



POLICY AND RESOURCES COMMITTEE 21 JUNE 2007

ANNUAL TREASURY MANAGEMENT REPORT

Report by Director of Finance and Corporate Resources

PURPOSE OF REPORT To provide Members with a report on the Comhairle's treasury activities for 2006/07

COMPETENCE

- 1.1 CIPFA's Code of Practice for Treasury Management requires a report on the activities of the preceding year's treasury operation, including annual measurements of performance.
- 1.2 Borrowing operations of local authorities are governed by the Local Government in Scotland Act 2003. This report is wholly concerned with financial matters.
- 1.3 Section 35 of the Local Government in Scotland Act 2003 governs the capital spending power of Scottish Local Authorities. From 1 April 2004 this is determined by way of an agreed Prudential Code for Capital Finance in Local Authorities.

SUMMARY

- 2.1 This report illustrates that, compared to budget, Loan Charges for 2006/07 produced savings of £420,571. The savings resulted from:
 - a) the effect of the write-off of debt associated with Housing Stock Transfer;
 - b) the effect of replacing £15m PWLB debt with an average rate of 4.483% with £15m PWLB with an average rate of 4.10%;
 - c) borrowing at rates below those budgeted;
 - d) slippage in the Capital Programme; and
 - e) the judicious investment of surplus cash balances.
- 2.2 This report also confirms the Comhairle's compliance with the Prudential Indicators which were set for 2006/07.

RECOMMENDATION

- 3.1 **It is recommended that the Report be noted.**

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Appendices:
A: Loan Charges 2006/07
B: Comhairle Approved Lending List
C: Monthly Investment Balances
D: PWLB Debt Maturity Profile

BACKGROUND

- 4.1 Treasury Management in Local Government is governed by the CIPFA Code of Practice on Treasury Management in the Public Services and in this context is the “management of the Council’s cash flows, its banking and its capital market transactions; the effective control of the risks associated with those activities and the pursuit of optimum performance consistent with those risks”. The Comhairle has adopted the Code and complies with its requirements, one of which is the receipt by Policy and Resources Committee, of an Annual Strategy Report for the forthcoming financial year and an Annual Review Report after the financial year-end.
- 4.2 The Prudential Capital Finance System came into force on 1 April 2004. The Comhairle determines its own capital expenditure and can borrow or use alternative financing methods to finance capital spending provided that capital plans are demonstrably affordable, prudent and sustainable. The Prudential Code for Capital Finance in Local Authorities requires indicators to be set – some of which are limits – for a minimum of three forthcoming financial years.

SCOPE

- 5.1 This Annual Report covers:
- The Comhairle’s debt and investment positions at the beginning and end of the year;
 - The forecast for, and the prevailing economic background during the year;
 - The strategy for borrowing and other financing options for the year and its outcome;
 - Debt restructuring activity and its impact on the debt portfolio;
 - The annual investment strategy and its outcome;
 - Compliance with Treasury Limits and Prudential Code indicators;
 - Housing Stock Transfer.

PORTFOLIO POSITION

- 6.1 The Comhairle’s debt and investment positions were:

	Balance at 01/04/06 £k	%	Premature redemptions £k	Maturing loans £k	New Borrowing £k	Balance at 31/03/07 £k	%
Long-term Borrowing							
Fixed rate loans - PWLB	179,780	6.92	53,539	7,164	27,000	146,077	6.69
Fixed rate loans – Market	2,000	10.72	0	0	0	2,000	10.72
Variable rate loans - PWLB	0		0	0	0	0	
Variable rate loans – Market	14		0	0	0	14	
Temporary Borrowing	0		0	36,500	36,500	0	
Total Borrowing	181,794	6.96	53,539	43,664	63,500	148,091	6.74

	Balance at 01/04/06 £k	%	Investments Made £k	Investments Repaid £k	Balance at 31/03/07 £k	%
TOTAL INVESTMENTS	6,485	4.50	742,235	744,246	4,474	5.25

ECONOMIC OUTLOOK FOR 2006/07

7.1 At the time of determining the Treasury Strategy Statement for 2006/07, the outlook for the economy and interest rates was as follows:

- a) Base rate was 4.50% at the beginning of calendar year 2006.
- b) Longer-term inflation expectations appeared to be well contained. The Bank of England's November 2005 Inflation Report was more sanguine about moderating inflation expectations.
- c) House price inflation was expected to slow and facilitate the stabilisation of the housing market.
- d) Data from the British Retail Consortium (BRC) and the CBI painted a hesitant outlook for the retail sector. However, the UK services sector was forecast to show resilience and shrug off High Street woes.
- e) UK GDP was expected to recover from the low of 1.75% in 2005 to 2%-2.5% in 2006, the budgetary shortfall being made up through higher gilt sales.
- f) The view was that the Bank of England's Monetary Policy Committee would respond to the benign inflation outlook and the softer-than-expected growth prospects by cutting rates later in 2006.

OUTTURN FOR THE ECONOMY AND INTEREST RATES

8.1 UK Economic data and events;

- a) UK CPI (Consumer Price Index) was generally on an upward trend although it exhibited some volatility month on month. The February 2007 inflation projection showed a more volatile pattern for CPI and pointed to increasing uncertainty in the Bank's overall forecast.
- b) The MPC had been concerned about 'second round effects' i.e. higher inflation feeding into higher wage settlements and creating a wage-price spiral. RPI, which is the traditional measure used for wage settlements had risen to 4.6%. However, wage growth actually moderated in the new year wage round (January's average earnings excluding bonus slowed to 3.6%) as inward migration continued to weigh against wage increases.
- c) House prices growth remained buoyant with both Halifax and Nationwide reporting near 10% growth year-on-year. However, mortgage approvals showed signs of slowing as higher interest rates increasingly stretched affordability. However, this was offset by limited housing supply and looser lending policies by mortgage providers and explained the resilience of this sector.
- d) The Bank of England's MPC surprised markets by raising rates by 0.25% to 4.75% in August 2006 although the decision failed to muster unanimous support. Rates were raised by 0.25% in November and again in January 2007 to reach 5.25% by the financial year-end. The January increase delivered in a 'non-Inflation Report month' was a shock to economists and markets alike. However, strong December 2006 Consumer Price Inflation (CPI) at 3% y/y, which is the outer boundary of the MPC's inflation remit, backed-up the Committee's decision.

8.2 Impact on money markets and bond markets:

- a) Money market rates benefited from the favourable assessment of the UK economy and an upward shift in interest rate expectations. By the end of the fourth quarter of the financial year, the money markets had built in two 0.25% increases in interest rates to 5.75%. 12-month rates benefited the most during the financial year, rising by 1.1% during the 12-month period.
- b) Gilt yields rose across all maturities. As expectations for cuts in rates quickly gave way to expectations of increases, short-dated gilts (i.e. 0-5 years) bore the brunt, rising over 0.80% and returned just 3% for the financial year. The increase in long-dated gilt yields was less pronounced and yields fluctuated within a narrower band during the year; the low point was in October. The 30-year gilt yield rose nearly 30bp ending the year at 4.42%, the 50-year gilt yield rose 0.23% ending the year at 4.20%.

LONG-TERM BORROWING

9.1 Since 1992 the Comhairle has adopted a strategy focused towards longer-term objectives. This includes the maintenance of the debt and investment portfolio on a low cost, low risk basis

9.2 The approved framework for 2006/07 featured the following:

- a) permission to borrow forecast net cash flows up to one year in advance;
- b) an obligation to maintain a prudent level of variable rate interest borrowing, up to a maximum ratio of variable to overall debt of 40%;
- c) to obtain long-term funding at the cheapest rate possible or at least consistent with the rates contained in the revenue budget. (Budgeted long-term was 4.75% and short-term was 4.50%);
- d) to maximise the use of PWLB borrowing which is commonly the cheapest and most flexible means of finance.

9.3 The central forecast for long-dated PWLB rates (i.e. 30-50 years) was that they would trend between 4.20% to 4.40% (30 years) and between 4% and 4.25% (50 years). The Comhairle's strategy was to fund its borrowing requirement at optimum rates and with a spread of maturities. This was achieved with the help of the Comhairle's Treasury Consultants who monitor the markets and advise on all aspects of borrowing.

9.4 The following loans were raised during the year:

Date	Lender	Principal £	Rate %	Period of loan (years)
20/09/06	PWLB	1,500,000	4.20	46
20/09/06	PWLB	1,500,000	4.20	47
20/09/06	PWLB	1,500,000	4.20	48
20/09/06	PWLB	3,500,000	4.20	49
06/11/06	PWLB	1,000,000	4.05	45 ½
06/11/06	PWLB	1,000,000	4.05	46 ½
06/11/06	PWLB	1,000,000	4.05	47 ½
06/11/06	PWLB	1,000,000	4.05	48 ½
		£12,000,000		

which includes the refinancing of £7.164m of debt which matured in 2006/07.

9.5 The Comhairle operates a loans pool so that loans are not linked to specific assets. Thus all borrowing is aggregated. Also, there is no requirement to separately identify loans that relate to unsupported borrowing i.e. Prudential Borrowing.

DEBT RESTRUCTURING

10.1 The main objective of debt restructuring is to reduce the Comhairle's overall exposure to the risk of interest rate movements, to lower the long-term interest charges paid on its debt, to smooth the maturity profile without compromising the overall longer-term stability, or to alter its volatility profile (i.e. exposure to variable rate debt).

10.2 The Comhairle undertook the following restructuring activity during the year:

Loans repaid/restructured:

Date	Lender	Principal £	Rate %	Premium/(Discount)
18/07/06	PWLB	321,775	4.50	(7,111)
18/07/06	PWLB	614,125	4.50	(13,571)
18/07/06	PWLB	3,000,000	4.45	(46,643)
18/07/06	PWLB	4,000,000	4.40	(43,564)
18/07/06	PWLB	3,650,962	4.50	(49,962)
18/07/06	PLWB	2,500,000	4.60	0
18/07/06	PWLB	1,000,000	4.55	(7,134)
		£15,086,862		£167,985

Replacement Borrowing:

Date	Lender	Principal £	Rate %	Period of loan
27/09/06	PWLB	2,000,000	4.10	40 ½
27/09/06	PWLB	2,500,000	4.10	41 ½
27/09/06	PWLB	4,500,000	4.10	42 ½
27/09/06	PWLB	3,000,000	4.10	43 ½
27/09/06	PWLB	3,000,000	4.10	44 ½
		£15,000,000		

- 10.3 The above restructuring achieved a reduction in the overall debt cost whilst increasing the average life and the smoothing of the maturity profile.
- 10.4 Discounts arising on premature redemption were written off in the year in accordance with the 2006 SORP.
- 10.5 The 2007 SORP introduces changes to the accounting treatment for premiums and discounts arising from debt restructuring. The Scottish Executive has produced guidance under Section 12(2)(b) of the Local Government in Scotland Act 2003 to mitigate some of the effects on revenue arising from the revised treatment of premiums and discounts. Consequently there is no effect on the outstanding premium held on the Balance Sheet at 31/03/07 relating to previous restructuring exercises.
- 10.6 As a result of new borrowing, maturities during the year and debt restructuring activity, the average rate on the Comhairle's debt changed from 6.96% at 31/03/2006 to 6.74% at 31/03/2007.

ANNUAL INVESTMENT STRATEGY AND OUTTURN

- 11.1 In the absence of Statutory Guidance on Local Government Investments in Scotland, the Comhairle places its investments with regard to risk aversion, liquidity requirements, interest receivable whilst retaining flexibility for debt management alternatives.
- 11.2 Investments attracted an average rate of 4.83% during the year and produced a total of £231k of income. This reflected the healthy position of reserves and balances held by the Comhairle during 2006/07 and the increased trend towards funding specific projects in the Capital Programme by Capital Grant.
- 11.3 Appendix C details the investments held at the end of each month throughout 2006/07.
- 11.4 All investments made during the year complied with the Comhairle's agreed Treasury Management Strategy, Prudential Indicators, Treasury Management Practices and prescribed limits. Maturing investments were repaid to the Comhairle in full and in a timely manner.

COMPLIANCE WITH TREASURY LIMITS AND PRUDENTIAL INDICATORS.

- 12.1 The 2003 Prudential Code for Capital Finance in Local Authorities requires the Comhairle to set a number of Prudential Indicators for the financial year and the two succeeding years. Indicators may be revised during the year but need Comhairle approval.
- 12.2 The recommended Prudential Indicators for 2006/07 were approved by Policy and Resources Committee on 30 March 2006. The Indicators are local to the Comhairle and were based on the decisions of the Comhairle regarding the revenue budget and capital programme.

12.3 Actual Capital Expenditure

This indicator is set to ensure that the level of proposed investment in capital assets remains within sustainable limits and, in particular, to consider the impact on the Comhairle. The Comhairle's capital plan as approved for 2006/07 had a neutral impact on council tax. This reflects the fact that capital costs were financed from traditional resources (grants and capital receipts) and that any borrowing undertaken is supported through the Revenue Support Grant system

Prudential Indicator	2006-07	2006-07
	Estimated £k	Outturn £k
General Fund Capital Expenditure	14,316	14,810

12.4 Estimated and Actual Ratio of Financing Costs to Net Revenue Stream

This is an indicator of affordability and demonstrates the revenue implications of capital investment decisions by highlighting the proportion of the revenue budget required to meet the borrowing costs associated with capital spending.

Prudential Indicator	2006-07	2006-07
	Estimated %	Outturn %
General Fund Ratio of Financing Costs to Net Revenue Stream	11	11

12.5 Capital Financing Requirement

The Capital Financing Requirement (CFR) measures a Council's underlying need to borrow for a capital purpose. In order to ensure that over the medium term net borrowing will only be for a capital purpose, the Comhairle ensures that net external borrowing does not, except in the short term, exceed the Capital Financing Requirement in the preceding year plus the estimates of any additional CFR for the current and next two financial years.

12.6 The Comhairle met this requirement in 2006/07.

31/03/2006	31/03/07	31/03/07	31/03/08	31/03/09
Actual £k	Estimated £k	Outturn £k	Estimated £k	Estimated £k
151,934	155,530	152,215	161,000	161,000

Authorised Limit and Operational Boundary for External Debt

12.7 The Local Government in Scotland Act 2003 and supporting regulations require the Comhairle to decide and keep under review how much it can afford to allocate to capital expenditure and how much it can afford to borrow. The limit on borrowing is referred to in the Prudential Code as the Authorised Limit.

12.8 The Limit has been set on the estimate of the most likely, prudent but not worst case scenario for its total external debt gross of investments with, in addition, sufficient headroom over and above this to allow for unusual cash movements. The limit is consistent with the Comhairle's existing commitments, proposals for capital expenditure and financing and with its approved treasury management policy statement and practices. A change in the Authorised Limit would automatically trigger a review of all indicators having regard to their affordability.

12.9 The Comhairle's Authorised Limit was set at £215m for 2006/07. The Comhairle maintained its total external borrowing and other long-term liabilities well within this limit.

12.10 The Director of Finance and Corporate Resources has delegated authority to effect movement between the separately agreed limits for borrowing and other long-term liabilities as deemed prudent and best value for money. No such movements were made in the 2006/07.

- 12.11 The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit.
- 12.12 The Operational Boundary was set at £203m.
- 12.13 The Director of Finance and Corporate Resources confirms that there were no breaches to the Authorised Limit and the Operational Boundary during the financial year.

HOUSING STOCK TRANSFER

- 13.1 On 12 September 2006, the Comhairle's Housing Stock was transferred to the Hebridean Housing Partnership. At the same time £37,663,450 of debt and associated premium of £16,685,691 was written off by the Scottish Executive. In addition the HRA share of outstanding premium relating to previous restructuring exercises, of £788,777, was written off by the Scottish Executive at the same time.