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CABINET – 7 JULY 2008 PORTFOLIO: FINANCE AND EFFICIENCY

ANNUAL REPORT ON THE TREASURY MANAGEMENT SERVICE AND ACTUAL PRUDENTIAL INDICATORS 2007/08

1. INTRODUCTION

1.1 The annual treasury report is a requirement of the Council's reporting procedures and covers the treasury activity for 2007/08. The report also covers the actual Prudential Indicators for 2007/08 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 DCLG 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 2007/08;
- A summary of the economic factors affecting the strategy over 2007/08;
- The decisions taken and performance of the treasury service and their revenue effects;
- The Council's treasury position at 31 March 2008;

Appendix 2

- The main Prudential Indicators and compliance with limits;
- Performance indicators set for 2008/09;
- Risk and performance.

3. CRIME AND DISORDER, EQUALITY AND DIVERSITY IMPLICATIONS AND ENVIRONMENTAL IMPLICATIONS

3.1 None arising directly from this report.

4. REVIEW PANEL COMMENTS

4.1 The Corporate Overview Panel supported the Annual Report of the Treasury Management Service and the Actual Prudential Indicators 2007/08.

5. PORTFOLIO HOLDER COMMENTS

5.1 The Finance and Efficiency Portfolio Holder supports the recommendation. All prudential indicators have been complied with and the treasury function is managed prudently according to the strategy set for the year.

6. RECOMMENDATIONS

The Cabinet are asked to note the Annual Report.

For Further Information Please Contact:	**Background Papers**
Jan Hawker Treasury Management Accountant Tel (023) 8028 5722 E-mail: jan.hawker@nfdc.gov.uk	The Prudential Code, CIPFA Guidance Notes and ODPM Investment Guidance Published Papers

APPENDIX 1

TREASURY MANAGEMENT PERFORMANCE - 1 APRIL 2007 TO 31 MARCH 2008

1. INTRODUCTION

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

2. TREASURY STRATEGY SUMMARY FOR 2007/08

2.1 Borrowing Strategy

The borrowing strategy for 2007/08 estimated that: -

- Bank base rates would average 5.3% for the year;
- Long-term borrowing to meet capital expenditure would not be undertaken as the preference expressed by Members was that the Council should remain debt-free for the time being;
- The Council would borrow temporarily for cash flow purposes;
- Interest payments of £40,000 were estimated.

2.2 Investment Strategy

The investment strategy for 2007/08 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 £744,000;
- Interest earnings on the In-house Managed Fund was estimated to be £624,000;

3. SUMMARY OF ECONOMIC FACTORS

At the start of the year market analysts had predicted increases in official interest rates during the course of 2007 to combat the underlying strength of inflation and to prevent any major deterioration in inflation expectations. A tightening of monetary policy was considered inevitable.

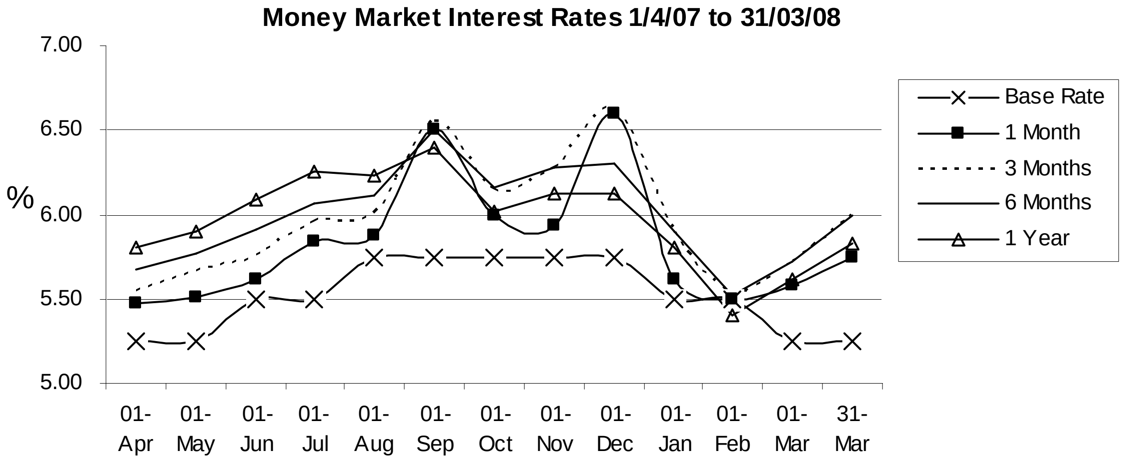
The rising trend in UK rates persisted to the late summer. The Bank Base Rate was raised to 5.5% in May and 5.75% in July in response to the deteriorating inflation outlook. In addition, the Bank of England's May and August Inflation Reports hinted that more hikes might be necessary if the Government's target was to be met over the medium term.

The market was plunged into chaos in September as the tightening of credit conditions, triggered initially by the failure of a selection of US mortgage lending institutions, placed upward pressure upon deposit rates up to one year. Money Market Rates rose to well over 6.5% as financial organisations' reluctance to lend money to counterparties caused a severe shortage of funds in the market.

In the UK, the crisis came to a head with the failure of the Northern Rock Bank. While the danger of other significant failures was defused by the government's decision to guarantee all deposits with this institution, this failed to prevent a prolonged tightening of credit conditions as banks and other financial organisations remained reluctant to lend to each other. This situation ensured a severe shortage of liquidity.

Worries about the prospect of falling house prices and a slowing domestic economy resulted in bank base rates being reduced in December, and again in February, in spite of ongoing market liquidity problems.

The following chart shows how the money market interest rates increased over the year and then fell back to end the year at similar levels.



The movements in the bank base rate during the year were as follows:

Date	Bank Base Rate
At 1 April 2007	5.25%
11 May 2007	5.50%
6 July 2007	5.75%
6 December 2007	5.50%
8 February 2008	5.25%

Analysts forecasted a further bank base rate reduction in the spring of 2008. Consequently the Monetary Policy Committee reduced the bank base rate to 5.00% in April 2008.

4. LONG-TERM BORROWING

4.1 The Council had no existing long-term borrowing at 1 April 2007 and no long-term loans were raised during the year.

5. TEMPORARY BORROWING AND INVESTMENT

Borrowing

There were no temporary loans outstanding on 1 April 2007.

Eighteen temporary loans were raised during the year for cash flow purposes. The loans were for periods up to 17 days and for amounts up to £2.5 m.

There were no temporary loans outstanding at 31 March 2008.

5.2 Temporary Cash flow Investment

5.2.1 The original estimate for 2007/08 for interest receivable on temporary investments was £744,000 based on an anticipated earnings benchmark of 5.15% for the year. The actual interest receivable was £1,114,000; a variation of £370,000.

5.2.2 The main cause of this variation was due to an underspend of revenue expenditure, and an underspend and the rephasing of capital expenditure, totalling approximately £5m (£195,000). The remaining variation was because of a higher than anticipated interest rate for the year caused both by a change in expectation of interest rate movements and the credit crisis (£175,000). Of this variation £380,000 was reported to this Panel during the year. The reduction of £10,000 from the figure already reported was due to interest due on the underpayment of PAYE and NI for the year and realised in March 2008.

5.2.3 The actual interest earned on temporary investments for the year was equivalent to an annual rate of return of 5.6%.

5.2.4 The average rate of 7 day LIBID, the interest rate used for benchmarking the Council's interest earnings for 2007/08, was 5.6%. Therefore, the interest earned on temporary investments equalled the average rate of interest money market interest rate.

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

5.2.6 The table below shows the list of temporary investments at 31 March 2008.

Borrower	Amount £	Interest Rate %
HSBC	1,000,000	4.81
HSBC	2,000,000	5.25
Cheshire Building Society	1,500,000	5.00
EBS	2,000,000	5.40
Derbyshire Building Society	1,000,000	5.48
Total	**7,500,000**	

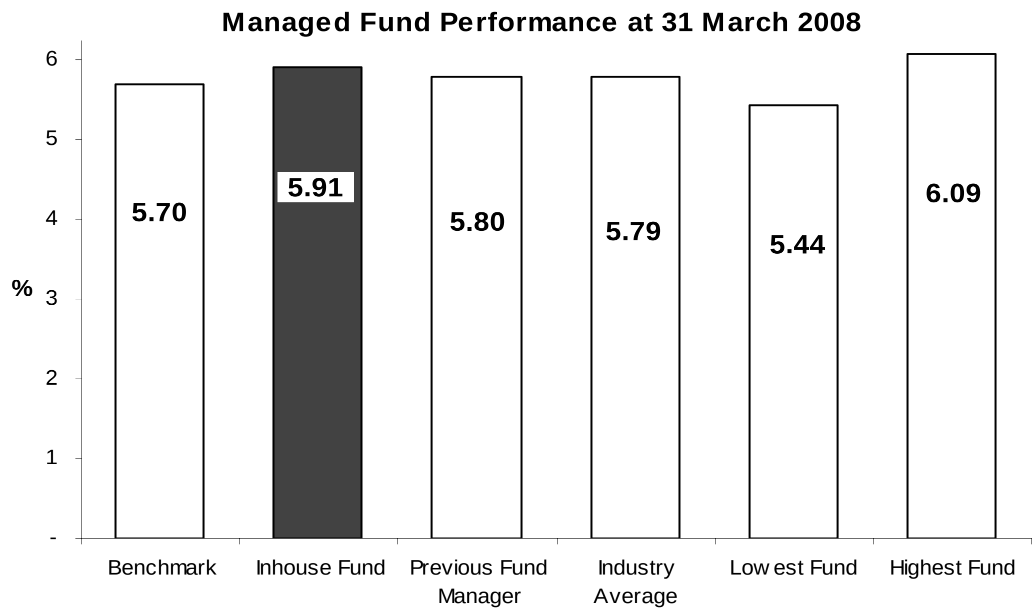
6. MANAGED FUNDS

6.1 At 1 April 2007 the Council had £12m invested and managed in-house by council staff.

6.2 The fund is expected to achieve a benchmark return during the year. 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 compounded benchmark return for the period 1 April 2007 to 31 March 2008 was 5.70%. The in-house fund achieved a rate of return of 5.91%.

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



6.5 The performance of the in-house fund was higher than the benchmark.

6.6 The in-house fund earnings exceeded the industry average and the returns of the external fund manager who managed a proportion of this Council’s fund three years ago.

6.7 The in-house fund earnings were lower than the one managed fund which was the highest performing fund in the local authority market.

6.8 Results to 31 March 2008 are summarised as follows: -

	In-house Fund %	Industry Average %
Actual Return	5.91	5.79
Benchmark Return	5.70	5.70
	£000	**£000**
Actual Return	709	695
Benchmark Return	684	684
Return above/(-)below benchmark	25	11

6.9 The value of the interest earned on the in-house fund as at 31 March 2008 was £25,000 above the benchmark figure as shown at paragraph 6.8 and £11,000 higher than the industry average.

6.10 The interest earned on the in-house fund was higher than that of the previous external fund manager.

6.11 The original estimate for the managed fund interest earnings for 2007/08 was £624,000 based on a budgeted return of 5.20%.

6.12 A revised forecast for interest earnings of £700,000 for 2007/08 was reported to Cabinet in April 2008 based on a return of 5.83%.

6.13 The actual earnings for 2007/08 were £709,000 and the rate of return 5.91%.

6.14 Investment Portfolio Strategy

6.14.1 The in-house fund is invested in cash deposits. Gilts and CD's are not used as the fund is managed by council staff.

6.14.2 At the start on the year the portfolio was invested in instruments with interest rates averaging 5.29%.

6.14.3 At the beginning of the year the anticipation was that interest rates would rise with the peak at 5.5% before falling back to sub 5% rates.

6.14.4 In the summer expectations of the money markets changed forecasting higher interest rates to stem inflation worries. Money Market rates were forecasting bank base rates in excess of 6%.

6.14.5 As the year progressed the credit crisis developed and deposits were made for periods of between 6 months and one-year where the interest rates where at their highest.

6.14.6 The continued increase in money market rate expectations through 2007/08 resulted in the benchmark being higher than initially forecast.

6.14.7 The fund was invested in deposits earning an average of 6.18% at the year end. This average rate is likely to reduce through 2008/09 as the credit crisis diminishes.

7. TREASURY POSITION AT 31 MARCH 2008

The following table shows the treasury position at the 31 March 2008 compared with the previous year.

	31 March 2007		**31 March 2008**	
	Principal	**Average Rate**	**Principal**	**Average Rate**
Total Debt	**£0**	**0%**	**£0**	**0%**
In-house Managed Fund				
Variable Interest Rate	£12.0m	5.3%	£4.5m	6.2%
Fixed Interest Rate	£0.0m	0.0%	£7.5m	6.1%
Total Managed Funds	**£12.0m**	**5.3%**	**£12.0m**	**6.2%**
Temporary Cash-flow Investments	£10.0m	5.1%	£7.5m	5.2%
Call Account (variable interest rate)	£0.5m	4.8%	£0.5m	4.8%
Total Investments	**£22.5m**	**5.2%**	**£20.0m**	**5.8%**

APPENDIX 2

PRUDENTIAL INDICATORS AND COMPLIANCE ISSUES TO 31 MARCH 2008

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 2007/08 with the original indicator for 2007/08 and the actual figure for 2006/07.

2.2 The original indicator for 2007/08 is the same as was included in the Treasury Strategy Report 2007/08.

		2006/07 Actual £000	2007/08 Original Indicator £000	2007/08 Actual £000
1	**Capital Expenditure**	11,753	15,751	11,747
2	**Capital Financing Requirement (CFR) at 31 March**			
	Housing	1,897	1,897	1,897
	Non Housing	2,822	7,349	4,641
	Total	**4,719**	**9,246**	**6,538**
3	**Treasury Position at 31 March**			
	Borrowing	0	0	0
	Other long term liabilities	0	0	0
	Total Debt	**0**	**0**	**0**
	Investments	22,550	16,800	20,000
	Net Borrowing/Investments (-)	**-22,550**	**-16,800**	**-20,000**
4	**Authorised Limit (against maximum position)**	Maximum 3,797	Limit 24,000	Maximum 2,500
5	**Operational Boundary**	3,797	5,000	2,500
6	**Ratio of financing costs to net revenue stream**	-3%	-2%	-4%
7	**Incremental impact of capital investment decisions on the Band D council tax**	£ 8.30	£ 5.70	£ 2.81

8	**Incremental impact of capital investment decisions on the housing rent levels**	£ 1.09	£ -0.17	£ -1.31
9	**Upper limits on fixed interest rates (against maximum position)**	**Maximum** 99%	**Maximum** 100%	**Maximum** 99%
10	**Upper limits on variable interest rates (against maximum position)**	**Maximum** 4%	**Maximum** 50%	**Maximum** 26**%**
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	**Maturity structure of variable rate investments (against maximum position)**			
	Under 12 months	100%	**Upper Limit** 100%	100%
	12 months to 2 years	0%	50%	0%
	2 years to 5 years	0%	50%	0%
13	**Estimated maximum principal funds invested (against maximum position)**	**Maximum** 44,192	**Maximum** 50,000	**Maximum** 46,441

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 2007 **Actual**	**31 March 2008 Original Indicator**	**31 March 2008** **Actual**
Net borrowing position	**-£22.5m**	**-£16.8m**	**-£20.0m**
Capital Financing Requirement	**£4.7m**	**£9.2m**	**£6.5m**

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 2007/08.

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

3.2 Borrowing Limits

	2007/08
Authorised Limit	**£24.0m**
Operational Boundary	**£5.0m**
Maximum gross borrowing position during the year	**£2.5m**
Minimum gross borrowing position during the year	**£0.0m**

The Authorised Limit must not be breached. The table demonstrates that during 2007/08 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 2007/08

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.

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 2007/08.

5.5 For investments managed in-house returns have been higher than the benchmark and there is a low risk associated with these types of investments.