CABINET

10 JULY 2012

TREASURY MANAGEMENT OUTTURN ANNUAL REPORT

Report from: Mick Hayward, Chief Finance Officer

Author: Andy Larkin Finance Support Manager

Summary

This report gives an overview of treasury management activity during 2011/12.

1. Budget and Policy Framework

1.1 The council's treasury management strategy and policy are approved by Full Council following consideration by Business Support Overview and Scrutiny and Cabinet. However, Full Council approved that reporting of the Treasury Management Annual Outturn is to Cabinet followed by Audit Committee.

2. Background

2.1 This Council is required through regulations issued under the Local Government Act 2003 to produce an annual treasury report reviewing treasury management activities and the actual prudential and treasury indicators for 2011/12. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

2.2 During 2011/12 the minimum reporting requirements were that the full Council should receive the following reports:

- An annual treasury strategy in advance of the year (Council 24 February 2011)
- A mid-year (minimum) treasury update report (Council 12 January 2012)
- An annual report following the year describing the activity compared to the strategy (this report).

2.3 Recent changes in the regulatory environment place a much greater onus on Members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by Members.

2.4 This Council also gives prior scrutiny of the Treasury Strategy, with a mid year review submitted to the Business Support Overview and Scrutiny Committee before reporting to the full Council. The revised Code of Practice introduced by CIPFA (following the Icelandic banking collapse) and adopted as part of the Council's Treasury Strategy for 2009/10 prompted training for Members as a discreet issue preceeding that strategy change. This was then supplemented with a follow up session in the Autumn. Future training will be incorporated as part of the member induction programme.

2.5 This annual treasury outturn report covers:

- The Council's treasury position as at 31 March 2012;
- Borrowing activity 2011/12;
- Performance measurement
- The strategy for 2011/12
- The economy and interest rates in 2011/12
- Borrowing rates in 2011/12
- The borrowing outturn for 2011/12
- Debt rescheduling;
- Compliance with treasury limits and Prudential Indicators;
- Investment rates in 2011/12
- Investment outturn for 2011/12

3. The Economy and Interest Rates

3.1 The financial year 2011/12 continued the challenging investment environment of the past few years, namely low investment returns and continuing heightened levels of counterparty risk. The original expectation for 2011/12 was that Bank Rate would start gently rising from quarter 4, 2011. However, economic growth in the UK was disappointing during the year due to the UK austerity programme, weak consumer confidence and spending, a lack of rebalancing of the UK economy to exporting and weak growth in our biggest export market - the European Union (EU). The UK coalition Government maintained its tight fiscal policy stance against a background of warnings from two credit rating agencies that the UK could lose its AAA credit rating. Key to retaining this rating will be a return to strong economic growth in order to reduce the national debt burden to a sustainable level. The USA and France lost their AAA credit ratings from one rating agency during the year. Weak UK growth resulted in the Monetary Policy Committee increasing quantitative easing by £75bn in October and another £50bn in February. Bank Rate therefore ended the year unchanged at 0.5% while CPI inflation peaked in September at 5.2%, finishing at 3.5% in March, with further falls expected to take the index below 2% over the next two years. The EU sovereign debt crisis grew in intensity during the year until February when a second bailout package was eventually agreed for Greece, followed by the more recent uncertainty over the political structure in the country.

3.2 Gilt yields fell for much of the year, until February, as concerns continued building over the EU debt crisis. This resulted in safe haven flows into UK gilts which, together with the two UK packages of quantitative easing during the year, combined to depress PWLB rates to historically low levels.

3.3 Investment rates. The overall balance of risks is weighted to the downside and a low Bank Rate, coupled with a possible extension of quantitative easing, has kept investment returns depressed.

4. Treasury Position as at 31 March 2012

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

Table 1 – borrowing and investment levels

Description of debt/investment	31 March 2012 Principal £m	31 March 2012 Rate %	31 March 2011 Principal £m	31 March 2011 Rate %
Borrowing				
- fixed rate borrowing	182.3		173.3	
- variable rate borrowing	0.1		0.1	
Total debt	182.4	4.16	173.4	3.98
Investments				
- in-house	42.4	1.42	46.6	0.99
- fund managers	22.9	1.77	22.5	1.17
Total investments	65.3	1.51	69.1	1.03

5. Borrowing Activity 2011/2012

5.1 The borrowing strategy for the council confirmed the holding of £101.8 million in Lenders Options, Borrowers Options (LOBO) debt. These are debts that are subject to immediate repayment or variation of interest chargeable and the option to repay, on request from the lender on the review dates. However, the lender can only apply this clause once within the lifetime of the LOBO. This type of borrowing has therefore been classed as fixed rate.

5.2 Due to the very low interest rates being earned on investments and restrictions to mitigate counterparty risk, officers have been repaying existing and deferring taking out new debt.

5.3 The implementation of housing finance reform at the end of the year abolished the housing subsidy system financed by central government and, consequently, all housing debt has been reallocated nationally between housing authorities. The result of this reallocation is that this Council made a capital payment to the Department of Communities and Local Government of £19.144m. This resulted in an increase in the Capital Financing Requirement (CFR) and total borrowing of £19.144m at the end of the year which was financed by new external borrowing of £19.144m from the Public Works Loans Board (PWLB) at preferential interest rate. There has been no impact on HRA revenue finances in 2011/12 due to compensating adjustments being made in the HRA determination.

6. The Strategy for 2011/12

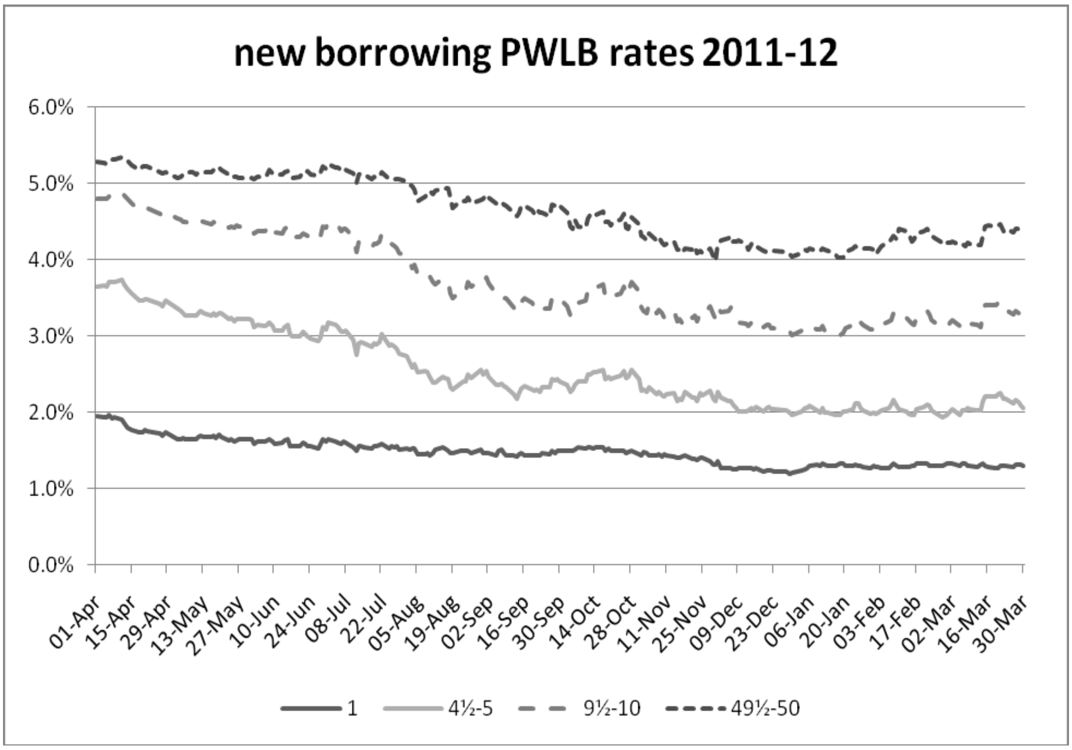
6.1 The expectation for interest rates within the strategy for 2011/12 anticipated low but rising Bank Rate rising to 1.00% by March 2012. However, in reality the bank rate has remained at the historically low level of 0.5% throughout this period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

6.2 In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of low return investments and reduce the counterparty risk.

7. Borrowing rates in 2011/2012

7.1 PWLB borrowing rates - the graph below shows how PWLB rates fell to historically very low levels during the year.

Table 2 - PWLB new Borrowing rates 2011-12



8. Borrowing Outturn for 2011/12

8.1 During 2011/12 the only new borrowing undertaken was a £19.144m 25 year PWLB loan to fund the Housing Finance reform. At the stage of compiling the Borrowing Strategy for 2011/12, the best indication was that this transaction would occur in 2012/13, however, the CLG subsequently announced that the transactions would occur on 28 March 2012. As a consequence in our strategy we had anticipated a year end debt position of £163.3m whereas this transpired to be £182.4m

8.2 As highlighted in section 4 above the average debt portfolio interest rate has moved over the course of the year from 3.98% to 4.16% and the total debt increasing by some £9m as £10m debt fell due for repayment and was not replaced, but new borrowing of £19.144m taken out. The approach during the year was to use cash balances to finance new capital expenditure or maturing debt so as to run down cash balances and minimise counterparty risk incurred on investments. This also maximised treasury management budget savings, as investment rates were much lower than most new borrowing rates.

9. Debt Rescheduling

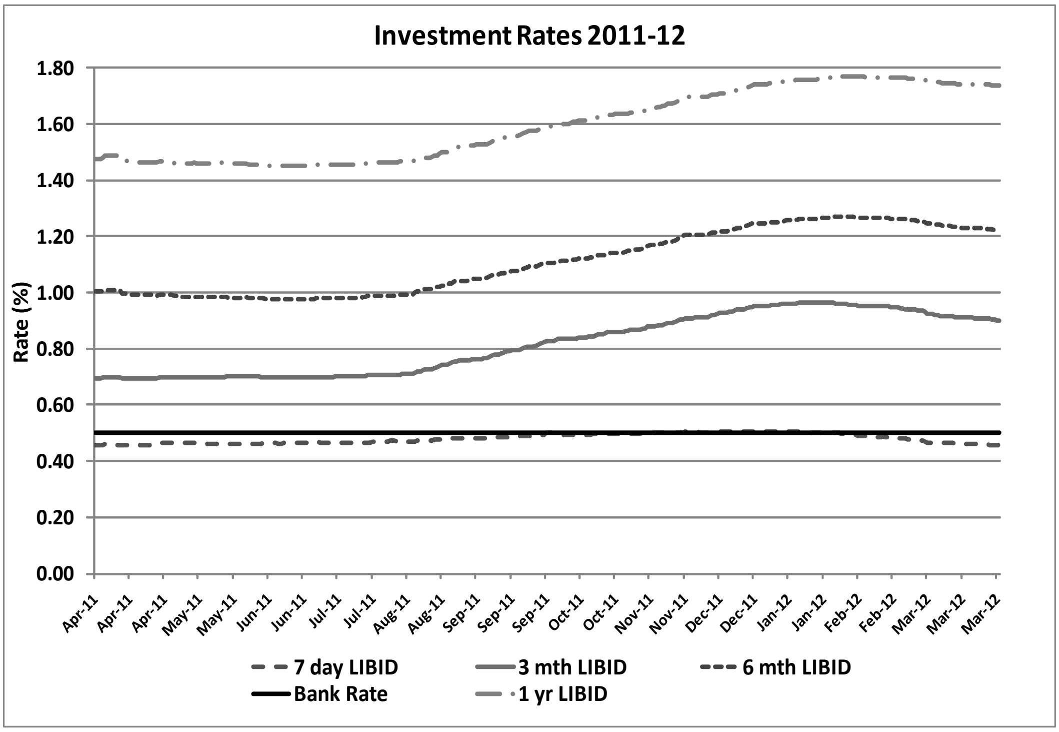
9.1 No debt restructuring was undertaken during 2011/12 and it is not envisaged that that there will be any opportunities where the debt restructuring would be economically viable in 2012/13.

10 Investment Rates in 2011/12

10.1 The tight monetary conditions following the 2008 financial crisis continued through 2011/12 with little material movement in the shorter-term deposit rates. However, one month and longer rates rose significantly (in relative terms) in the second half of the year as the Eurozone crisis grew. Bank Rate remained at its historic low of 0.5% throughout the year while market expectations of the start of monetary tightening were gradually pushed further and further back during the year to the first quarter of 2014 at the earliest.

10.2 Overlaying the relatively poor investment returns were the continued counterparty concerns generated by the Eurozone sovereign debt crisis.

Table 3 – Investment rates 2011/12



11 Investment Outturn for 2011/2012

11.1 **Investment Policy** - The Council's investment policy is governed by CLG guidance, which was implemented in the Annual Investment Strategy (which is incorporated within The Treasury Management Strategy Statement) that was approved by Council on 24 February 2011. This policy sets out the approach for choosing investment counterparties for the in-house team, and is based on credit ratings provided by the three main credit rating agencies supplemented by additional market data (such as rating outlooks, credit default swaps etc.). The Council also employs an external fund manager Investec and they have their own policy setting out their approach for choosing investment counterparties which also was approved at Council on the 24 February 2011.

11.2 **Internally Managed Investments** – The Council manages its investments in-house and invests with the institutions listed in the Council's approved lending list. The council can invest for a range of periods from overnight to 5 years dependent on the Council's cash flows, the durational and counterparty limits set out in the approved investment strategy, its interest rate view and the interest rates on offer. During the year all investments were made in full compliance with the council's treasury management policies and practices. The Annual Investment Strategy, outlines the Council's investment priorities as 1) Security of capital and 2) Liquidity and lastly the Council seeks to achieve optimum return (yield) on investments commensurate with the proper levels of security and liquidity.

11.3 **Externally Managed Investments** – The Council also has investments managed externally by Investec. The fund management agreement between the Council and the Fund Manager defines the limits for maximum weighting in gilts/bonds and maximum duration of the fund. Counterparty criteria and exposure limits are also pre-defined therein.

11.4 **Investment performance for 2010/11 –** Detailed below is the result of the investment strategy undertaken by the Council.

Table 4 Investment Performance 2010/11

	Average Investment	Rate of Return (gross of fees)	Benchmark Return *
Internally Managed	£63.740	1.42%	Cash Fund Manager 1.773%
Externally Managed	£22.460m	1.773%	7 Day Local Authority Deposit Rate 0.40% In-House team 1.42%

11.5 No institutions in which investments were made during 2011/2012 had any difficulty in repaying investments and interest in full during the year.

12 Compliance with Treasury Limits

12.1 During the financial year the Council operated within the Treasury Limits and Prudential Indicators set out in the Council's annual Treasury Strategy Statement. The outturn for the Prudential Indicators is shown in appendix 1.

13 Risk Management

13.1 As stated within the Treasury Strategy, a key driver for the review of the CIPFA code has been the exposure to risk evidenced by the Icelandic investments and more generally by the financial crisis. Risk and the management thereof is a key feature throughout the strategy and in detail within the treasury management practices (TMP1) within the Treasury Strategy.

14 Financial and Legal Implications

14.1 Overall the Interest and Financing budget made a surplus over it's targeted budget by £0.272m. In light of the continued historically low bank rate which continued at 0.5% throughout 2011/12, the overall rate achieved for the in-house team was 1.42% and 1.77% for the fund manager averaging an overall return of 1.51%. The body of the report and the appendices outline the significant financial implications. Any transactions undertaken on either investments or borrowings are governed by the London Code of Conduct, the council's treasury policy statement, and the CIPFA Code of Practice on Treasury Management in Local Authorities.

14.2 Legal implications – For the financial year 2011/12 our investments were managed in compliance with the Codes of Practices, guidance and regulations made under the Local Government Act 2003

15 Audit Committee – 10 July 2012

15.1 The Cabinet's comments and recommendation will be reported verbally to the Audit Committee.

16 Recommendation

16.1 In accordance with the CIPFA Code of Practice, Cabinet is asked to note the content and recommend this report to Audit Committee.

17. Suggested Reasons for Decision

17.1 In line with CIPFA's Code of Treasury Management Practice an annual report must be taken to Cabinet detailing the council's treasury management outturn within six months of the close of each financial year.

Appendices

Appendix 1 Prudential Indicators

Background papers

CIPFA Code of Practice on Treasury Management in the Public Services, the CIPFA Prudential Code for Capital Finance in Local Authorities and background advisory papers held by officers within the financial support division.

Lead officer contact

Mick Hayward, Chief Finance Officer, Gun Wharf, Tel (01634) 332220, e-mail mick.hayward@medway.gov.uk

Appendix 1

PRUDENTIAL INDICATORS

PRUDENTIAL INDICATOR	2010/11	2011/12	2011/12	2011/12
	£'000	£'000	£'000	£'000
	Actual	Original	Revised	Actual Outturn
Capital Expenditure				
Non - HRA	79,949	48,923		69,312
HRA	2,597	5,572		5,855
TOTAL	82,546	54,495		75,167
Ratio of financing costs to net revenue stream				
Non - HRA	3.36%	2.96%		4.73%
HRA	14.24%	14.39%		9.95%
Net borrowing requirement				
brought forward 1 April	113,036	93,013	93,013	108,176
carried forward 31 March	104,612	89,032	108,176	122,635
in year borrowing requirement	(8,424)	-3,980	15,163	14,459
Capital Financing Requirement as at 31 March				
Non – HRA	214,112	209,543	209,543	209,543
HRA	22,013	22,013	41,146	41,146
TOTAL	236,125	231,556	250,689	250,689
HRA Limit on Indebtedness			45,846	45,846
Annual change in Cap. Financing Requirement				
Non – HRA	5,211	-165		-4,569
HRA	846	735		19,133
TOTAL	6,057	570		14,564

2. TREASURY MANAGEMENT INDICATORS

	2011/12 original £'000	2011/12 Revised £'000	2011/12 Breach?
Authorised Limit for external debt -			
borrowing	414,212	433,356	No Breach
other long term liabilities	8	8	No Breach
TOTAL	414,220	433,364	No Breach
Operational Boundary for external debt -			
borrowing	376,556	395708	No Breach
other long term liabilities	8	8	No Breach
TOTAL	376,564	395,716	No Breach
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing / investments	100%	No Change	No Breach
Upper limit for variable rate exposure			
Net principal re variable rate borrowing / investments	40%	No Change	No Breach
Upper limit for total principal sums invested for over 364 days	£150,000	No Change	No Breach
(per maturity date)			

Maturity structure of fixed rate borrowing during 2010/11	upper limit	lower limit	Breach ?
under 12 months	50%	0%	No Breach
12 months and within 24 months	50%	0%	No Breach
24 months and within 5 years	50%	0%	No Breach
5 years and within 10 years	50%	0%	No Breach
10 years and above	100%	25%	No Breach