

Report to: **Cabinet**

Date: **14 June 2005**

By: **Deputy Chief Executive & Director of Corporate Resources**

Title of report: **Treasury Management – Stewardship Report**

Purpose of report: **To present the County Council's performance on treasury management for the year 2004/05.**

RECOMMENDATION

The Cabinet is recommended to note the treasury management performance in 2004/05

1. Financial Appraisal

The annual stewardship report reviews the Council's treasury management performance and is required by the Code of Practice for Treasury Management. There are no direct financial consequences of this report.

2. Supporting Information

2.1 Introduction

The County 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;
- Statutory Instrument (SI) 3146 2003 develops the controls and powers within the Act;
- The SI requires the County Council to undertake any borrowing activity with regard to the Chartered Institute of Public Finance and Accountancy (CIPFA) Prudential Code for Capital Finance in Local Authorities;
- Under the Act the Office of the Deputy Prime Minister has issued Investment Guidance to structure and regulate the Council's investment activities.

The County 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. The Code requires 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).

This report sets out:

- A summary of the strategy agreed for 2004/05 and the economic factors affecting this strategy (Appendix A);
- The treasury management activity during the year (Appendix B);
- The Prudential Indicators which relate to the Treasury function and compliance with limits (Appendix C);

2.2 The economic conditions compared to our original strategy for 2004/05

The original strategy and the economic conditions prevailing in 2004/05 are set out in Appendix A which is attached to this report. Overall the advice was that interest rates would rise over the two years 2005/06 and 2006/07.

2.3 **The treasury activity during the year on borrowing and short term investments:**

Short term lending

The amount received in interest on short term lending during 2004/05 was £7.51m at an average rate of 4.65%. This was above the average of base rates in the same period (4.59%).

Long term borrowing

Details of our long term borrowing are included in Appendix B of the report.

The important points are summarised as:

- The County Council borrowed £47.7m (£35m net) from the Public Works Loans Board (PWLB) during 2004/05 at an "average" rate of 4.84%. The total outstanding loan debt at 31 March 2005 is £252m.
- Within the borrowing of £47.7m, £12.7m was refinancing of debt repaid early. This will result in total savings of £353,000 in interest paid over the life of the original loans.
- The average interest rate of all PWLB debt at 31 March 2005 was 5.836% compared to 5.99% at 31 March 2004.
- It was considered that interest rates would generally be rising over 2004/05 and 2005/06 and opportunities were taken to borrow at favourable rates early in the year.

Short term borrowing

The County Council borrowed on a short term basis from the market for only 16 days in 2004/05. The interest amounted to £13,765 and was at an average rate of 4.38%.

2.4 **Prudential Indicators which relate to the Treasury function and compliance with limits**

The County Council is required by the Prudential Code to report the actual prudential indicators after the end of each year. There are five indicators which relate to treasury management and they are set out in Appendix C.

The actual position for the County Council for 2004/05 is that all borrowing and prudential indicators are within the limits set in the Strategy for the year.

3. **Conclusion and reason for recommendation**

This report fulfils the requirement to submit an annual report in the form prescribed in the Treasury Management Practices. It includes borrowing and lending transactions, including the economic climate and interest rate conditions prevailing in the period and the Prudential Indicators which relate to the Treasury function and compliance within limits.

Cabinet will wish to note that the proactive approach adopted means that new borrowing has reduced the average interest rate on long term debt and allowed some debt to be replaced at lower interest rates at no risk. Short term lending has achieved better than base rate and that exposure to future risk continues to be minimised through managing the loan maturity profile.

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BACKGROUND DOCUMENTS

Cabinet 8 June 2004 Borrowing Limit and Treasury Management Strategy for 2004/05

Cabinet 8 June 2004 Treasury Management Stewardship Report for 2003/04

CIPFA Treasury Man't in the Public Services- Code of practice and cross sectional guidance notes
Local Government Act 2003

Local Government Investments –Guidance from the Office of the Deputy Prime Minister

Appendix A to Cabinet Report on Treasury Management Stewardship Report for 2004/05

A summary of the strategy agreed for 2004/05 and the economic factors affecting this strategy

1. Original strategy for 2004/05

1.1 The Cabinet at its meeting on 8 June 2004 agreed its treasury management strategy for 2004/05, taking account of the current economic scene and the current and forecast levels of interest rates.

1.2 It was agreed that the strategy was to continue to aim to borrow long term to finance the capital programme at the lowest rate available during the year and for short term borrowing and lending to be at the best rates available consistent with low risk. Opportunities were to be taken to restructure long term debt if and when they arose.

1.3 At the same time, the Treasury Management Policy Statement was agreed for 2004/05.

East Sussex County Council defined its treasury management activities as:

“The management of the organisation’s cash flows, its banking, money market and capital market transactions (other than those of the Pension Fund) the effective management of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.”

The County Council regards the successful identification, monitoring and management of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation.

This authority acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving best value in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

1.4 The strategy for 2004/05 took into account the economic scene and the current and forecast levels of interest rates. The main points of the advice received on interest rates for 2004/05 were:

- Short term rates, which stood at 3.75% in January, were expected to increase to 4% before the start of 2004/05 and were likely to increase to 4.5% by the end of the year.
- Long term interest rates were expected to be 0.7% higher than the average rate in 2003/04 (4.8%). The estimated rate was therefore estimated at 5.5%.
- The advice received for the following years was that it was estimated that short term rates would increase to an average of 4.6% in 2005/06 and 4.8% in 2006/07 but decrease in 2007/08 to 4.5%.
- The average long term interest rates would be slightly higher at 5.6% in 2005/06 and 2006/07 but would reduce to 5.2% in 2007/08.

Overall the advice was that interest rates would rise over the two years 2005/06 and 2006/07.

2. Actual economic conditions prevailing in 2004/05

2.1 The rise in UK interest rates which commenced in mid-2003 continued during 2004/05 as the Monetary Policy Committee (MPC) tightened policy to combat the effects rising economic activity might have upon inflation. As a result, Base Rates which started the year at 4% were raised in quarter-point steps in May and June to 4.5%. Market pessimism was fuelled by this comparatively aggressive stance and longer-dated money rates rose to in excess of 5% to reflect this.

2.2 Base Rates were raised again in August to 4.75%, the peak for the year. Thereafter, the MPC adopted a comparatively neutral stance. A steep rise in world oil prices triggered a slowdown in economic activity in industrialised economies, notably in the USA. This and low inflation caused the Bank of England to adopt a more optimistic view of medium-term inflation prospects, and it was hinted that rates may have peaked. Money market rates adjusted to accommodate this assessment and longer fixed interest rates slipped lower.

2.3 Base Rates remained unaltered for the balance of the year but confidence that the rate cycle had peaked was undermined in the last few months of the period. Quoting stronger activity, tighter labour market conditions and rising raw material prices, the Bank of England February 2005 Inflation Report cast some doubt upon the ability of inflation to maintain a subdued performance over the medium term. Money rates rose in reaction to the view that a further tightening of monetary policy was not out of the question.

2.4 Long-term interest rates (PWLB rates) tended to track the movements in the money market. A rise in the early part of the year, in response to market interest rate pessimism, was reversed in the autumn and winter of 2004 as weaker economic activity placed downward pressure upon fixed interest rates across the globe. Rates returned to a rising trend in the closing months as the lacklustre performance of key international bond markets combined with a more pessimistic view on rates to drive yields modestly higher.

Appendix B to Cabinet Report on Treasury Management Stewardship Report for 2004/05

The treasury activity during the year on borrowing and short term investments

1. Short term lending interest rates

As mentioned in Appendix A, base interest rates started at 4.00%. The rate increased by 0.25% in May, June and August but did not change again during the year and finished the year at 4.75%. The total amount received in short term interest for 2004/05 was £7.51m at an average rate of 4.65%. This was above the average of base rates in the same period (4.59%).

2. Long-term borrowing

2.1 The Public Works Loan Board (PWLB) is a body set up by the Government that makes loans available for local authorities to borrow long term for capital spending and to refinance existing loans. Their rates are the cheapest available in the market on a like-for-like basis.

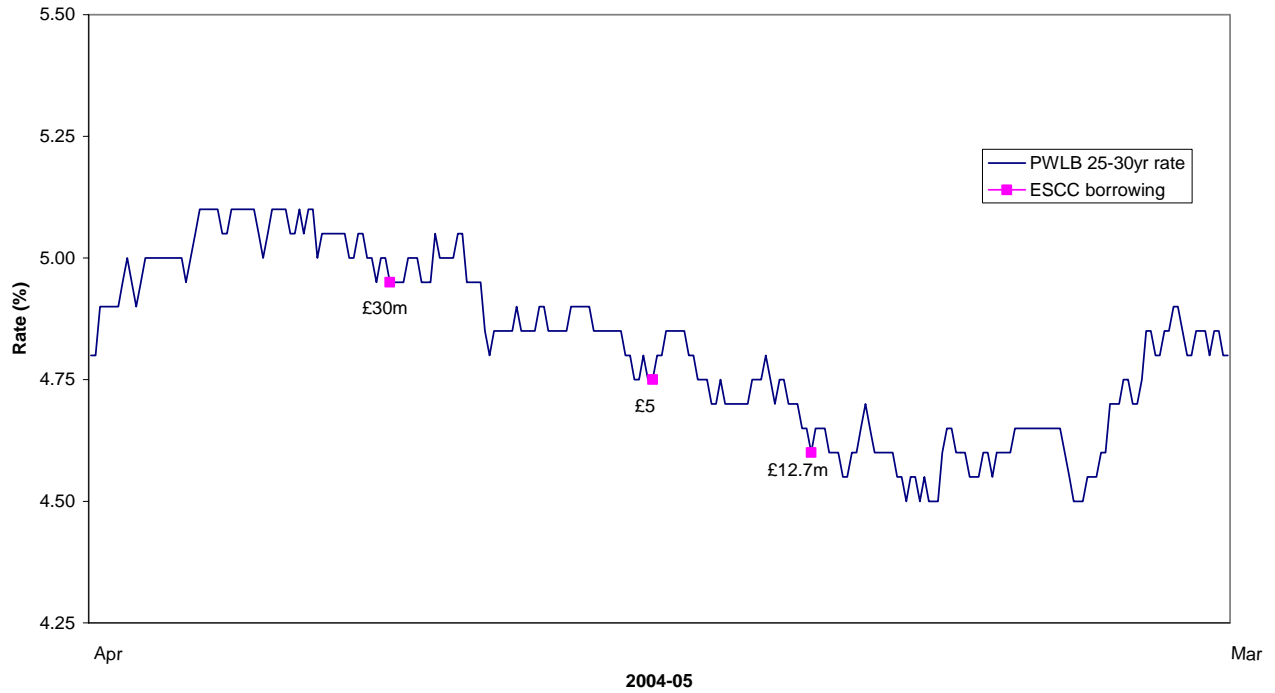
2.2 During the year, the following loans were taken.

Date of Loan	Amount £m	Rate	Length of loan
8 July	2.0	4.95%	26 years
8 July	2.0	4.95%	27 years
8 July	4.5	4.95%	28 years
8 July	6.8	4.95%	29 years
8 July	7.4	4.95%	30 years
8 July	7.3	4.95%	30 years
29 September	5.0	4.75%	30 years
19 November	3.7 *	4.60%	25 ½ years
19 November	3.0 *	4.60%	26 ½ years
19 November	3.0 *	4.60%	27 ½ years
19 November	3.0 *	4.60%	28 ½ years
	47.7	average 4.84%	

* Replaced £12.7m of existing debt

Within the borrowing of £47.7m, £12.7m was used to replace existing debt of the same amount. This resulted in savings of £7,000 in net interest paid in 2004/05 and £19,000 per annum in future years with a total saving of £353,000 in interest charges over the remaining life of the original loans.

2.3 The graph below shows the borrowing in 2004/05 compared to the PWLB rates offered:



2.4 All of the loans taken were PWLB loans at fixed rate and are set out in the table below:

Period in Years	Interest Rates				Loans Taken
	At 1.4.2004	At 31.3.2005	Minimum in Year	Maximum in Year	
25-30	4.80%	4.80%	4.50%	5.10%	£30.0m @ 4.95% £5.0m @ 4.75% £12.7m @ 4.6%

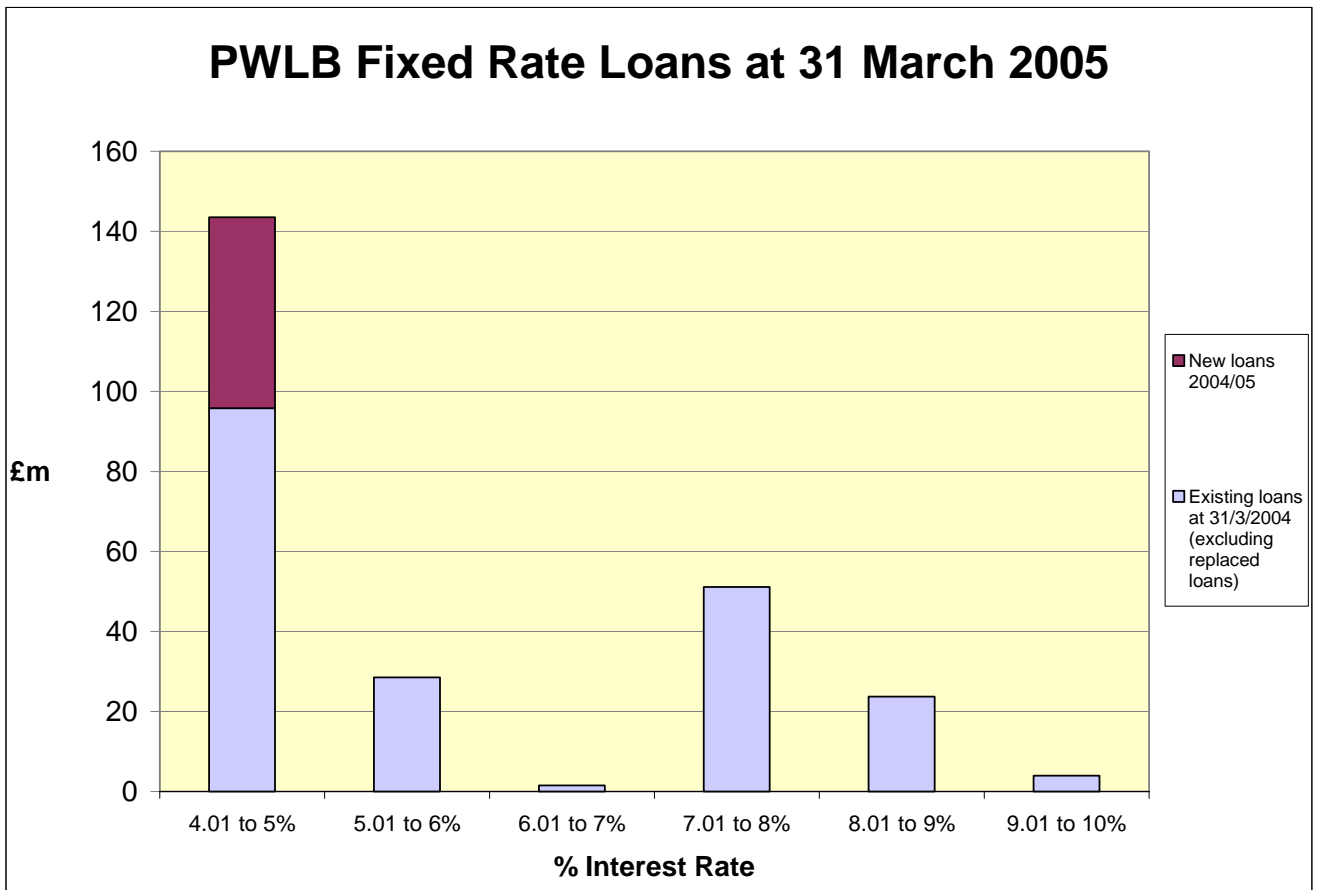
The County Council borrowed a total of £47.7m from the Public Works Loans Board (PWLB) during 2004/05. The “average” rate of long term borrowing in 2004/05 was 4.84%. The total outstanding loan debt at 31 March 2005 is £252m.

The average interest rate of all our PWLB debt at 31 March 2005 was 5.836% compared to 5.99% at 31 March 2004.

2.5 The PWLB loans are at various rates of interest. Due to taking new loans at lower rates, the interest rate profile of long term borrowing has improved:

- 68% of long term loans are currently at 6% or lower compared to 63% a year ago and 59% two years ago
- 14% of long term loans are currently at 8% or higher compared to 16% a year ago and 18% two years ago
- £144m (57%) of long term loans out of a total of £252m are at 5% or lower, compared to £108m (50%) of loans out of a total of £217m a year ago, and £87m (44%) of loans out of a total of £196m two years ago

The range of interest rates payable in all the PWLB fixed rate loans is illustrated in the graph below:



2.6 No loans matured in 2004/05.

Appendix C to Cabinet Report on Treasury Management Stewardship Report for 2004/05

Prudential Indicators which relate to the Treasury function and compliance with limits

1.1 The County Council is required by the Prudential Code to report the actual prudential indicators after the end of each year. There are five indicators which relate to treasury management and they are set out below:

- Operational and authorised borrowing limits
- Interest rate exposure
- Maturity structure of debt
- Maturity structure of investments
- Compliance with the Treasury Management Code of Practice

1.2 Operational and authorised borrowing limits.

The table below sets out the estimate and projected outturn for borrowing in 2004/05

		2004/05 Estimate £m	2004/05 Actual £m
	Borrowing as at 1 April 2004	217	217
ADD	Change to borrowing rules as at 1 April 2004		2
ADD	Borrowing to support capital programme	29	29
ADD	Contingency headroom for supplementary approvals	10	
	Borrowed in advance for future year		13
LESS	Provision for repayments of debt	-9	-9
		247	252
ADD	Net borrowing for next year	21	
	Operational Limit	268	
ADD	Short term borrowing	19	
	Authorised Limit	287	

The Operational Limit for borrowing was based on the same estimates as the authorised limit. It reflected directly the authorised borrowing limit estimate without the additional amount for short term borrowing included to allow, for example, for unusual cash movements. The Operational Limit represents a key management tool for in year monitoring and long term borrowing control.

The Authorised Limit was consistent with the County Council's current commitments, existing plans and the proposals for capital expenditure and financing, and with its approved treasury management policy statement and practices. It was based on the estimate of most likely, prudent but not worst case scenario, with in addition sufficient headroom (short term borrowing) over and above this to allow for day to day operational management, for example unusual cash movements or late receipt of income. Risk analysis and risk management strategies were taken into account as were plans for capital expenditure, estimates of the capital financing requirement and estimates of cash flow requirements for all purposes.

The Authorised Limit is the "Affordable Borrowing Limit" required by S3 of the Local Government Act 2003 and must not be breached. The long term borrowing at 31 March 2005 of £252m is under the Operational Limit and Authorised Limit set for 2004/05.

1.3 Interest rate exposure

The County Council continued the practice of seeking to secure competitive fixed interest rate exposure for 2004/05. To provide flexibility however it set limits on our variable rate exposure in case that became a more effective approach. There are figures for both borrowing and lending and a combined borrowing and lending table.

<u>Borrowing</u>	2004/05 <u>Estimate</u>	!
Fixed Rate Exposure		
Upper Limit	100%	
Lower Limit	81%	
Variable Rate Exposure		
Upper Limit	19%	
Lower Limit	0%	
 <u>Lending</u>		
Fixed Rate Exposure		
Upper Limit	100%	
Lower Limit	0%	
Variable Rate Exposure		
Upper Limit	100%	
Lower Limit	0%	
 <u>Borrowing and Lending combined</u>		
Fixed Rate Exposure		
Upper Limit	100%	
Lower Limit	54%	
Variable Rate Exposure		
Upper Limit	46%	
Lower Limit	0%	

In 2004/05, all borrowing and lending was at fixed rates i.e.100% at fixed.

1.4 Maturity structure of debt

The County Council set upper and lower limits for the maturity structure of its borrowings as follows.

<u>2004/05</u>	<u>Estimated Lower limit</u>	<u>Estimated Upper limit</u>
Under 12 months	0%	25%
12 months and within 24 months	0%	25%
24 months and within 5 years	0%	25%
5 years and within 10 years	0%	50%
10 years and above	50%	100%

The County Council has not exceeded the limits set in 2004/05.

	<u>Actual at 31.3.2005</u>
Under 12 months	0%
12 months and within 24 months	0%
24 months and within 5 years	4.4%
5 years and within 10 years	8.2%
10 years and above	87.4%

New borrowing was undertaken giving due consideration to the debt maturity profile, ensuring that an acceptable amount of debt is due to mature in any one financial year. This helps to minimise the authority's exposure to the risk of having to replace a large amount of debt in any one year or period when interest rates may be unfavourable. The bar chart in the attached Annex shows the maturity profile. There is only one year (2034/35) where the amount of debt maturing is more than £16m out of a total of £252m. The exposure in this year is currently under 7% (last year the maximum in any one year was 8%) of the total which is not excessive.

1.5 Maturity structure of investments

From 1 April 2004, the Investment Guidance issued by the Officer of Deputy Prime Minister, allowed local authorities the freedom to invest for more than for one year. The County Council has taken advantage of this freedom. The limits set were:

- Investments of over one year and up to five years
- Only institutions of the highest quality
- The list of banks will continue to be regularly monitored to ensure that their financial strength and low risk has been maintained.
- All investments over one year to be classified as Non-Specified Investments
- A limit of £19m for 2004/05 that can be held within this category at any time.
- Any investments made of over one year must match the County Council's policies, for example, investment of the Waste reserve where the balances can be lent out for a known period before being required.

Year invested	Opening balance	Maximum amount invested over 364 days and up to 5 years	Closing balance
Actual	£m	£m	£m
2004/05	0	15	15

The limits set have not been exceeded and £15m of Non-Specified Investments have been taken within our overall portfolio of investments.

1.6 Compliance with the Treasury Management Code of Practice

East Sussex County Council has adopted the CIPFA *Code of Practice for Treasury Management in the Public Services*.

Annex

Debt Maturity Profile at 31 March 2005

