CANNOCK CHASE COUNCIL

COUNCIL

28 JUNE 2006

REPORT OF DEPUTY CHIEF EXECUTIVE

ANNUAL TREASURY REPORT 2005-06

1. Purpose of Report

1.1 To advise Members of the Council's Treasury activities during 2005-06.

2. Recommendation

2.1 That the contents of this report be noted.

3. Key Issues

3.1 The Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management 2001 was adopted by this Council on 4 March 2003 and this Council fully complies with its requirements. The primary requirements of the Code are the:-

(a) creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities;

(b) creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives;

(c) receipt by the Council of an annual strategy report for the year ahead and an annual review report of the previous year;

(d) delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

Treasury management in this context is defined as:

"The management of the local authority's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities and the pursuit of optimum performance consistent with those risks".

3.2 This annual treasury report covers:

- the Council's current treasury position;

- performance measurement;
- the strategy for 2005/06;
- the economy in 2005/06;
- borrowing and investment rates in 2005/06;
- the borrowing outturn for 2005/06;
- compliance with treasury limits and Prudential Indicators;
- investment outturn for 2005/06;
- debt rescheduling;
- other issues

3.3 During 2005-06 the Council did not increase its Long Term Borrowing Portfolio but managed this requirement by careful use of investment resources.

3.4 Although the investment return again exceeded the accepted benchmark of the uncompounded LIBID 7 day rate, investments were of necessity kept in small amounts and on the whole, short term (i.e. 3 months or less). This inevitably decreases the return available but based upon market conditions in the year actually increases the amount of interest earned by the Council.

3.5 None of the prudential indicators set at the beginning of the year were exceeded and all investments were carried out with institutions listed in the Council's approved lending list.

REPORT INDEX

Section 1

1. Background

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c. Receipt by the Cabinet/Council of an annual strategy report for the year ahead and an annual review report of the previous year.

d. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

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- debt rescheduling;
- other issues.

Section 2

2. Details of Matters to be Considered

2.1 Current Treasury Position

2.1.1 The Council's debt and investment position at the beginning and the end of the year was as follows:-

	31 March 2006 Principal		Rate/Return	31 March 2005 Principal	Rate/Return
Fixed Rate Funding:					
- PWLB	£13.9m			£14.3m	
- Market	£- m	£13.9m	8.50%	£- m	8.50%
Variable Rate Funding:					
- PWLB	£- m			£- m	
- Market	£0.5m	£0.5m	5.71%	£0.5m	5.71%
Total Debt		£14.4m	8.49%	£14.8m	8.52%
Investments:					
- In-house	£13.0m		4.58%	£12.7m	4.67%
- With Managers	£- m		-%	£- m	-%
Total Investments		£13.0m	4.58%	£12.7m	4.67%

2.2 Performance Measurement (Optional Area)

2.2.1 One of the key changes in the revision of the Code in 1996 was the formal introduction of performance measurement relating to investments, debt and capital financing activities. Whilst investment performance criteria have been well developed and universally accepted, debt performance indicators continue to be a more problematic area with the traditional average portfolio rate of interest acting as the main guide (as incorporated in the table in section 1).

2.3 The Strategy for 2005/06

2.3.1 The recommended treasury strategy for 2005/06 was based on our view of a weakening of the rate of growth of GDP in the UK economy precipitated by a downturn in household spending, in conjunction with a weakening of the housing market. Inflation was expected to rise due to increases in oil and commodity prices which would cause the Monetary Policy Committee to be on alert for second round inflation effects in increases in the prices of goods and services and pay inflation. Our forecast for base rate was that there would probably be enough steam in the upswing of the economic cycle to warrant one final increase in base rate to 5.0% in quarter 1 of 2005. After that, the MPC would be on hold until the downswing in economic activity gathered momentum and inflation pressures subsided to enable base rate to be cut to 4.5% by the end of 2005/06.

2.3.2 The US Fed was expected to continue its policy of a gradual increase in the FED rate (still only 2.25% at the beginning of 2005) as the economy continued to expand at a robust rate, though less strong than in 2004. The Eurozone growth rate was expected to improve, but only weakly, and so the European Central Bank was therefore forecast to leave rates unchanged at 2.0% for probably most of 2005/06 until economy showed some stronger signs of stirring. Inflation in all three areas was expected to be well contained.

2.3.3 The effect on interest rates for the UK was therefore expected to be as follows:-

Shorter-term interest rates – The “average” City view anticipated that the peak of growth in the UK, US and world economies had passed in 2004 and moderating growth rates in 2005 would lead to only a slight decrease in UK base rate from an average of 5.0% in 2006 to reach about 4.75% by the end of 2007.

Longer-term interest rates – The view on longer-term fixed interest rates was that long term PWLB rates would be fairly stable around the 4.75% level for most of the financial year (equivalent to a long term gilt yield of approximately 4.60%).

2.3.4 The Adopted Treasury Strategy – The agreed strategy put to the Council/Cabinet, based upon the above forecast, was that:-

a. That the expectation for falling base rates in the future was so strong that the drawing of cheaper, shorter term funding later in the year for some of the FY 2005/06 borrowing requirement would assist in lowering debt servicing costs. The risk was that leaving longer term borrowing to later years could eventually entail higher longer-term interest costs.

b. That the risks intrinsic to shorter term variable interest rates are such, when compared to historically low long term funding costs, that the Council will maintain a stable, longer term portfolio by drawing longer term fixed rate funding.

c. The Council operated both borrowing and investment portfolios and as a consequence was at lower risk from being impacted by a sharp, unexpected rise in short-term variable interest rates. The strategy for the year was therefore to maintain a balance of funding at short-term rates to match short-term investments thus maintaining balanced treasury risk.

2.4 The Economy

2.4.1 Shorter-term interest rates – Base rate started 2005/06 at 4.75%, having been unchanged at this level since August 2004. It fell to 4.5% in August 2005 and remained at that level for the rest of the year. The strong growth of consumer expenditure and housing prices in 2004 became positively anaemic during 2005 though the housing market did pick up to recover a bit later in the year and in quarter 1 2006. High oil prices and major increases in utility prices reduced spending power and negatively impacted sentiment. Claimant count unemployment increased each month during the year while manufacturing output was actually in recession for the first two quarters of 2005 before staging a recovery. GDP growth picked up from a low point of 1.7% y/y in Q2 to 2.3% in Q1 2006 i.e. still slightly below the long term average growth rate of about 2.5% p.a.

2.4.2 Longer-term interest rates – The PWLB 25-30 year rate started the year at 4.750% and fell to a low of 3.85% before rising back to a new peak of 4.25% at the end of the year. Fifty year gilts were launched in 2005 and on 7 December, the PWLB introduced new PWLB borrowing maturity periods longer than 25-30 years and up to a maximum of 45-50 years. This longest band started at a rate of 4.20% (compared to 4.30% for 25-30 year borrowing) and the rate bottomed at 3.70% in later January before ending the year at 4.15%.

2.5 Borrowing and Investment Rates in 2005/06

2.5.1 12-month bid rates: The 12-month LIBID rate started the year at a high point for the year of just over 5.0% but then fell and made a number of brief sorties down to around 4.35% in July to October before market expectations of one possible imminent further cut in base rate to 4.25% finally vanished. By the end of 2005/06, the rate had climbed steadily back up to 4.70% as market expectations geared themselves up for an increase in base rate as being the next move on the back of the recovery of GDP growth to near the long term average and concerns around inflation.

2.5.2 Longer-term interest rates – The PWLB 25-30 year rate started the year at 4.750% and then fell into a range of 4.30-4.50% for most of 2005 after mid May. However, long gilt yields plunged to levels unprecedented in recent history in late January and the 25-30 year rate bottomed out at 3.85% before rising back to a new peak of 4.25% at the end of the year. A major innovation in 2005/06 was the introduction by the Government of the longest maturity period gilts since the 1960s, namely for 50 years. The first issue of £2.5bn on 26.5.05 was followed by further similar sized tranches in July, December and February. The PWLB took its cue from the 7 December issue to introduce at the same time new PWLB borrowing for maturity periods longer than 25-30 years and up to a maximum of 45-50 years. This longest band started at a rate of 4.20% (compared to 4.30% for 25-30 year borrowing) and the rate bottomed at 3.70% in late January before ending the year at 4.15%. The phenomenally low rates above were widely interpreted as having been caused by unusually high demand for long gilts from non UK institutions including oil rich and Asian countries buying financial assets with their cash mountains.

2.6 Borrowing Outturn for 2005/06

2.6.1 As comparative performance indicators, average PWLB maturity loan interest rates for 2005/06 were:-

1 year	4.43%
9-10 year	4.44%
25-30 year	4.35%
45-50 year	4.00%
1 month GBR variable	4.58%

2.6.2 Debt Performance – As highlighted in section 1, above the average debt portfolio interest rate has moved over the course of the year from 8.52% to 8.49%. The approach during the year was to fund borrowing from surplus cash.

2.7 Compliance with Treasury Limits

2.7.1 During the financial year the Council operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Policy Statement and annual Treasury Strategy Statement. The outturn for the Prudential Indicators is shown in appendix 1.

2.8 Investment Outturn for 2005/06

2.8.1 Internally Managed Investments – The Council manages its investments in-house and invests with the institutions listed in the Council's approved lending list. The Council invests for a range of periods from overnight to 364 days, dependent on the Council's cash flows, its interest rate view and the interest rates on offer.

2.8.2 Investment Strategy – The expected short-term investment strategy for in-house managed funds was that the Council viewed the market's expectation for base rates as too low, and that short term rates would rise during the year. Investments were, accordingly, kept short, with a view to enabling returns to be compounded more frequently, however, our treasury advisors, Sector, in their November 2004 forecast, forecast a peak in the base rate cycle of 5.0% in Q1 of 2005 followed by the first cut to 4.75% in Q3 2005, then 4.5% in Q1 2006 and a floor of 4.25% in Q3 2006. This was changed in their February 2005 forecast to a peak of 5.0% in Q2 2005, 4.75% in Q3, 4.5% in Q1 2006 and a floor of 4.25% in Q1 2007.

2.8.3 Throughout 2005/06 Sector has advised to lengthen duration of investments within internal portfolios in the belief that the underlying economy is not as robust as the Treasury forecasts would suggest, thus there will be a need to cut interest rates to stimulate activity.

2.8.4 In the early months of the period markets began discounting such a move but, in Sector's opinion, had moved too far. Therefore, maturities were not replaced but placed in base rate liquidity accounts which actually paid higher rates in anticipation of spikes in the term deposit interest rates. These duly materialized in August, the month in which the Repo rate was actually cut. Advice was made for two two year deposits at 4.50% and 4.60% respectively on 3 August and 11 August.

2.8.5 Since that time maturities have been replaced in periods of one and two years, to lock into rates that will generate strong returns when the projected rate cuts take effect in 2006. These investments were 2 years at 4.55% on 28 September, one year at 4.50%, 4.59%, 4.57%, 4.60% and 4.66% on 19 October, 30 November, 25 January, 27 February and 23 March, with a further two year investment at 4.81 on 29 March.

2.8.6 The Sector return on their model portfolio for the year was 4.88%, compared to the annualised quarter on quarter 7 day LIBID benchmark of 4.61%. Given that the rate cuts forecast have yet to take place, an out performance of 27 basis reflects well. This also compares favourable with returns generated by the fund Management industry. Average duration for the portfolio at 382 days reflecting the Sector interest rate view.

2.8.7 Investment Outturn for 2005/06 – Detail below is the result of the investment strategy undertaken by the Council.

	Average Investment	Rate of Return (gross of fees)	Rate of Return (net of fees)	Benchmark Return
Internally Managed	£14.363m	4.58	N/A	4.54%
Externally Managed	-	-	-	-

No institutions in which investments were made had any difficulty in repaying investments and interest in full during the year.

2.9 Debt Rescheduling

2.9.1 No opportunity for debt rescheduling presented itself during the year and none was therefore undertaken.

2.10 Other Issues

2.10.1 During the year the Council was preparing for a vote on LSVT. The Treasury unit, cognisant of this, maintained it's borrowing and lending portfolios in the most suitable state for either outcome.

Section 3

3. Contribution to CHASE

3.1 As a major contributor to attaining the Budget requirements Treasury Management enables the Council to fulfil all aspects of CHASE.

Section 4

4. Section 17 (Crime Prevention) Implications

4.1 There are no Section 17 implications arising from this report.

Section 5

5. Human Rights Act Implications

5.1 There are no identified implications in respect of the Human Rights Act 1998 arising from this report.

Section 6

6. Data Protection Act Implications

6.1 There are no implications arising from this report.

Section 7

7. Risk Management Implications

7.1 Treasury Management is a high risk area due to the large amounts of money dealt with on a daily basis. However, the Council has a Treasury Policy and Strategy in place which is approved each year for the following 12 months. The Council also has advice on investment and lending from the leading company in the field and has instituted a strict control and delegation of duties regime which reduces all risks to a minimum.

Section 8

8. Legal Implications

8.1 The legal implications are set out throughout the report..

Section 9

9. Financial Implications

9.1 There are no direct financial implications arising from this report.

Section 10

10. Human Resource Implications

10.1 There are no Human Resource Implications arising from this report.

Section 11

11. Conclusions

11.1 Treasury Management during the year has been carried out in line with the previously approved Treasury Management Strategy and Policy taking advice from our treasury advisors. No additional borrowing has been required during the year while both performance indicator returns and budgeted investment income have been exceeded.

Section 12

List of Background Papers

Statement by the Leader of the Council 2004-05 – 2005-06.

ENCLOSURE 10.11

Annex 1

Prudential Indicators

	2004-05 Actual	2005-06 Original	2005-06 Projection	2005-06 Actual	Variance
Affordability					
Ratio Financing Costs to Net Revenue Stream					
General Fund	-6.90%	-4.52%	-4.64%	-4.04%	0.60%
HRA	10.39%	10.10%	9.19%	8.95%	-0.24%
Incremental impact of capital investment decisions on Council Tax	0	0	£1.70	£1.70	£0.00
Incremental impact of capital investment decisions on average weekly housing rents	0	0	0	0	0
Capital Expenditure	**£m**	**£m**	**£m**	**£m**	**£m**
Total Capital Expenditure (including external funding)					
General Fund	1.054	3.395	1.636	1.789	0.153
HRA	8.673	8.175	7.923	7.976	0.053
Capital Financing Requirement as at 31March					
General Fund	5.584	5.824	5.823	5.831	0.008
HRA	17.083	17.990	17.888	17.848	-0.040
External Debt					
Authorised Limit	16.905	17.897	17.897	17.897	0.000
Operational Boundary	15.785	16.173	16.173	16.173	0.000
External Debt as at 31 March if no new borrowing undertaken	15.198	14.759	14.758	14.758	0.000
Net Borrowing (i.e. less Investments) as at 31 March	2.515	2.241	2.644	1.775	-0.869