments would be made for longer periods with fixed rates when the money markets priced in stronger increases than those forecast by the Council to lock in good value;
- Interest earnings on the Council's temporary cash flow investments was estimated to be £550,000;
- Interest earnings on the In-house Managed Fund was estimated to be £227,250;
- Interest earnings on the Externally Managed Fund was estimated to be £308,750;

3. SUMMARY OF ECONOMIC FACTORS

3.1 The following graph shows interest rate movements for bank base rates and for longer-term interest rates over the year.

3.2 The rising trend in UK interest rates which commenced in mid-2003 continued during the 2004/05 financial year as the Monetary Policy Committee tightened policy to contain the effects rising economic activity might have upon inflation.

3.3 These concerns were most in evidence during the early stages of the year and Base Rates were raised in quarter-point steps in May, June and August to 4.75%. Longer-dated money rates rose to in excess of 5%.



3.4 In the late summer a steep rise in world oil prices (to in excess of $50 per barrel) triggered a slowdown in economic activity in industrialised economies, notably the US. This caused the Bank of England to take the view that interest rates may have peaked. Money market rates adjusted to accommodate this assessment and longer fixed interest rates slipped lower.

3.5 Base Rates remained unaltered for the rest of the year but confidence that interest rates had peaked was undermined in the last few months of the period. Because of stronger activity, tighter labour market conditions and rising raw material prices, the Bank of England's February 2005 Inflation Report cast some doubt upon the ability of inflation remain low. Money rates rose in reaction to the view that a further tightening of monetary policy was possible.

3.6 Long-term borrowing interest rates (PWLB rates) tended to track the movements in the money market. A rise in the early part of the year was reversed in the autumn and winter of 2004 as weaker economic activity placed downward pressure upon fixed interest rates. Rates increased again in the closing months as a more pessimistic view drove yields modestly higher.

4. LONG-TERM BORROWING

4.1 The Council had no existing long-term borrowing at 1 April 2004 and no long-term loans were raised during the year.

5. TEMPORARY BORROWING AND INVESTMENT (SEE GLOSSARY)

5.1 Borrowing

5.1.1 An existing loan of £3.5 million was repaid on 1 April 2004.
5.1.2 Seventeen temporary loans were raised during the year for cash flow purposes. The loans were for periods up to 13 days and for amounts up to £2.5m.

5.1.3 The table below shows the list of temporary loans outstanding at 31 March 2005. These loans were repaid on 1 April 2005.

Lender	Amount £	Interest Rate %
The Humberbridge Board	500,000	4.75
Royal Mail Group PLC	500,000	4.76
Devon & Cornwall Police	500,000	4.70
Devon & Cornwall Police	1,500,000	4.80

5.2 Temporary Cashflow Investment

5.2.1 The original estimate for 2004/05 for interest receivable on temporary investments was £550,000 based on an anticipated earnings benchmark of 4% for the year. The actual interest receivable was £677,000.

5.2.2 The actual interest earned on temporary investments for the year was equivalent to an annual rate of return of 4.52%.

5.2.3 The average rate of interest over the year, which is used as a base for the calculation for the compounded benchmark used when comparing the earnings of the external fund managers, was also 4.52%. Therefore, the interest earned on temporary investments was at the same average rate of interest as the average money market interest rate.

5.2.4 All temporary investments have been made in accordance with the parameters set within the Council's Treasury Policy Statement.

5.2.5 The table below shows the list of temporary investments at 31 March 2005.

Borrower	Amount £	Interest Rate %
Singer & Friedlander	2,000,000	4.93
Singer & Friedlander	1,000,000	5.00
Cheshire Building Society	2,000,000	4.00
Norwich & Peterborough Building Society	2,000,000	5.00
RBS Financial Markets	500,000	5.16
EBS Building Society	500,000	5.03

6. MANAGED FUNDS

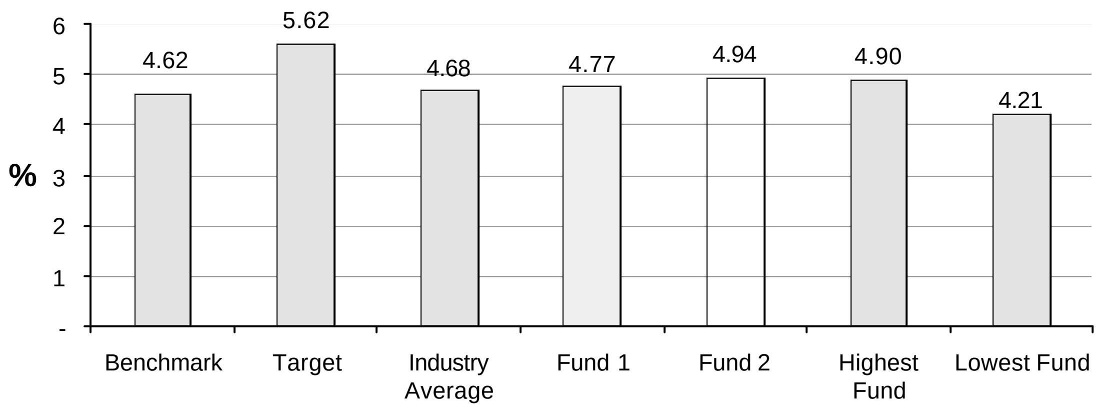
6.1 At 1 April 2004 the Council had £12m invested in managed funds. An external fund manager (Fund 1) managed £6.5m and council staff (Fund 2) managed £5.5m.

6.2 The external fund manager is set a performance target of achieving a return of 1% above a benchmark figure. The benchmark is based on the return the Council could achieve by investing the funds on a short-term basis and compounding the interest weekly.

6.3 The benchmark return for the period 1 April 2004 to 31 March 2005 was 4.62%. The target return for the same period was 5.62%.

6.4 The chart below shows the difference in performance of the funds against the benchmark, the target, the industry average and other fund managers.

Managed Fund Performance 2004-05



6.5 The performances of both funds were higher than the benchmark and lower than the target.

6.6 Both funds earnings exceeded the industry average for the year.

6.7 The earnings for Fund 1 were lower than the highest performing fund; Fund 2 exceeded all of the fund managers used for comparison.

6.8 The industry average reflects the rate of interest earnings of all of the funds weighted by the number of funds held by each fund manager. The managers of Fund 1 are the largest in the market and therefore the industry average reflects their earnings. Most of the funds used for comparison therefore returned earnings of less than the industry average.

6.9 Results to 31 March 2005 are summarised as follows: -

	Fund 1	**Fund 2**	**Total**
	%	**%**	**%**
Target Return	5.62	5.62	5.62
Benchmark Return	4.62	4.62	4.62
Actual Return	4.77	4.94	4.85
	£000	**£000**	**£000**
Target Return	365	309	674
Actual Return	310	272	582
Benchmark Return	300	254	554
Return above benchmark	10	18	28

6.10 The value of the interest earned on the funds as at 31 March 2005 was £28,000 more than the benchmark figure as shown at paragraph 6.9.

6.11 The original estimate for the combined managed fund interest earnings for 2004/05 was £536,000 based on a combined budgeted return of 4.47%.

6.12 In March 2005 a revised forecast of £577,000 was reported to cabinet based on a combined return of 4.82%.

6.13 The actual earnings for 2004/05 were £582,000 and the return 4.85%.

6.14 The figures shown are net of fees.

6.15 Investments in Gilts

6.15.1 A proportion of Fund 1 can be invested in gilts.

6.15.2 Gilts are used as an investment instrument and have two sources of earnings.

6.15.3 One source is the yield that the investment earns, i.e. the interest earnings. The other source is the increase in the capital value of the stock, i.e. the capital gains. The capital value can decrease as well as increase.

6.15.4 The external fund managers buy gilts when they anticipate that the capital value will increase. This should ensure that the funds benefit from a good yield and also that there would be an element of capital gain to boost the total earnings.

6.15.5 Fund 2 is invested in cash instruments. No investments are made in gilts.

6.16 Investment In Certificates Of Deposit (CDs)

6.16.1 The proportion of Fund 1 not invested in gilts will be invested mostly in CDs that have a maturity period of less than one year.

6.16.2 CDs are used as an investment instrument and have two sources of earnings, as do gilts, as explained at 4.3 above. However, any capital gains, or losses, are minimised because of the restricted period of the investment. Generally CDs are kept until they mature and are not traded by the fund managers unless the advantage of any capital gain far exceeds the yield.

6.16.3 The capital value can decrease as well as increase.

6.16.4 The external fund managers buy CDs when they anticipate that there is no capital gain to be achieved by holding gilts.

6.16.5 Fund 2 is invested in cash instruments. No investments are made in CD's.

6.17 Investment Portfolio Strategy – Fund 1

6.17.1 The fund performed erratically over the year with earnings for some months exceeding the benchmark and some months underperforming.

6.17.2 The fund was invested in CD's for most of the year with a small portion of the portfolio invested in gilts in late March.

6.17.3 More than 50% of the portfolio was invested in instruments with a maturity profile of between 6 and 12 months through out the year. This action allowed the portfolio to earn the higher coupon rates that were available at the longer end of the interest yield curve.

6.18 Investment Portfolio Strategy – Fund 2

6.18.1 Fund 2 is invested in cash deposits. Gilts and CD's are not used as Council staff manage the fund.

6.18.2 At the start on the year most of the portfolio was invested in instruments with interest rates of less that 4%.

6.18.3 As the year progressed the money markets forecast a further rise in base rates to 5% and beyond. This resulted in money market rates spiking for short periods and gave opportunities to lock in investments at those higher rates. Most of the investments made in the year were for durations of 1 year and for interest rates in excess of 5%.

6.18.4 This action helped the fund to increase the return for the year.

7. TREASURY POSITION AT 31 MARCH 2005

The following table shows the treasury position at the 31 March 2005 compared with the previous year. All debt and investments have interest payable at a fixed coupon rate for the period of the investment other than the Call Account which is variable: -

	31 March 2004		**31 March 2005**	
	Principal	**Average Rate**	**Principal**	**Average Rate**
Total Debt	**£3.5m**	**4.0%**	**£3.0m**	**4.8%**
Managed Funds				
Fund 1	£6.5m	3.9%	£6.5m	5.1%
Fund 2	£5.5m	3.9%	£5.5m	5.3%
Total Managed Funds	**£12.0m**	**3.9%**	**£12.0m**	**5.2%**
Temporary Cashflow Investments	£7.7m	3.6%	£8.0m	4.7%
Call Account	£0.2m	3.2%	£0.2m	4.3%
Total Investments	**£19.9m**	**3.8%**	**£20.2m**	**5.0%**

APPENDIX 2

PRUDENTIAL INDICATORS AND COMPLIANCE ISSUES TO 31 MARCH 2005

1. INTRODUCTION

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

1.2 The following table, at Paragraph 2, provides a schedule of all the mandatory prudential indicators.

1.3 Certain of these indicators must be compared to others and are detailed later in this appendix.

2. ESTIMATED AND ACTUAL TREASURY POSITION AND PRUDENTIAL INDICATORS

		2003/04 Actual £000	**2004/05 Revised Indicator £000**	**2004/05 Actual £000**
1	**Capital Expenditure**	12,434	12,537	10,541
2	**Capital Financing Requirement (CFR) at 31 March**			
	Housing	1,897	1,897	1,897
	Non Housing	1,974	3,191	2,929
	Total	**3,871**	**5,088**	**4,826**
3	**Treasury Position at 31 March**			
	Borrowing	3,500	1,218	3,000
	Other long term liabilities	0	0	0
	Total Debt	**3,500**	**0**	**3,000**
	Investments	19,900	14,000	20,200
	Net Borrowing	**-16,400**	**-13,000**	**-17,200**
4	**Authorised Limit (against maximum position)**	N/a	Limit 23,000	Maximum 4,326
5	**Operational Boundary**	N/a	1,000	4,326
6	**Ratio of financing costs to net revenue stream**	-3%	-4%	-4%
7	**Incremental impact of capital investment decisions on the Band D council tax**	0%	0%	0%
8	**Incremental impact of capital investment decisions on the housing rent levels**	0%	0%	0%
9	**Upper limits on fixed interest rates (against maximum position)**	N/a	Limit 100%	Maximum 100%
10	**Upper limits on variable interest rates (against maximum position)**	N/a	Limit 50%	Maximum 0%

11	**Maturity structure of fixed rate borrowing (against maximum position)**			
	Under 12 months	N/a	100%	100%
	12 months to 2 years	N/a	50%	0%
	2 years to 5 years	N/a	50%	0%
	5 years to 10 years	N/a	50%	0%
	10 years and above	N/a	50%	0%
12	**Estimated maximum principal funds invested (against maximum position)**	N/a	**Limit** 35,000	**Maximum** 38,000

In addition to the above the Council is required as a Prudential Indicator to:

- Adopt the CIPFA Code of Practice. The compliance for this indicator is shown at paragraph 2.2 in the body of the report.

- Ensure that over the medium term borrowing will only be for a capital purpose (i.e. net external borrowing is less than the CFR). The compliance for this indicator is shown at paragraph 2.1 below.

2. LIMITS TO BORROWING ACTIVITY

2.1 Net external borrowing

	1 March 2005 Revised Indicator	**1 March 2005 Actual**
Net borrowing position	**- £13.0m**	**-£17.2m**
Capital Financing Requirement	**£5.1m**	**£4.8m**

The Capital Financing Requirement (CFR) shows the Council's underlying need to borrow for a capital purpose, and this is an indication of the Council's debt position. In order to ensure that borrowing net of investments will only be for a capital purpose, net borrowing should not exceed the CFR for 2004/05.

The table above shows that the Council has complied with this requirement.

2.2 Borrowing Limits

	2004/05
Authorised Limit	**£23.0m**
Operational Boundary	**£1.0m**
Maximum gross borrowing position during the year	**£4.3m**
Minimum gross borrowing position during the year	**£0.0m**

The Authorised Limit must not be breached. The table demonstrates that during 2004/05 the Council has maintained gross borrowing within its Authorised Limit.
The Operational Boundary is the expected average borrowing position of the Council 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.

3. TREASURY SERVICE PERFORMANCE INDICATORS FOR 2004/05

The treasury service has set the following performance indicators:

- The In-house fund performance should be higher than a benchmark of the 7-day LIBID rate compounded weekly.

- The external fund manager's performance should be higher than a benchmark of the 7 day LIBID rate compounded weekly and have a target return of 1% above that benchmark annually.

4. RISK AND PERFORMANCE

4.1 The Council has complied with all of the 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 that its capital expenditure is prudent, affordable and sustainable, and that its treasury practices demonstrate a low risk approach.

4.2 The Council is aware of the risks of passive management of the treasury portfolio and has proactively managed the investments over the year.

4.3 Shorter-term market rates and likely future movements in interest 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.

4.4 Fund manager investment returns have been adequate compared to the benchmark but falls short of the target return.

4.5 For investments managed in house returns are improved against the benchmark even though there is a lower risk associated with these types of investments.

4.6 Section 6 of appendix 1 shows the returns for 2004/05. The In-house fund, fund 2, exceeded the performance benchmark. The externally managed fund, fund 1, also exceeded the benchmark but did not reach the target.