

REPORT TO THE CABINET – 29TH JUNE 2004

ANNUAL TREASURY MANAGEMENT REPORT 2003/2004

REPORT OF THE DIRECTOR OF RESOURCES

PART A

Purpose of Report

1. To advise the Cabinet of the action taken and the performance achieved in respect of the treasury management activities of the Council in 2003/2004.

Recommendation

2. The Cabinet is ASKED TO NOTE this report.

Reasons for Recommendation

3. 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.

Timetable for Decisions

4. Under the CIPFA Code of Practice it is necessary to report on treasury management activities undertaken in 2003/2004 by the end of September 2004, although our own policy is to produce a report before the end of July. The report will be referred to the Resources Scrutiny Committee following its approval by the Cabinet.

Resources Implications

5. During the year the actual cost in respect of the financing of capital was £20.20m compared to an original budget of £20.85m. As explained later in this report, less new debt was taken than estimated and the rates were lower. Debt scheduling was also a major factor. Interest earned, at £2.5m, was £300,000 above the original budget mainly because cash balances were higher than forecast.

Circulation Under Sensitive Issues Procedures

6. None

Officers to Contact

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PART B

Background

7. 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".

8. 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 in 2003/2004

9. There were no departures from the Treasury Management Policy Statement which was agreed by the Cabinet on 1st April 2003 in relation to the sources and methods of borrowing and approved organisations for lending temporarily surplus funds.

Position at 31st March 2004

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

	31 st March 2004			31 st March 2003		
	Principal	Average Rate	Average Life	Principal	Average Rate	Average Life
Fixed Rate Funding:						
- PWLB	£231.3m	6.37%	40 yrs	£253.6m	6.33%	40 yrs
- Market	£ 2.0m	8.12%	13 yrs	£ 2.0m	8.12%	14 yrs
Variable Rate Funding:						
- Market (1)	£ 30.0m	3.14%	5 yrs	-	-	-
Total Debt	<u>£263.3m</u>	6.02%	37 yrs	<u>£255.6m</u>	6.34%	40 yrs

- (1) Rates guaranteed for at least four more years, thereafter potentially becoming variable rate but with our option to repay in the event of a variation.

11. 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, ESPO and the Combined Fire Authority when dealing in the London money markets. The available balance generally varies between £60m and £120m, and at the end of the 2003/04 financial year stood at £88.4m.

Borrowing Undertaken in 2003/2004

12. The first 3 or 4 months of the financial year saw debt markets preoccupied with the fear of deflation, and Central Banks responding by cutting already low interest rates to ensure that this did not happen. After July economic statistics, particularly in the US, picked up substantially and short and long term interest rates began to rise. This increase in rates was, however, not achieved without the odd period when markets became nervous and as a result the rates available were quite volatile.
13. At the beginning of the year it was anticipated that about £20m of net new debt would need borrowing in order to finance the Capital Programme. In the event the external debt portfolio only increased by £7.7m, and at the year end the difference was being funded via a reduction in the cash available for investment. Cash balances are sufficiently high that this 'internal borrowing' can be, and will be, sustained whilst the interest rate foregone by not having the cash available for lending is lower than the rate that would be payable on loans raised.
14. Although net debt increased by only £7.7m over the course of the year, some £50m of new loans were raised and £42.3m was repaid (£12m on maturity and £30.3m prematurely). Details of the new loans raised are:

Public Works Loan Board (PWLB)

£5m	1 Year Fixed Rate @ 3.40%	13 th May 2003
£5m	1 Year Fixed Rate @ 3.55%	6 th August 2003
£10m	5 Year Fixed Rate @ 4.35%	6 th August 2003

*Market LOBO's **

£10m	5 years/45 years @ 2.99%/4.25%	2 nd June 2003
£10m	5 years/45 years @ 3.44%/4.75%	5 th January 2004
£10m	4 years/50 years @ 2.99%/4.75%	23 rd January 2004

- * A LOBO (Lender's Option/Borrower's Option) is an instrument which guarantees a rate of interest for an initial period of time – in the above cases either 4 or 5 years – after which time the rates will revert to a higher level. After this initial period the lender has the option to increase the rate above that agreed, in which case the borrower may repay without penalty or accept the new rate. Acceptance of the new rate provides a new, and higher, 'floor' for the remaining period.
15. Early repayment of debt – or debt rescheduling when replacement debt is taken – becomes attractive when relatively large differences occur in the interest rates payable on different maturity loans. There was a period in the middle of the 2003/2004 financial year when long term rates rose at a much faster level than short or medium term rates, thereby making it beneficial to repay existing debt with an average of 22 years to maturity and an average rate of 5.39% and replace it with either LOBO's or PWLB debt at lower rates. The net saving on this debt rescheduling is around £500,000 p.a. for at least the next 4 years after which the saving will depend on what decision is taken in respect of the

LOBO's. It is expected that there will continue to be an ongoing saving, albeit at a much smaller level, after this initial four year period.

Investment Undertaken in 2003/2004

16. Bank base rates began the year at 3.75% and were cut by a further 0.25% in July 2003. At this time people's minds were focused on the possibility of deflation and Central Banks throughout the World took decisive action to minimise this risk. With the benefit of hindsight money markets, as usual, overestimated the level to which base rates in the UK would be lowered and also the timing of any subsequent increases. In the event strong economic figures prompted the Bank of England's Monetary Policy Committee to increase rates by 0.25% in both November 2003 and February 2004. The sharp turnaround in sentiment, and interest rates available for 1 year investments, would have been very difficult to foresee.
17. The investment portfolio began the year with a number of loans that had been placed at advantageous rates in the previous financial year. Whilst this was beneficial, the inherent assumption by the market that rates were heading down to around 3% made it unattractive to place longer term monies unless you agreed with this negative outlook. However as existing loans matured and new money was received it became overly risky to keep very large balances invested in short term deposits, as these short term rates are generally volatile. Whilst not fully agreeing with those who predicted ever-lower base rates, it became necessary to place some money in longer term periods. The sharp turnaround in sentiment that occurred makes some of these loans look ill-judged, but over the year as a whole the investment portfolio outperformed its relevant benchmarks.

Performance of Portfolios

18. Investment performance criteria have been well developed and universally accepted. In contrast debt performance indicators are more problematic as almost all debt portfolios are dominated by historic debt which has a large influence on the average rate. The only directly comparable statistics are published annually by CIPFA, a year in arrears, and simply replicate figures produced by each authority. Surprisingly large year-on-year variations for individual authorities have cast some doubt onto the validity of the statistics, so they should be treated with caution.
19. At 31st March 2003 the Leicestershire debt portfolio had an average rate payable of 6.34%, a reduction of 0.13% over the year. This was, for the first time, above the average for English Counties (6.20%) shown in the CIPFA statistics. Whilst it is expected that average rates would have reduced over the financial year – because maturing and new debt will have been borrowed at lower rates than the average of existing portfolios – the extent of the drop by counties in aggregate (by 0.40%) is very surprising, particularly as it is a substantially larger drop than that achieved by other types of authorities. The action taken during 2003/04 reduced the LCC average rate to 6.02%.

20. The average rate achieved on investments during 2003/2004 was 4.02%, which is 0.31% above the average base rate for the year. The most relevant comparator is the Local Authority 7 day Return Index, which calculates the rates actually payable in the market for short term loans – it effectively shows what would happen if no longer term decisions were taken within the portfolio. This index achieved a return of 3.62% over the year (0.09% below base rate), which highlights the weakness of short term deposit rates. In cash terms, the outperformance of the 7 day index earned approximately an extra £250,000 in interest over the year.
21. The performance of the investment portfolio in recent years has been consistently above the relevant benchmark. This consistent outperformance has been achieved by the willingness to make the necessary decisions to lend money for longer periods when the rates available seem attractive. Inevitably not all of these decisions will prove beneficial and the portfolio will underperform at some stage – for example the current financial year has not started particularly well, although there is sufficient time left to turn things around. Since Local Government reorganisation the investment portfolio has outperformed both base rate and 7 day rates in each financial year. Our portfolio has achieved an average return of 5.65% p.a. over the 7 year period; the comparative figures for base rate and the 7 day rate are 5.33% and 5.23% respectively.

Summary

22. Treasury Management is an integral part of the Council's overall finances and the performance of this area is very important. Whilst individual years are obviously important the debt portfolio, in particular, should be viewed on a more medium term basis. The current debt portfolio has an attractive average rate and although it may be difficult to reduce this rate much further, the long term outlook for the portfolio is for a gradually reducing average rate. Any opportunities that arise to improve the medium term position will be actively considered.

Equal Opportunities Implications

None.

Background Papers

Report to Cabinet 1st April 2003 – Treasury Management Strategy for 2003/2004.