EAST AYRSHIRE COUNCIL

POLICY AND RESOURCES COMMITTEE – 30 MARCH 2006

TREASURY MANAGEMENT ANNUAL STRATEGY REPORT FOR 2006/2007

Report by Executive Head of Finance

1. PURPOSE OF REPORT

1.1 To seek the approval of the Committee of the proposed Treasury Management Strategy for the financial year 2006/07 and the prudential indicators in relation to treasury activity which are required to be set and approved by the Council in advance of the financial year.

2. BACKGROUND INFORMATION

2.1 The Local Government in Scotland Act 2003 (via regulation) requires the Council to adopt the CIPFA Prudential Code. The code operates by the provision of prudential indicators and requires the production of an annual treasury management strategy.

2.2 A report to this committee on 8 February 2006 sought members approval of the prudential indicators relating to capital expenditure plans, borrowing levels and affordability. These indicators considered the affordability and impact of capital expenditure decisions. There are further prudential indicators which cover the effective funding of these decisions through treasury activity which require approval and are included in this report.

2.3 Treasury Management is an integral part of the overall financial management of the Council. Its importance has increased as a result of the new freedoms provided by the prudential code. It covers the borrowing and investment activities and the effective management of the risks associated with these processes. Treasury Management activities are strictly regulated by statutory requirements and by the CIPFA Code of Practice on Treasury Management. The Treasury Management Policies and Practices require that the Executive Head of Finance reports on annual treasury strategy to this Committee outlining the forecast activity for the coming year. A further report is produced after the year end to report on actual activity for the year.

2.4 A key requirement of the strategy report is to explain the risks and the management of these risks that are associated with the treasury management service. This strategy report covers: -

- The current treasury position
- The expected movement in interest rates
- The Council's borrowing and debt strategies
- Treasury performance indicators and revenue implications
- Impact of the potential implementation of FRS 25 & 26

3. THE CURRENT TREASURY POSITION

3.1 All monetary transactions of the Council are pooled centrally and operated through the consolidated loan fund (C.L.F) which functions as a central banking function for the Council. Monies are thereafter “advanced” to Departments to meet revenue and capital commitments during the year. Interest is charged or credited to Departments based upon average monthly balances in the same way that a normal bank account would operate.

3.2 The Council’s projected actual and estimated pooled external borrowing and investment position as at 31 March 2006 and 31 March 2007 respectively is shown in the following table: -

		31/3/2006 Projected Actual £M	Average Interest Rate	31/3/07 Estimate £M	Average Interest Rate
External Debt	**PWLB**	123.663	6.532%	123.363	6.525%
	Market	67.101	4.314%	67.100	4.260%
	Other	1.060	5.090%	1.000	5.000%
Total Debt		**191.824**	**5.748%**	**191.463**	**5.723%**
Total Investments		**(39.800)**	**4.870%**	**(40.000)**	**4.550%**
Net External Borrowing		**152.024**	**5.978%**	**151.463**	**6.033%**

4. EXPECTED MOVEMENT IN INTEREST RATES

4.1 The Councils treasury management advisors – Butlers provide an annual economic forecast which is summarised in the following paragraphs.

4.2 The Base Rate was held at 4.5% following the Monetary Policy Committee monthly meeting in March 2006.It is forecast that there is room for a further rate reduction in early to mid 2006/7, following the weak GDP growth resulting from high debt servicing costs and the slowdown in house price inflation. Recovery in growth is expected towards the end of the year.

4.3 The view put forward by the Bank of England is that higher rate growth should result from a combination of increased public spending and investment by the corporate sector. Butlers are of the opinion that such an assumption may be over simplistic, given the volatility of the current economic climate.

4.4 On the international front the uncertainty experienced in the major economic markets create potential problems in forecasting. Traditionally, UK long term rates have been heavily influenced by the performance of the US rates. At present there is substantial pressure to increase rates in the US which would, in turn, increase the upward pressure on UK rates.

4.5 The rate of inflation expected in 2 years time, the indicator used to help determine interest rate decisions, currently sits within the 2 to 2.5% target set by the government. There are no major inflationary pressures prevailing at present although future concerns on oil and general power costs may change this view.

4.6 Butlers' forecast is shown below indicating a slight reduction in 2006/07 in the Base Rate before a gradual upward turn resulting from stronger growth in GDP.

Medium-Term Rate Forecasts – Annual Averages %

Year	Base Rate	5-year Gilt	20-yr Gilt
2005/06	4.6	4.3	4.5
2006/07	4.3	4.4	4.6
2007/08	4.5	4.6	4.7
2008/09	4.8	4.8	4.7

4.7 The forecast is based on modest growth experienced by the UK economy and other major world economies. If, however, this growth is not achieved, there is a real danger that interest rates will fall significantly. The majority view is that this scenario will be avoided and that moderate to high growth is the more likely outcome.

5. BORROWING AND DEBT STRATEGY 2006/07- 2008/09

5.1 The growing uncertainty over future interest rates increases the risks associated with treasury activity and the Council will continue take a cautious approach to its treasury strategy.

5.2 The Council's estimated capital financing or net borrowing requirement for 2006/07 and future years is as follows :.

	2006/07 Estimated £M	2007/08 Estimated £M	2008/09 Estimated £M
Capital Financing Requirement	23.267	11.443	9.627

5.3 Long-term fixed interest rates are expected to rise modestly and base rates are expected to fall initially by ¼% before rising again in 2007/08. The Executive Head of Finance, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above. It is likely that longer term fixed rates will be considered if borrowing rates remain relatively low.

5.4 During 2005/06 a rescheduling exercise was carried out in which a £9.700M market loan with a maturity period of 40 years and a 4.625% variable rate was repaid and replaced with a £9.7M market loan with a maturity period of 60 years and a three year initial fixed rate of 4.250% before reverting to 4.625% variable rate for the remainder of the loan. No premium was payable and the savings over the initial 3 years are estimated at £0.095M.

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5.5 With the likelihood of increasing interest rates future debt restructuring is likely to take place later in 2006/07 or in future years, although the Executive Head of Finance and treasury consultants will monitor prevailing rates for any opportunities during the year taking account of any impact of accounting changes highlighted later in this report.

6. INVESTMENT STRATEGY 2006/07 - 2008/09

6.1 The main principle governing the Council's investment criteria is the security and liquidity of its investments before yield, although the yield or return on the investment will be a consideration, subject to adequate security and liquidity. Adopting this main principle, action will be taken to ensure:

(a) There is liquidity within the investment portfolio. For this purpose consideration will be taken of the maximum periods for which funds may be prudently committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

(b) That a policy is maintained covering the categories of investment types selected to invest in, the criteria for choosing investment counterparties with adequate security, and the monitoring of their security.

6.2 The Executive Head of Finance maintains a counterparty list in compliance with the criteria set out within the approved Treasury Policies and Practices. This is reviewed on a regular basis in conjunction with the treasury advisors to ensure the maximum availability in investment opportunity.

6.3 The existing counterparty limits in the treasury management policy and practices are as follows:-

Counterparty	Limit
UK Clearing Banks	£4M
Overseas Banks	£1M
Building Societies	£1M - £5M
UK Local Authorities & Public Bodies	£5M

These limits are the maximum permissible. However as the council continues to hold significant cash investment balances it is proposed that these limits can be increased to up to £10M for UK clearing banks and building societies by the Executive Head of Finance. Any increase being separately determined by individual organisation and dependant on the credit rating of the specific organisation and the advice of our treasury advisors. The existing restriction of no more than 25% of the total investment portfolio being held with any single counterparty would be maintained.

6.4 Expectations on shorter-term interest rates, on which investment decisions are based, show a likelihood of falling by ¼% in early 2006 and potentially rising again in 2007. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts. It is likely that investment decisions will be made for longer periods with fixed investments rates to lock in good value and security of return if opportunities arise. The Executive Head of Finance, under delegated powers, will undertake the most appropriate form of investments depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above.

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7. TREASURY MANAGEMENT PRUDENTIAL INDICATORS AND LIMITS ON ACTIVITY

7.1 The Council adopted the Code of Practice on Treasury Management on 2 May 2002, and as a result adopted a treasury management policy and practices statement. This adoption meets the requirements of the first of the treasury prudential indicators.

7.2 There are four further treasury prudential indicators. The purpose of these prudential indicators is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to reduce costs. The indicators are:

(a) Upper limits on variable rate exposure – This indicator identifies a maximum limit for variable interest rates based upon the debt position net of investments.

(b) Upper limits on fixed rate exposure – Similar to the previous indicator this covers a maximum limit on fixed interest rates.

(c) Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

(d) Total principal funds invested for greater than 364 days – These limits are set to reduce the need for early sale of an investment, and are based on the availability of investments after each year-end. The use of investments greater than 364 days, although under review, is currently prohibited in Scotland, so this indicator is set as nil. Indicative rates are proposed that would be adopted if legislation is enabled in the forthcoming financial year.

The Council is asked to approve the following prudential indicators:

Interest rate Exposure: -

	2006/07 Upper Limit	2006/07 Upper Limit	2007/08 Upper Limit
Debt – variable rate interest	50%	50%	50%
Debt – fixed rate interest	100%	100%	100%

Maturity of Long Term External Debt: -

Maturity Period	Upper Limit	Lower Limit
Under 12 months	10%	0%
12 months to 2 years	10%	0%
2 years to 5 years	10%	0%
5 years to 10 years	25%	0%
10 years and above	100%	0%

Indicative Upper Limits on Sums Invested for more than 364 Days: -

Investment Period	Upper Limit
Under 12 months	100%
12 months to 2 years	40%
2 years to 5 years	10%
5 years to 10 years	5%
10 years and above	5%

8. PERFORMANCE INDICATORS

8.1 The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. Examples of performance indicators often used for the treasury function are:

(a) Investment Activity – Comparison of average interest rates achieved for investments compared to average 7 day rate available.

(b) Comparison of average rate of interest and expenses incurred during the financial year – “Pool Rate”.

The results of these indicators will be reported in the Treasury Annual Report for 2005/06.

9. REVENUE IMPLICATIONS 2006-07 ONWARDS

9.1 The following table sets out the assumptions made about interest and expenses together with debt redemption in setting the annual debt charges estimates for 2006/07 and the subsequent 2 financial years.

LOANS FUND REVENUE ACCOUNT	2006/07 £M	2007/08 £M	2008/09 £M
Interest	12.570	13.685	14.230
Loans Fund Expenses	0.300	0.320	0.350
Annual Cost of Premiums	0.440	0.440	0.440
Principal Redemption In Year	6.390	7.190	8.015
Investments – Interest Received	(1.000)	(1.000)	(1.000)
Total Costs to Recharge in Year	**18.700**	**19.900**	**21.100**
Service Allocation	**2006/07 £M**	**2007/08 £M**	**2008/09 £M**
General Fund Services	13.500	14.500	15.500
Housing Revenue Account	5.200	5.400	5.600
Total	**18.700**	**19.900**	**21.100**

9.2 These estimates will provide a base position against which the performance of the loans fund will be monitored and reported on during the financial year.

10. FINANCIAL REPORTING STANDARDS FRS 25 AND FRS 26

10.1 On a regular basis CIPFA / LASAAC issue consultation papers on the impact of the introduction of Financial Reporting Standards (FRS) on Local Government finance.

10.2 In November 2005 CIPFA / LASSAC issued a consultation paper covering FRS 25 - Financial Instruments: Disclosure and Presentation and FRS 26 - Financial Instruments: Measurement. These papers relate to the accounting treatment of loans and investments and are due to be implemented in the financial year 2007/08. Of particular relevance is the inclusion of standards covering the trading of loans and investments and accounting for any profits or losses associated with this activity.

10.3 These types of papers are of a technical accounting nature, and do not normally impinge on Council policy. However the potential impact of the specific proposals contained within FRS25 and 26 on the Council's financial position is of particular significance.

10.4 The consultation paper proposes that any profits or losses arising from trading in loans and investments must be accounted for in the year in which they arise. In Local Authority terms, profits and losses will arise when there has been a loan debt restructuring exercise.

10.5 Existing accounting arrangements are that any profits or losses arising from the restructuring of Council's loans must be matched with the economic benefit arising from these activities. Thus they are spread over the life of the replacement loans.

10.6 The adoption of the proposed accounting standard would have a direct impact on the Treasury Management activities of the Council and indeed across the whole public sector. The specific areas that this would impact on are:

- premiums arising from previous Debt Restructuring exercises

- The ability to actively and effectively manage the Treasury Management activity of the Council

10.7 As at 31st March 2005 the Council had premiums outstanding arising from previous loan debt restructuring exercises of £15.712M. The current arrangements are that the average period that these sums are re-charged to the Revenue account is 35.94 years. If they had to be written off in one year in 2007/08 the Council would need to achieve additional savings of the outstanding amount at that time, estimated at £14.832M, or increase council tax by around 35% to fund this cost.

10.8 The Executive Head of Finance has written to the Chartered Institute of Public Finance and Accountancy expressing concern over the impact if FRS 25 & 26 are adopted as they stand. The Scottish Executive are also aware of the position.

11 FINANCIAL IMPLICATIONS

11.1 The financial implications of the proposed Treasury Management Strategy have been included within the respective estimates for the General Fund and the Housing Revenue Account for 2006/07.

12 POLICY/LEGAL IMPLICATIONS

12.1 The Treasury Management Policies and Practices will be updated as appropriate to reflect the above.

13 RECOMMENDATIONS

It is recommended that the Committee: -

13.1 authorise the Executive Head of Finance to increase the counterparty investment limits to £10M as outlined in paragraph 6.3.

13.2 recommend to the Council that the Prudential Indicators set out in paragraph 7.2 are approved. and

13.3 otherwise, note the content of the report.

Alex McPhee
Executive Head of Finance

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13 March 2006

LIST OF BACKGROUND PAPERS
NIL

Any person who wishes any further information on this report should contact Lorna Service, Exchequer Manager, Tel 01563 576405