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CABINET – 3 JULY 2006 **PORTFOLIO: POLICY & RESOURCES**

ANNUAL REPORT ON THE TREASURY MANAGEMENT SERVICE AND ACTUAL PRUDENTIAL INDICATORS 2005/06

1. INTRODUCTION

1.1 The annual treasury report is a requirement of the Council's reporting procedures 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.

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 2005/06);
- 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 2005/06;
- A summary of the economic factors affecting the strategy over 2005/06;
- The decisions taken and performance of the treasury service and their revenue effects;
- The Council's treasury position at 31 March 2006;
- The reasons for the withdrawal of the investments from Fund 1 managed by the external fund manager.

Appendix 2

- The main Prudential Indicators and compliance with limits;
- Performance indicators set for 2005/06;
- Risk and performance.

3. CRIME AND DISORDER AND ENVIRONMENTAL IMPLICATIONS

3.1 None arising directly from this report.

4. REVIEW PANEL COMMENTS

4.1 The Corporate Overview Panel supported the recommendations below.

5. PORTFOLIO HOLDER COMMENTS

5.1 The Portfolio Holder welcomes the results of the Treasury Management Strategy and is pleased that the Council continues to maintain a prudent policy that gives continuing beneficial results to the council taxpayer.

6. RECOMMENDATIONS

Members are recommended to:

6.1 Note the actual 2005/06 prudential indicators within the report.

6.2 Note the treasury management stewardship report for 2005/06.

Further Information:

Please contact Jan Hawker, Treasury Management Accountant Ext 5722
e-mail: jan.hawker@nfdc.gov.uk

Background Papers:

The Prudential Code, CIPFA Guidance Notes and ODPM Investment Guidance
Published Papers

APPENDIX 1

TREASURY MANAGEMENT PERFORMANCE - 1 APRIL 2005 TO 31 MARCH 2006

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 2005/06

2.1 Borrowing Strategy

The borrowing strategy for 2005/06 estimated that: -

- Bank base rates would average 4.60% for the year;
- Long-term borrowing to a maximum of £5m would be undertaken to meet capital expenditure if required;
- The Council would borrow temporarily for cash flow purposes;
- Interest payments of £21,000 were estimated.

2.2 Investment Strategy

The investment strategy for 2005/06 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 £410,000;
- Interest earnings on the In-house Managed Fund was estimated to be £275,000;
- Interest earnings on the Externally Managed Fund was estimated to be £357,000;

3. SUMMARY OF ECONOMIC FACTORS

3.1 The following graph shows interest rate movements for bank base rates and for short term money market interest rates over the year.

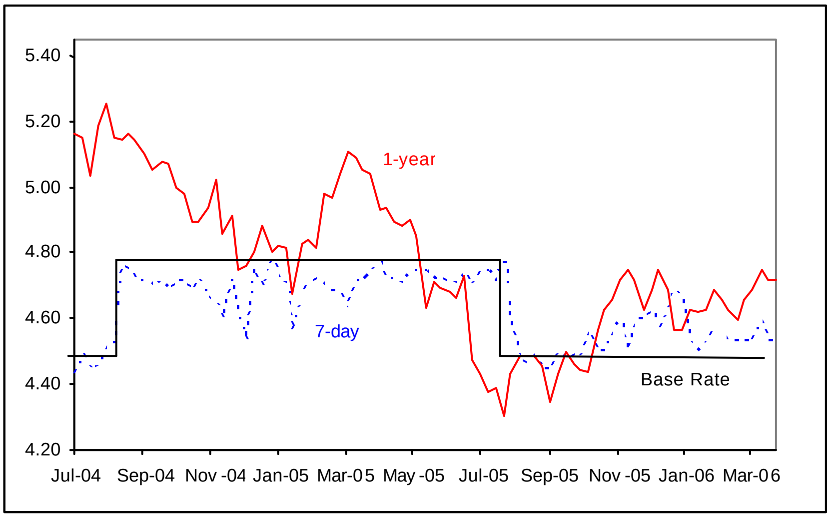
3.2 The first six months of the year saw money markets forecasting base rate reductions. During this period money markets predicted historically low interest rates for both borrowing and lending.

3.3 UK economists were predicting even lower interest rates for the remainder of 2005/06 and well into 2006/07.

3.4 In the months following the Bank Base Rate reduction in July 2005 there was a change of sentiment as some doubts emerged about the continuing fall of interest rates.

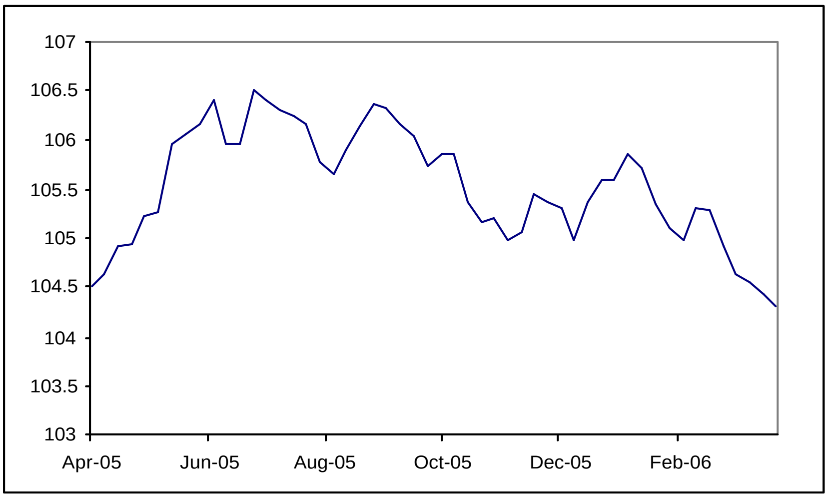
3.5 Hopes of an early cut in official interest rates did persist until the February meeting of the Monetary Policy Committee when it was hoped that the Bank of England's Quarterly Inflation Report would deliver a projection of disappointing growth performance and low inflation. However, the Bank reported a strong rebound in consumer spending which removed one of the main arguments used to support the predictions of lower interest rates.

3.6 Money Market Rates



3.7 The gilt-edged market also had a volatile performance. The rally that had been underway in December continued through to January. This had little to do with the economic background and more to do with the aggressive buying on the part of pension funds and heavy inflows of money to the market from overseas.

3.8 5-year Gilt-Edged Prices



3.9 Fund managers purchased Gilts at the end of January in expectation of a further rally in prices. However, the final few months of 2005/06 saw the gilt-edged market suffer a period of weakness which extended through to the quarter end: this was the undoing of a number of fund managers.

4. LONG-TERM BORROWING

4.1 The Council had no existing long-term borrowing at 1 April 2005 and no long-term loans were raised during the year.

5. TEMPORARY BORROWING AND INVESTMENT (SEE GLOSSARY)

5.1 Borrowing

5.1.1 Existing temporary loans of £3 million were repaid on 1 April 2005.

5.1.2 Sixteen temporary loans were raised during the year for cash flow purposes. The loans were for periods up to 14 days and for amounts up to £1.5m.

5.1.3 There was one temporary loan outstanding at 31 March 2006. The table below shows the details of this loan which was repaid on 3 April 2006.

Lender	**Amount £**	**Interest Rate %**
Royal Mail Group PLC	1,000,000	4.48

5.2 Temporary Cash flow Investment

5.2.1 The original estimate for 2005/06 for interest receivable on temporary investments was £410,000 based on an anticipated earnings benchmark of 5.0% for the year. The actual interest receivable was £726,000.

5.2.2 The main cause of this large variation was due to the original 2005/06 calculation, which is based on the 2004 mid-year interest expectations, being greatly underestimated. This was reported to this Panel in November 2005. The revised interest earnings figure in November was £695,000 based on an estimated return of 4.65%.

5.2.3 The actual interest earned on temporary investments for the year was equivalent to an annual rate of return of 4.65%.

5.2.4 The additional interest of £31,000, from the revised figure to the actual, was due to cash-flow.

5.2.5 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 4.63%. Therefore, the interest earned on temporary investments was at a marginally higher average rate of interest than the average money market interest rate.

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

5.2.7 The table below shows the list of temporary investments at 31 March 2006.

Borrower	**Amount £**	**Interest Rate %**
Singer & Friedlander	2,000,000	4.51
EBS Building Society	2,000,000	4.52
Norwich & Peterborough Building Society	1,000,000	4.57

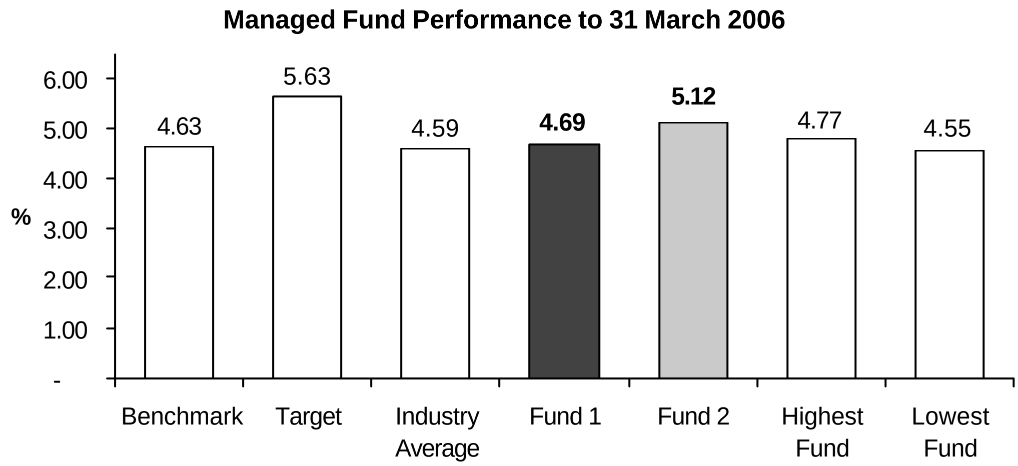
6. MANAGED FUNDS

6.1 At 1 April 2005 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 2005 to 31 March 2006 was 4.63%. The target return for the same period was 5.63%.

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.



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 the fund managers used for comparison.

6.8 Results to 31 March 2006 are summarised as follows: -

	Fund 1	Fund 2	Total
	%	**%**	**%**
Target Return	5.63	5.63	5.63
Benchmark Return	4.63	4.63	4.63
Actual Return	4.69	5.12	4.91
	£000	**£000**	**£000**
Target Return	366	310	676
Actual Return	305	282	587
Benchmark Return	301	255	556
Return above benchmark	4	27	31

6.9 The value of the interest earned on the funds as at 31 March 2006 was £31,000 more than the benchmark figure as shown at paragraph 6.9.

6.10 The original estimate for the combined managed fund interest earnings for 2005/06 was £632,000 based on a combined budgeted return of 5.27%.

6.11 In October 2005 a revised forecast of £607,000 was reported to Cabinet based on a combined return of 5.06%.

6.12 The actual earnings for 2005/06 were £587,000 and the return 4.89%.

6.13 The figures shown are net of fees.

6.14 Investments in Gilts

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

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

6.14.3 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.

6.14.4 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.

6.14.5 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 6.14.3 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 Fund 1 was one of the most prominent participants in the gilt-edged market during the last quarter. The rise in yields in mid-January was regarded as an opportunity to take a strategic exposure in the market. Exposure was maintained until the end of March 2006.

6.17.2 Money market investment was comparatively low key, partly because funds were being switched from this market to gilts. New purchases of CDs were directed to longer maturity issues to lock-in high yields ahead to the interest rate falls the manager was anticipating.

6.17.3 The fund performed well for the first quarter with earnings substantially exceeding the benchmark. However, a very poor performance over the remaining months of the year significantly eroded the gains of the first quarter.

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 the portfolio was invested in instruments with interest rates in excess of 5%.

6.18.3 As the year progressed the expectations of the money markets reversed. During 2004 it was anticipated that interest rates would rise to 5.25% or higher by the end of 2005. This was revised throughout the year with expectations for the base rate to fall to 4.25% in the early part of 2006. In the UK this adjustment was made for several reasons. Firstly, any rise in interest rates would have put unwelcome pressure on sterling in the foreign exchange markets. Secondly, inflation looked likely to remain below the

Government's target. Thirdly consumer borrowing had moderated and there were clear signs that the housing market was cooling and, finally, economic growth was forecast to moderate following several years of strong performance.

6.18.4 This resulted in money market rates falling over 2005/06. Consequently, the benchmark was lower than initially forecast and new investments were made generally at a lower interest rate than those being replaced.

6.18.5 In the event, interest rates did not fall as far as feared but there was some reduction with the base rate ending at 4.5% for the year.

6.18.6 During the year Fund 2 was invested in cash deposits with maturities beyond the end of the financial year and for interest rates which averaged 4.88% at the year end. This secured a higher return than the benchmark for 2005/06.

7. FUTURE POSITION FOR THE MANAGED FUNDS

7.1 The following table summarises the performances of the managed funds for the last 4 years:-

Year	Benchmark	Fund 1	Fund 2
2002/03	3.83%	5.76%	4.51%
2003/04	3.63%	2.66%	3.96%
2004/05	4.62%	4.77%	4.94%
2005/06	4.63%	4.69%	5.12%

7.2 As Fund 2 has a lower investment risk strategy and has outperformed Fund 1 for the last three years, notice has been served to the managers of Fund 1 so that the fund will be liquidated on 3 April 2006.

7.3 Fund 1 and Fund 2 will then be managed together as the in-house fund for the time being.

7.4 The value of investments in the in-house fund will be £12m from 3 April 2006.

8. TREASURY POSITION AT 31 MARCH 2006

The following table shows the treasury position at the 31 March 2006 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 2005		31 March 2006	
	Principal	Average Rate	Principal	Average Rate
Total Debt	**£3.0m**	**4.8%**	**£1.0m**	**4.5%**
Managed Funds				
Fund 1	£6.5m	5.1%	£6.5m	4.6%
Fund 2	£5.5m	5.3%	£5.5m	4.9%
Total Managed Funds	**£12.0m**	**5.2%**	**£12.0m**	**4.8%**
Temporary Cash-flow Investments	£8.0m	4.7%	£5.0m	4.5%
Call Account	£0.2m	4.3%	£0.4m	4.0%
Total Investments	**£20.2m**	**5.0%**	**£17.4m**	**4.7%**

APPENDIX 2

PRUDENTIAL INDICATORS AND COMPLIANCE ISSUES TO 31 MARCH 2006

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

2.1 The following table compares the actual figure for 2005/06 with the revised indicator for 2005/06 and the actual figure for 2004/05.

2.2 The revised indicator for 2005/06 is the same as was included in the Treasury Strategy Report 2005/06, but is revised from the 2004/05 strategy report which showed the estimated original 2005/06 figure.

		2004/05 Actual £000	**2005/06 Revised Indicator £000**	**2005/06 Actual £000**
1	**Capital Expenditure**	10,541	13,483	10,586
2	**Capital Financing Requirement (CFR) at 31 March**			
	Housing	1,897	1,897	1,897
	Non Housing	3,149	4,568	3,990
	Total	**5,046**	**6,465**	**5,887**
3	**Treasury Position at 31 March**			
	Borrowing	3,000	3,000	1,000
	Other long term liabilities	0	0	0
	Total Debt	**3,000**	**3,000**	**1,000**
	Investments	20,200	12,000	17,400
	Net Borrowing/Investments (-)	**-17,200**	**-9,000**	**-16,400**
4	**Authorised Limit (against maximum position)**	**Maximum** 4,326	**Limit** 20,000	**Maximum** 4,172
5	**Operational Boundary**	4,326	3,000	4,172
6	**Ratio of financing costs to net revenue stream**	-4%	-2%	-3%
7	**Incremental impact of capital investment decisions on the Band D council tax**	0%	£ 9.94	£ 9.77

8	**Incremental impact of capital investment decisions on the housing rent levels**	0%	£ 3.82	£ 1.57
9	**Upper limits on fixed interest rates (against maximum position)**	**Maximum** 100%	**Maximum** 100%	**Maximum** 100%
10	**Upper limits on variable interest rates (against maximum position)**	**Maximum** 0%	**Maximum** 0%	**Maximum** 0%
11	**Maturity structure of fixed rate borrowing (against maximum position)**			
	Under 12 months	100%	**Upper Limit** 100%	100%
	12 months to 2 years	0%	100%	0%
	2 years to 5 years	0%	100%	0%
	5 years to 10 years	0%	100%	0%
	10 years and above	0%	100%	0%
12	**Estimated maximum principal funds invested (against maximum position)**	**Maximum** 38,000	**Maximum** 37,000	**Maximum** 38,300

2.3 Any indicators that were exceeded were guideline limits only. There were no breaches of statutory limits during the year.

2.4 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 3.1 below.

3. LIMITS TO BORROWING ACTIVITY

3.1 Net external borrowing

	31 March 2005 Actual	31 March 2006 Revised Indicator	31 March 2006 Actual
Net borrowing position	**-£17.2m**	**-£9.0m**	**-£16.4m**
Capital Financing Requirement	**£5.0m**	**£6.5m**	**£5.9m**

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 2005/06.

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

3.2 Borrowing Limits

	2005/06
Authorised Limit	**£20.0m**
Operational Boundary	**£3.0m**
Maximum gross borrowing position during the year	**£4.2m**
Minimum gross borrowing position during the year	**£0.0m**

The Authorised Limit must not be breached. The table demonstrates that during 2005/06 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.

4. TREASURY SERVICE PERFORMANCE INDICATORS FOR 2005/06

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.

5. RISK AND PERFORMANCE

5.1 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.

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

5.3 Shorter-term market rates and likely future movements of 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.

5.4 Section 6 of appendix 1 shows the returns for 2005/06.

5.5 Fund manager investment returns have been marginally higher than the benchmark but fall short of the target return.

5.6 For investments managed in-house returns have been significantly higher than the benchmark even though there is a lower risk associated with these types of investments.