Leicestershire County Council

SCRUTINY COMMISSION – 13th JULY 2006

ANNUAL TREASURY MANAGEMENT REPORT 2005/2006

REPORT OF THE DIRECTOR OF RESOURCES

Purpose of Report

1. To report on the action taken and the performance achieved in respect of the treasury management activities of the Council in 2005/06.

Policy Framework and Previous Decisions

2. The Director of Resources has delegated authority to carry out treasury management activities on behalf of the County Council and this report is produced in order to comply with the CIPFA Code of Practice in respect of Treasury Management in Local Authorities.

3. Under the CIPFA Code of Practice it is necessary to report on treasury management activities undertaken in 2005/2006 by the end of September 2006, although our own policy is to produce a report before the end of July.

Resource Implications

4. Treasury management is an integral part of the Council's finances. Interest on revenue balances generated £5.2m in 2005/06 and the cost of financing the debt portfolio was £24.6m. Minimising the net cost of the two portfolios is extremely important.

Background

5. The term management 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".

6. The Director of Resources is responsible for carrying out treasury management on behalf of the County Council, under guidelines agreed annually and contained within the Treasury Management Policy. Part of the policy is the requirement to report on the performance by the end of July following each year-end.

Treasury Management 2005/2006

7. There were no departures from the Treasury Management Policy Statement which was agreed by the full Council on 23rd February 2005 in relation to the sources and methods of borrowing and approved organisations for lending temporarily surplus funds.

Position at 31st March 2006

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

	31st March 2006			31st March 2005		
	Principal	Average Rate	Average Rate	Principal	Average Rate	Average Life
Fixed Rate Funding						
- PWLB	£277.5m	5.98%	39 yrs	£227.5m	6.41%	39 yrs
-Market	£ 2.0m	8.12%	11 yrs	£ 2.0m	8.12%	12 years
Variable Rate Funding:						
- Market (1)	£ 70.0 m	3.27%	3 yrs	£ 60.0m	3.15%	4 yrs
Total Debt	£349.5m	5.45%	32 yrs	£289.5m	5.74%	32 yrs

(1) Rates guaranteed for between 6 months and 9 ½ years, thereafter potentially becoming variable rate but with our option to repay in the event of a variation.

9. The position in respect of investments varies throughout the year as it depends on large inflows and outflows of cash. It is also complicated by the fact that the Council pools its own cash with that belonging to a large number of schools with devolved banking arrangements, the Pension Fund and ESPO when dealing in the London money markets. The available balance varied during 2005/06 between £96m and £183m, and at the end of the 2005/06 financial year stood at £150m.

Borrowing Undertaken in 2005/2006

10. Available rates for borrowing began the financial year at relatively unattractive levels but decreased throughout the early part of the year as the outlook for UK economic growth worsened. In December 2005 the Public Works Loan Board (PWLB), which lends to Local Authorities at levels that are marginally above Government Bond yields in the relevant maturity periods, unexpectedly increased the maximum available loan period from 30 years to 50 years. This change coincided with the issuance of a 50 year government bond, with the bond itself being issued to satisfy demand for very long-dated government debt by some Pension Funds. The new 45-50 year PWLB period, introduced on 7th December 2005 at a rate of 4.20%, ultimately reached a level of 3.70% in late January before retracing its steps to end the financial year at 4.15%. At their low point long-term PWLB interest rates reached a level not seen since the mid-1950's.

11. Rates available at various points of the year were very attractive in historical terms, and the opportunity was taken to borrow sufficient monies to be able to fund both the 2005/06 and the 2006/07 Capital Programmes. The surprise re-introduction of lending for periods of longer than 30 years (which had been withdrawn 6 years previously) and the seemingly unjustified fall in bond yields in January – which made very low rates available for a short period – makes some of the loans taken during 2005/06 look sub-optimal, with the benefit of hindsight. Current rates available in the relevant periods are, however, now above the rates achieved and in

the medium-term it is expected that the loans will be cost-effective. By way of comparison, the 25-30 year PWLB rate – a period of borrowing that was available for the whole year – averaged 4.35% during 2005/06, and currently stands at 4.55%. The average rate of borrowing in 2005/06 was 4.23%.

New Loans Taken

Public Works Loan Board

£10m 26 years fixed @ 4.45%. 20th May 2005
£10m 8 years fixed @ 4.45% 23rd May 2005
£10m 26 years fixed @ 4.35% 30th June 2005
£10m 8 years fixed @ 4.20% 6th September 2005
£10m 26 years fixed @ 4.25% 25th November 2005
£10m 46 years fixed @ 3.90% 11th January 2006

Market LOBO's *

£10m 10 years/60years @ 3.99% 12th December 2005

* This LOBO (Lender's Option/Borrower's Option) guarantees a rate of interest for the initial period of 10 years of 3.99%. After the initial period the lender has the option (every 6 months) to increase the rate to above that agreed, in which case we may repay without penalty. In the event that the loan runs until maturity, it will be repaid in 2065.

12. The County Council also borrowed three further loans totalling £12.5m to fund the new ESPO building. These loans were all taken for a period of 25 years, over which period ESPO will reimburse the County Council for the cost of the loans. The loans were all taken on an Equal Instalments of Principal basis, meaning that ESPO will be repaying £½ m in capital each year plus a diminishing amount of interest. The rates achieved averaged 4.54%, and these loans are not included in the figures given previously as they are considered to be specific to ESPO.

13. Early repayment of debt – or debt rescheduling when replacement debt is taken – can be attractive if there are sizeable differences in rates between different periods (e.g. if 25 year borrowing is more expensive than 50 year borrowing) or if rates increase to levels that are believed to be unjustifiably high. The predictability of PWLB interest rates – they are set one day in arrears and are based on Government Bond yields – also provides opportunities to make relatively modest savings without any major changes to the maturity profile of the portfolio.

14. During 2005/06 three separate debt rescheduling exercises were carried out. The total amount of repayments (and reborrowings) was £25.6m, and the annual interest savings will be just over £46,000 p.a. Whilst the interest savings are relatively modest, the biggest advantage of the rescheduling is that the replacement debt was taken at historically very low levels which will assist in providing future opportunities to improve the debt portfolio.

Investment Undertaken in 2005/06

15. Bank base rates began the year at 4.75%, where they had stood since August 2004. During the early part of the year the economy showed signs of weakness, as

the previously strong growth in house prices and consumer spending became anaemic. The Bank of England reacted to these signs of weakness by reducing rates to 4.5%, where they remained until the year-end. After the base rate reduction the market anticipated that there would be at least one further cut to follow but UK economic data then began to show signs of resilience, whilst Europe and the United States continued to grow. Interest rates globally were increased - aggressively so in the United States - and by the year-end markets were anticipating base rate increases in late summer or autumn 2006.

16. The investment portfolio took action in the lead up, and immediately after, the base rate reduction that would have assisted in protecting the return in the event that rates had moved lower still. As this immediate threat receded and the market started to look towards the next movement being upwards, the portfolio took advantage by placing some longer term loans at what appeared attractive levels. 5 year callable loans - where the borrower has a six-monthly option to repay - were also used as the rate available seemed to fully discount any reasonable outlook for the path of base rates.

Performance of Portfolios

17. The average rate achieved on investments during 2005/06 was 4.90%, which is 0.24%, above the Local Authority 7 day Return Index. This index calculates the rate that would be achievable if no longer-term decisions were taken, and makes an allowance for the reinvestment of interest earned. The average base rate for the year was 4.59%.

18. Since performance measurement of the investment portfolio commenced, Leicestershire has produced 11 consecutive years of outperformance of both the 7 day index and the average base rate. This has been achieved by a willingness to take views that are contrary to the market, although the market's consistently very poor assessment of the timing and extent of base rate movements does give an inherent advantage. Over this 11 year period the portfolio has averaged a return of 0.35% p.a. over the 7 day index, although it is unlikely that this margin of outperformance can be maintained in the future as the level of volatility in the rates available is likely to be lower, given the relatively narrow band in which base rates now tend to move. A period of underperformance is, however, inevitable at some stage and the only way to avoid it would be to stop taking the decisions that have proved so productive in the past.

19. Over the last 5 years, our debt portfolio has moved from having an average rate of ½% below the average English County to ½% above, according to statistics provided by the individual authorities and published by CIPFA. This is somewhat surprising as we have actively managed our debt portfolio over this period and our Treasury Management Advisors – who have access to the portfolios of hundreds of other authorities – assure us that Leicestershire's portfolio has a rate that is below average. We are aware that a number of authorities have carried out major debt rescheduling exercises in recent years, incurring significant cost when repaying existing loans, and it is not thought that these costs are reflected in the data available.

Summary

20. Treasury Management is an integral part of the Council's overall finances and the performance in this area is very important. Whilst individual years are important, the debt portfolio (in particular) should be viewed on a medium/long term basis. The current debt portfolio has an attractive average rate, and also a reasonable proportion that has been taken in recent years at historically attractive rates. The outlook is for a gradually declining average rate, with opportunities to improve it via rescheduling exercises

Recommendation

21. The Commission is ASKED TO NOTE this report.

Equal Opportunities Implication

None

Background Papers

Report to County Council on 23rd February 2005 – 'Revenue Budget 2004/05 and 2005/06 and Capital Programme 2005/06 to 2007/08': Appendix H 'Treasury Management Strategy and Annual Investment Strategy 2005/06'.

Circulation Under Sensitive Issues Procedure

None

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CP/CG-Annual Management Report 2006.