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Leicestershire County Council

SCRUTINY COMMISSION – 18TH JULY 2007

ANNUAL TREASURY MANAGEMENT REPORT 2006/2007

REPORT OF THE DIRECTOR OF CORPORATE 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 2006/07.

Background

2. The term treasury 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".

3. The Director of Corporate 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 2006/2007

4. There were no departures from the Treasury Management Policy Statement which was agreed by the full Council on 22nd February 2006 in relation to the sources and methods of borrowing and approved organisations for lending temporarily surplus funds.

Position at 31st March 2007

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

	31st March 2007			31st March 2006		
	Principal	Average Rate	Average Rate	Principal	Average Rate	Average Life
Fixed Rate Funding						
- PWLB	£277.6m	5.86%	44 yrs	£277.6m	5.98%	39 yrs
-Market	£ 2.0m	8.12%	10 yrs	£ 2.0m	8.12%	11 yrs
Variable Rate Funding:						
- Market (1)	£ 70.0 m	3.46%	3 yrs	£ 70.0 m	3.27%	3 yrs
Total Debt	£349.6m	5.39%	36 yrs	£349.6m	5.45%	32 yrs

(1) £10m at 4.5% but subject to variation every 6 months by lender, with our option to repay in the event of a variation. Remaining £60m has rates guaranteed for between 1 and 8 ½ years, after which interest will be payable at a higher rate and subject to a 6 month variation. These loans all have an option to repay in the event of a variation.

6. 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 2006/07 between £105m and £227m, and at the end of the 2006/07 financial year stood at £140m.

Borrowing Undertaken in 2006/2007

7. Rates for medium and longer term borrowing moved in a relatively tight range over the course of the financial year, with the 45-50 year rate available from the Public Works Loan Board (PWLB) – generally the most appropriate source of borrowing for the Council – ranging between a high of 4.50% and a low of 4.05%. The lowest rates available were between late September and early November, and rates rose gradually thereafter as the outlook for inflation worsened and the Bank of England raised base rates. Shorter term rates (particularly in the periods up to 5 years) rose quite substantially during the year on the back of base rate rises and the 5 year rate varied between 4.50% and 5.50%.

8. Having taken advanced funding for the Capital Programme in previous financial years, when the rates available looked especially attractive, there was no requirement to raise any more funding during the financial year. An important part of Treasury Management is, however, pro-active management of the existing portfolio and there are sometimes opportunities to improve the portfolio by ‘debt rescheduling’ – in simple terms, the repayment of existing loans and their replacement with new ones. Sometimes debt rescheduling can take advantage of the different rates available from PWLB within different loan periods (e.g. a move from a 10 year loan to a 25 year loan may generate an ongoing saving), whilst on other occasions it can involve borrowing at particularly attractive rates with a view to repaying other loans when rates have increased (or, vice-versa, repaying and waiting for rates to fall). The portfolio ended the year at the same size that it had begun it, but debt rescheduling exercises improved the average rate during the year.

9. When an existing PWLB debt is repaid early, there is either a premium payable or a discount receivable which takes account of the difference between the current rate available in the remaining period to maturity and the rate at which the existing loan is running – repaying a loan running at 4.90% against a current rate of 4.50% would, for example, require a premium to be paid to the PWLB. These

premiums/discounts are taken into account when deciding whether a rescheduling exercise is worthwhile.

10. There were five separate debt rescheduling exercises carried out during the year, all of which were successful in reducing the long term cost of borrowing. A total of £99.6m of existing debt with an average interest rate of 4.50% was replaced with loans at an average rate of 4.18%, which will generate a saving of £319,000 p.a. in interest costs. Net discounts (i.e. amounts paid to the County Council following the repayment of the loans) totalling over £1.9m were also received and these will be written to the revenue account over a varying number of years, and the impact of these will be to further reduce debt financing costs by about £140,000 p.a. for the next 6 years and by £50,000 for many years after that. The deliberate by-product of the rescheduling is that the portfolio now has a number of very attractive long-term loans that will assist in carrying out pro-active treasury management in the years to come.

Investment Undertaken in 2006/07

11. Bank base rates began the year at 4.50%, where they had stood since August 2005, with no obvious sign of any significant upward pressure on them – if anything the market was expecting the next move to be downwards. There was, however, a significant change in sentiment when revisions to previous GDP figures showed that the UK economy had been performing much better than had been previously thought and markets began to factor in rate rises before the end of 2006. The markets were correct in their re-assessment and the Bank of England raised rates by ¼% in both August and November 2006. By this time there were signs of a re-ignition of the property market and – for the first time in a number of years – consumers appeared willing to pay higher prices in the high street and inflation increased gradually and to uncomfortably high levels. Although there was an expectation of at least one further base rate rise, the markets were shocked that the Bank of England increased rates as early as January 2007 to 5¼%, which is where they ended the year. Subsequent data releases – and particularly the fact that inflation has breached the Bank of England's upper inflation target – led to a further rise to 5½% in May 2007 (their highest level since early 2001), and it is unlikely that the increases are at an end.

12. Bank base rates have risen to higher levels and much quicker than was thought likely, and this has made some of the loans entered into during the last year look somewhat sub-optimal. Whilst these loans have not had a particularly noticeable impact within 2006/07 – for example a 3 year loan at 5.22% entered into in May 2006 was well above base rate for most of the year, and only marginally below it for the last three months – it is likely that performance will suffer during the current financial year. Although at the end of May 2007 the investment portfolio had an average rate of just above base rate, any further rate rises will take the average to below base rate.

Performance of Portfolios

13. The average rate achieved on investments during 2005/06 was 5.13%, which is 0.15%, 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 4.82%.

14. Since performance measurement of the investment portfolio commenced, Leicestershire has produced 12 consecutive years of outperformance of both the 7 day index and the average base rate and this has been achieved through active cash management. Over this 12 year period the portfolio has averaged a return of 0.34% p.a. over the 7 day index (which equates to about £5m over the 12 year period), although it is unlikely that this margin of outperformance can be maintained in the future as the level of volatility within 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 – most probably during the current financial year – and the only way to avoid it would be to stop taking the decisions that have proved productive in the past.

15. Despite the successful action taken within the debt portfolio over the last year, the average rate only decreased by 0.06%. This is partly due to the fact that one variable rate loan increased from the low initial level of 3.18% to a market level of 4.50% (which in itself pushed the average rate up by 0.04%), and partly because no net new borrowing was taken during the year – any new loans will inevitably be at below the current average and will reduce the average rate. The only statistics available in respect of other debt portfolios comes via CIPFA, and are available a year in arrears. The statistics rely on each authority providing accurate data, and there are some authorities that appear to have unrealistically low average rates. 6 years ago the Leicestershire debt portfolio had a rate of ½% below the average English County, according to these statistics, and by the end of 2004/05 this had changed to ½% above – this seemed an unlikely change given that the portfolio had been pro-actively managed over this period. The 2005/06 figures now show Leicestershire at 0.20% above the average, and again this 'clawing back' of 0.30% of performance seems implausible. 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, and this does call into question the CIPFA performance statistics. We are aware that a number of authorities have carried out major debt rescheduling exercises in recent years, incurring significant premia when repaying existing loans, and it is not thought that these costs are reflected in the data available. Contrary to the statistics, it is my belief that the debt portfolio is in a healthy position.

<u>Summary</u>

16. 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, and opportunities to improve it via rescheduling exercises will be taken if they arise.

Recommendation

17. The Scrutiny Commission is asked to note the report.

Resources Implications

18. Treasury management is an integral part of the Council's finances. Interest on revenue balances generated £7.0m in 2006/07 and the cost of financing the debt portfolio was £27.3m. Minimising the net cost of the two portfolios is extremely important.

Equal Opportunities Implications

None

Background Papers

Report to County Council on 22nd February 2006 – 'Medium Term Financial Plan': Appendix N 'Treasury Management Strategy Statement and Annual Investment Strategy 2005/06'.

Circulation Under Sensitive Issues Procedure

None

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