CABINET

5 JULY 2011

TREASURY MANAGEMENT OUTTURN ANNUAL REPORT

Portfolio Holder: Councillor Alan Jarrett, Deputy Leader and Finance

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Summary

This report gives an overview of treasury management activity during 2010/11.

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 2010/11. 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 2010/11 the minimum reporting requirements were that the full Council should receive the following reports:

- An annual treasury strategy in advance of the year (Council 25 February 2010)
- A mid year (minimum) treasury update report (Council 25 November 2010)
- 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 reported to the full Council. Member training on treasury management issues was undertaken during the year on 4 November 2011 in order to support Members' scrutiny role.

2.5 This annual treasury report covers:

- The Council's treasury position as at 31 March 2011;
- Borrowing activity 2010/11;
- Performance measurement
- The strategy for 2010/11
- The economy and interest rates in 2010/11
- Borrowing rates in 2010/11
- The borrowing outturn for 2010/11
- Debt rescheduling;
- Compliance with treasury limits and Prudential Indicators;
- Investment rates in 2010/11
- Investment outturn for 2010/11

3. Treasury Position as at 31 March 2011

3.1 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 2011 Principal £m	Rate %	31 March 2010 Principal £m	Rate %
Borrowing				
- fixed rate borrowing	173.3		198.3	
- variable rate borrowing	0.1		0.1	
Total debt	173.4	3.98	198.4	3.76
Investments				
- in-house	46.6	0.99	66.6	2.85
- fund managers	22.5	1.17	22.2	1.25
Total investments	69.1	1.03	88.8	2.55

4. Borrowing Activity 2010/2011

4.1 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.

4.2 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. The Strategy for 2010/11

5.1 The expectation for interest rates within the strategy for 2010/11 anticipated low but rising Bank Rate rising to 1.50% by March 2011. However, in reality the bank rate has remained at the historically low level of 0.5% throughout this period. The strategy did highlight that there was a downside risk to this forecast if the recession proved deeper and longer than expected at that time and this may mean that any rate rise would be delayed. 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.

5.2 In this scenario, the treasury strategy has been to postpone borrowing and thereby avoiding the cost of holding higher levels of investments and this also reduces the counterparty risk.

6. The Economy and Interest Rates

6.1 2010/11 proved to be another watershed year for financial markets. Rather than a focus on individual institutions, market fears moved to sovereign debt issues, particularly in the peripheral Euro zone countries. Local authorities were also presented with changed circumstances following the unexpected change of policy on Public Works Loan Board (PWLB) lending arrangements in October 2010. This resulted in an increase in new borrowing rates of 0.75 – 0.85%, without an associated increase in early redemption rates. This made new borrowing more expensive and repayment relatively less attractive.

6.2 UK growth proved mixed over the year. The first half of the year saw the economy outperform expectations, although the economy slipped into negative territory in the final quarter of 2010 due to inclement weather conditions. The year finished with prospects for the UK economy being decidedly downbeat over the short to medium term while the Japanese disasters in March, and the Arab Spring, especially the crisis in Libya, caused an increase in world oil prices, which all combined to dampen international economic growth prospects.

6.3 The change in the UK political background was a major factor behind weaker domestic growth expectations. The new coalition Government struck an aggressive fiscal policy stance, evidenced through heavy spending cuts announced in the October Comprehensive Spending Review, and the lack of any “giveaway” in the March 2011 Budget. Although the main aim was to reduce the national debt burden to a sustainable level, the measures are also expected to act as a significant drag on growth.

6.4 Gilt yields fell for much of the first half of the year as financial markets drew considerable reassurance from the Government’s debt reduction plans, especially in the light of Euro zone sovereign debt concerns. Expectations of further quantitative easing also helped to push yields to historic lows. However, this positive performance was mostly reversed in the closing months of 2010 as sentiment changed due to sharply rising inflation pressures. These were also expected (during February / March 2011) to cause the Monetary Policy Committee (MPC) to start raising Bank Rate earlier than previously expected.

6.5 The developing Euro zone peripheral sovereign debt crisis caused considerable concerns in financial markets. First Greece (May), then Ireland (December), were forced to accept assistance from a combined EU / IMF rescue package. Subsequently, fears steadily grew about Portugal, although it managed to put off accepting assistance till after the year-end. These worries caused international investors to seek safe havens in investing in non-Euro zone government bonds.

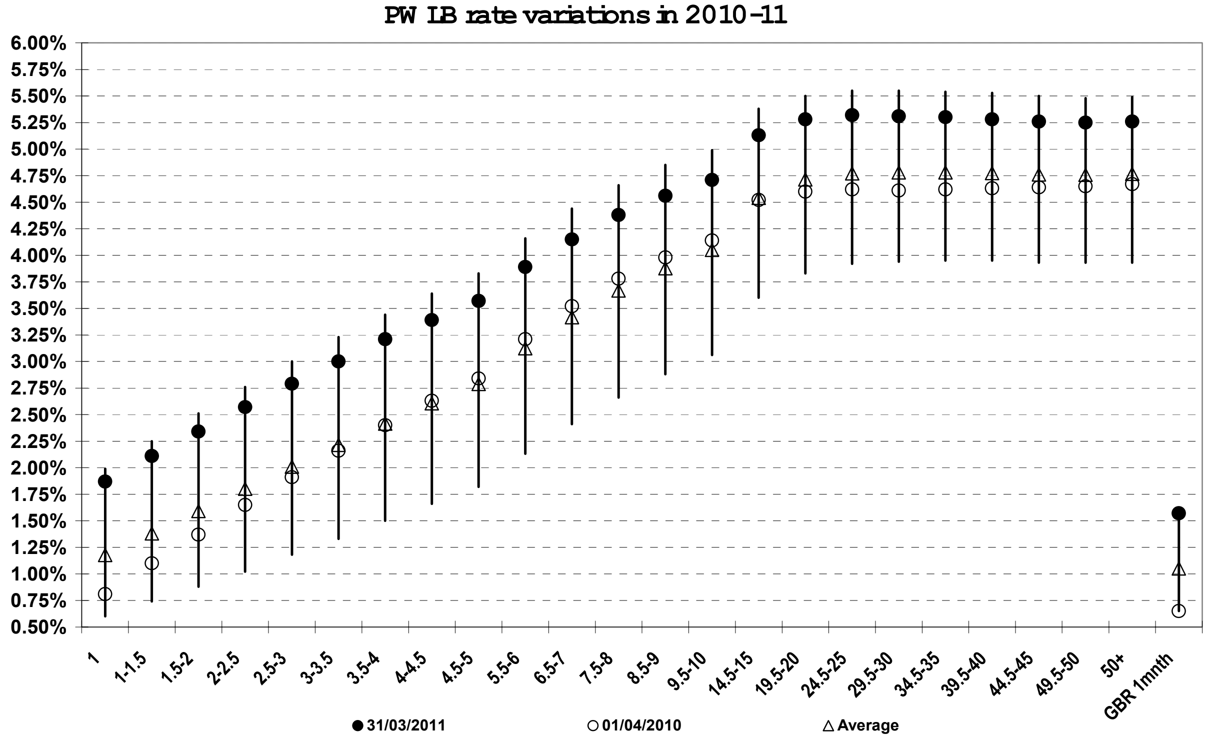
6.6 Deposit rates picked up modestly in the second half of the year as rising inflationary concerns, and strong first half growth, fed through to prospects of an earlier start to increases in Bank Rate. However, in March 2011, slowing actual growth, together with weak growth prospects, saw consensus expectations of the first UK rate rise move back from May to August 2011 despite high inflation. However, the disparity of expectations on domestic economic growth and inflation encouraged a wide range of views on the timing of the start of increases in Bank Rate in a band from May 2011 through to early 2013. This sharp disparity was also seen in MPC voting which, by year-end, had three members voting for a rise while others preferred to continue maintaining rates at ultra low levels.

6.7 Risk premiums were also a constant factor in raising money market deposit rates beyond 3 months. Although market sentiment has improved, continued Euro zone concerns, and the significant funding issues still faced by many financial institutions, mean that investors remain cautious of longer-term commitment. The European Commission did try to address market concerns through a stress test of major financial institutions in July 2010. Although only a small minority of banks “failed” the test, investors were highly sceptical as to the robustness of the tests, as they also are over further tests now taking place with results due in mid-2011.

7. Borrowing rates in 2010/2011

7.1 PWLB borrowing rates - the graph for PWLB maturity rates below show, for a selection of maturity periods, the range (high and low points) in rates, the average rates and individual rates at the start and the end of the financial year.

7.2 Variations in most PWLB rates have been distorted by the October 2010 decision by the PWLB to raise it’s borrowing rates by about 0.75 – 0.85% e.g. if it had not been for this change, the 25 year PWLB at 31 March 2011 (5.32%) would have been only marginally higher than the position at 1 April 2010.



8. Borrowing Outturn for 2010/11

8.1 During 2010/11 no new borrowing was undertaken, with the exception of a short-term (5 day) temporary cashflow loan in November 2010.

8.2 As highlighted in section 3 above the average debt portfolio interest rate has moved over the course of the year from 3.76% to 3.98% and the total debt has reduced by some £25m as debt fell due for repayment and was not replaced. 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. The repayment of some of the cheaper debt portfolio has been responsible for the marginal increase in average rate.

9. Debt Rescheduling

9.1 No debt restructuring was undertaken during 2010/11 and it is not envisaged that that there will be any opportunities where the debt restructuring would be economically viable in 2011/12.

10 Investment Rates in 2010/11

10.1 The tight monetary conditions following the 2008 financial crisis continued through 2010/11 with little material movement in the shorter-term deposit rates. Bank Rate remained at its historical low of 0.5% throughout the year, although growing market expectations of the imminence of the start of monetary tightening saw 6 and 12 month rates picking up.

10.2 Overlaying the relatively poor investment returns was the continued counterparty concerns, most evident in the Euro zone sovereign debt crisis, which resulted in rescue packages for Greece, Ireland and latterly Portugal. Concerns extended to the European banking industry with an initial stress testing of banks failing to calm counterparty fears, resulting in a second round of testing currently in train. This highlighted the ongoing need for caution in treasury investment activity.

Table 2 – Investment rates 2010/11

	Overnight	7 Day	1 Month	3 Month	6 Month	1 Year
01/04/2010	0.41%	0.41%	0.42%	0.52%	0.76%	1.19%
31/03/2011	0.44%	0.46%	0.50%	0.69%	1.00%	1.47%
High	0.44%	0.46%	0.50%	0.69%	1.00%	1.47%
Low	0.41%	0.41%	0.42%	0.52%	0.76%	1.19%
Average	0.43%	0.43%	0.45%	0.61%	0.90%	1.35%
Spread	0.03%	0.04%	0.07%	0.17%	0.24%	0.28%
High date	31/12/2010	30/03/2011	31/03/2011	31/03/2011	31/03/2011	31/03/2011
Low date	01/04/2010	01/04/2010	01/04/2010	01/04/2010	01/04/2010	01/04/2010

11 Investment Outturn for 2010/2011

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 25 February 2010. 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, they have their own policy setting out their approach for choosing investment counterparties which also was approved at Council on the 25 February 2010.

11.2 **Internally Managed Investments** – The Council manages a significant share of 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, other than one investment that is detailed in paragraph 12.2. 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 3 Investment Performance 2010/11

	Average Investment	Rate of Return (gross of fees)	Benchmark Return *
Internally Managed	£74.913m	0.994%	Cash Fund Manager 1.174%
Externally Managed	£22.236m	1.174%	7 Day Local Authority Deposit Rate 0.45% In-House team 0.994%

11.5 No institutions in which investments were made during 2010/2011 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 with the exception of the incident detailed in paragraph 12.2. The outturn for the Prudential Indicators is shown in appendix 1.

12.2 During August 2010 one breach occurred to our counterparty limits. On Friday 27 August we were in breach of the £20m overall investment limit with Natwest by £2.8m. We initially had £10m invested in our Natwest Special Interest Account and £10m in a fixed term deposit. At 3.20pm we received a receipt of an unexpected CHAPS payment from the PCT of £2.8m. At that time of day the only available deposit was Natwest Special Interest Account therefore a further £2.8m was invested there. This took the sum held in the Natwest Group to £22.8m. £2.8m was transferred out of the Natwest Special Interest Account on 31 August 2010, which was the next working day.

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 fell short of it's targeted budget by £1.319m, prior to any contributions from the rate equalisation reserve. The budget, however, was predicated upon anticipated earnings of 2% on internal investments and earnings from the fund manager and a contribution from the rate equalisation reserve of £908,000. In light of the continued historically low bank rate which continued at 0.5% throughout 2010/11, the overall rate achieved for the in-house team was 0.994% and 1.175% for the fund manager. We have therefore utilised the rate equalisation reserve for it's full £1.05m resulting in a short fall from budget of £0.269m. 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 2010/11 our investments were managed in compliance with the Codes of Practices, guidance and regulations made under the Local Government Act 2003

15 Recommendation

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

16 Suggested reasons for decision

16.1 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.

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Appendix 1

PRUDENTIAL INDICATORS

PRUDENTIAL INDICATOR	2009/10	2010/11	2010/11
(1). EXTRACT FROM BUDGET AND RENT SETTING REPORT	£'000	£'000	£'000
	Actual	Original	Actual Outturn
Capital Expenditure			
Non - HRA	61,339	103,363	79,949
HRA	5,148	4,150	2,597
TOTAL	66,487	107,513	82,546
Ratio of financing costs to net revenue stream			
Non - HRA	3.96%	3.19%	3.36%
HRA	13.60%	14.53%	14.24%
Net borrowing requirement			
brought forward 1 April	118,618	94,363	113,036
carried forward 31 March	113,036	100,077	104,612
in year borrowing requirement	(5,582)	5,714	(8,424)
Capital Financing Requirement as at 31 March			
Non – HRA	208,901	211,211	214,112
HRA	21,167	21,939	22,013
TOTAL	230,068	233,150	236,125
Annual change in Cap. Financing Requirement			
Non – HRA	995	(5,258)	5,211
HRA	560	735	846
TOTAL	1,555	(4,523)	6,057
Incremental impact of capital investment decisions	£ p	£ p	£ p
Increase in Council Tax (band D) per annum	(25.75)	(4.53)	(19.17)
Increase in average housing rent per week	(0.22)	2.53	0.70

2. TREASURY MANAGEMENT INDICATORS	2010/11 original £'000	2010/11 Breach?
Authorised Limit for external debt -		
borrowing	£418,165	No Breach
other long term liabilities	£8	No Breach
TOTAL	£418,173	No Breach
Operational Boundary for external debt -		
borrowing	380,150	No Breach
other long term liabilities	£8	No Breach
TOTAL	£380,158	No Breach
Upper limit for fixed interest rate exposure		
Net principal re fixed rate borrowing / investments	100%	No Breach
Upper limit for variable rate exposure		
Net principal re variable rate borrowing / investments	40%	No Breach
Upper limit for total principal sums invested for over 364 days	£150,000	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