Annual Report -Treasury Management 2011/12

Annual Treasury Management Review 2011/12

Purpose

This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of 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).

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 (Full Council on 02/02/2011)
- a mid year (minimum) treasury update report (Full Council on 14/12/2011)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

In addition, Members have received quarterly update reports as part of the Members Newsletter

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 year end position for treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Budget & Strategic Planning Working Group before they were reported to Full Council. Member training on treasury management issues has also been undertaken.

Executive Summary

During 2011/12, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Prudential and treasury indicators	2010/11 Actual £m	2011/12 Original £m	2011/12 Actual £m
Capital expenditure	5.169	5.726	4.585
Capital Financing Requirement: • Non-HRA • HRA • HRA due to housing finance reform • Total	 5.297 4.296 0 9.593	 5.406 4.282 0 9.688	 0.189 4.282 27.622 32.093
Net borrowing	3.838	8.873	16.961
External debt	6.988	6.988	31.861
Investments • Longer than 1 year • Under 1 year • Total	All investments- £3.15m are less than one year	N/A	All investments £14.9m are less than one year

Other prudential and treasury indicators are to be found in the main body of this report.

The Head of Central Services also confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit (the authorised limit), was not breached.

The financial year 2011/12 continued the challenging investment environment of previous years, namely low investment returns and continuing heightened levels of counterparty risk.

Housing finance reform

The implementation of housing finance reform at the end of 2011-12 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 £27.622m. This resulted in an increase in the CFR and total borrowing of £31.861m at the end of the year which was financed by internal borrowing and new external borrowing of £26.323m. There has been no impact on HRA revenue finances in 2011/12 due to compensating adjustments being made in the HRA determination.

Recommendations

The Council is recommended to:

1. Approve the actual 2011/12 prudential and treasury indicators in this report
2. Note the annual treasury management report for 2011/12

Introduction and Background

This report summarises:

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- Reporting of the required prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity.

1. The Council's Capital Expenditure and Financing 2011/12

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

General Fund	2010/11 Actual (£m)	**2011/12 Estimate (£m)**	2011/12 Actual (£m)
Capital expenditure	**4.23**	**4.135**	**3.225**
Financed in year	3.956	3.464	3.225
Unfinanced capital expenditure	**0.274**	**0.671**	**0**

HRA	2010/11 Actual (£m)	2011/12 Estimate (£m)	2011/12 Actual (£m)
Capital expenditure	**0.939**	**1.591**	**1.36**
Financed in year	0.639	1.291	1.36
Unfinanced capital expenditure	**0.3**	**0.3**	**0**

2. The Council's Overall Borrowing Need

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's debt position. The CFR results from the capital activity of the Council and what resources have been used to pay for the capital spend. It represents the 2011/12 unfinanced capital expenditure (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

Reducing the CFR – the Council's (non HRA) underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to reduce the CFR. This is effectively a repayment of the non-Housing Revenue Account (HRA) borrowing need (there is no statutory requirement to reduce the HRA CFR). This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

The Council's 2011/12 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report for 2011/12 on 2 February 2011.

The Council's CFR for the year is shown below, and represents a key prudential indicator.

HOUSING FINANCE REFORM

Housing finance reform has 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 has made a capital payment to the Department of Communities and Local Government of £27.622m. This has resulted in an increase in the CFR and total borrowing of £31.861m at the end of the year which was financed by existing borrowing and new external borrowing of £26.323m. There has been no impact on HRA revenue finances in 2011/12 due to compensating adjustments being made in the HRA determination.

CFR: General Fund	31 March 2011 Actual (£m)	31 March 2012 Original (£m)	31 March 2012 Actual (£m)
Opening balance	**5.27**	**5.297**	**5.297**
Add unfinanced capital expenditure (as above)	0.274	0.671	0
Less MRP/VRP	-0.247	-0.227	-0.228
Use of capital receipts to repay General Fund CFR	0	0	-4.88
Less PFI & finance lease repayments	0	0	**0**
Closing balance	**5.297**	**5.741**	***0.189**

* relates to the notional credit arrangement with the County Council in respect of the Registrar's agreement.

CFR: HRA	31 March 2011 Actual (£m)	31 March 2012 Original (£m)	31 March 2012 Actual (£m)
Opening balance	**4.01**	**4.296**	**4.296**
Add unfinanced capital expenditure (as above)	0.3	0	0
Add adjustment for HRA reform	0	0	27.622
Less MRP/VRP	-0.014	-0.014	-0.014
Less PFI & finance lease repayments	0	0	0
Closing balance	**4.296**	**4.282**	****31.904**

** the government sets a limit on HRA borrowing. The headroom figure available for new borrowing is currently £1.635m (£33.539m limit less actual HRA CFR of £31.904m).

Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

Net borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. This essentially means that the Council is not borrowing to support revenue expenditure. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2011/12 plus the expected changes to the CFR over 2011/12 and 2012/13 from financing the capital programme. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2011/12. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2011 Actual (£m)	31 March 2012 Original (£m)	31 March 2012 Actual (£m)
Net borrowing position	3.838	8.873	16.961
CFR	9.593	9.688	32.093

The authorised limit - the authorised limit is the “affordable borrowing limit” required by s3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. The table below demonstrates that during 2011/12 the Council has maintained gross borrowing within its authorised limit.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	2011/12 pre housing finance reform (£m)	2011/12 post housing finance reform (£m)
Authorised limit	19.0	47.0
Maximum gross borrowing position	6.99	31.861
Operational boundary	11.7	36.765
Average gross borrowing position	6.26	6.66
Financing costs as a proportion of net revenue stream	4.73%	3.84%

3. Treasury Position as at 31 March 2012

The Council's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the beginning and the end of 2011/12 the Council's treasury position was as follows:

TABLE 1	31 March 2011 Principal	Rate/ Return	Average Life yrs	31 March 2012 Principal	Rate/ Return	Average Life yrs
Fixed rate funding:						
-PWLB GF	£6.988m	3.92%	35.68yrs	£0m	N/A	N/A
-PWLB HRA	*	*	*	£31.86m	4.6%	39yrs
Variable rate funding:						
-PWLB	£0m	N/A	N/A	£0m	N/A	N/A
-Market	£0m	N/A	N/A	£0m	N/A	N/A
Total debt	***£6.988m***	***3.92%***	***35.68yrs***	***£31.86***	***4.6%***	***39yrs***
CFR	***£9.593m***			***£32.1m***		
Over/ under (-) borrowing	***-£2.605m***			***-£0.24m***		
* As at 31st March 2011 the Council did not operate separate loans pools. Following the HRA reform two separate pools are in operation from 31st March 2012						
Investments:						
- in house	£3.15m	0.37%	0	£14.9m	0.49%	0
- with managers	£0m	N/A	N/A	£0m	N/A	N/A
Total investments	***£3.15m***	***0.37%***	***0***	***£14.9m***	***0.49%***	***0***

The maturity structure of the debt portfolio was as follows:

	31 March.2011 Actual (£m)	31 March 2012 Actual (£m)
Under 12 months	1.45	0
12 months and within 24 months	0	0
24 months and within 5 years	0	0.448
5 years and within 10 years	0	0
10 years and above	5.538	31.413

The maturity structure of the investment portfolio was as follows:

	2010/11 Actual	2011/12 Original	2011/12 Actual
Investments Longer than 1 year Under 1 year Total	All investments are less than one year---£3.15m	N/A	All investments are less than one year---£14.9m

The exposure to fixed and variable rates for borrowing net of investments was as follows:

	31 March 2011 Actual (£m)	2011/12 Original Limits (£m)	31 March 2012 Actual (£m)
Fixed rate (principal or interest)	3.8	40	23
Variable rate (principal or interest)	0	7	-6

Both rows above are expressed as net principal sums outstanding of borrowing and investments. The credit figure for variable rates at 31 March 2012 relates to the use of money market funds as a form of investment.

4. The Strategy for 2011/12

The expectation for interest rates within the strategy for 2011/12 anticipated low but rising Bank Rate (starting in quarter 4 of 2011) with similar gradual rises in medium and longer term fixed borrowing rates over 2011/12. Variable or short-term rates were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

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

The actual movement in gilt yields meant that PWLB rates fell sharply during the year and to historically very low levels. This was caused by a flight to quality into UK gilts from EU sovereign debt and also from shares as investors became very concerned about the potential for a Lehmans type meltdown of financial markets if the Greek debt crisis were to develop into a precipitous default and exit from the Euro.

Change in strategy during the year – the strategy adopted in the original Treasury Management Strategy Report for 2011/12 approved by the Council on 2nd February 2011 was subject to revision during the year due to the introduction of Housing Finance Reform

The wording contained in the following sections numbered 5 to 8 inclusive have been provided by the Council's Treasury Management Advisors.

5. The Economy and Interest Rates

Sovereign debt crisis. 2011/12 was the year when financial markets were on tenterhooks throughout most of this period, fearful of the potential of another Lehmans type financial disaster occurring, sparked off by a precipitous Greek default. At almost the last hour, the European Central Bank (ECB) calmed market concerns of a liquidity crisis among European Union (EU) banks by making available two huge three year credit lines, totalling close to €1 trillion at 1%. This also provided a major incentive for those same banks to then use this new liquidity to buy EU sovereign debt yielding considerably more than 1%.

A secondary benefit of this initiative was the bringing down of sovereign debt yields, for the likes of Italy and Spain, below panic levels. The final planks in the calming of the EU sovereign debt crisis were two eleventh hour agreements: one by the Greek Government of another major austerity package and the second, by private creditors, of a "haircut" (discount) on the value of Greek debt that they held, resulting in a major reduction in the total outstanding level of Greek debt. These agreements were a prerequisite for a second EU / IMF bailout package for Greece which was signed off in March.

Despite this second bailout, major concerns remain that these measures were merely a postponement of the debt crisis, rather than a solution, as they did not address the problem of low growth and loss of competitiveness in not only Greece, but also in other EU countries with major debt imbalances. These problems will, in turn, also affect the financial strength of many already weakened EU banks during the expected economic downturn in the EU. There are also major questions as to whether the Greek Government will be able to deliver on its promises of cuts in expenditure and increasing tax collection rates, given the hostility of much of the population. In addition, an impending general election in April / May 2012 will deliver a democratic verdict on the way that Greece is being governed under intense austerity pressure from the northern EU states.

The UK coalition Government maintained its aggressive fiscal policy stance against a background of warnings from two credit rating agencies that the UK could lose its AAA 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, within the austerity plan timeframe. The USA and France lost their AAA ratings from one rating agency during the year.

UK growth proved mixed over the year. In quarter 2, growth was zero, but then quarter 3 surprised with a return to robust growth of 0.6% quarter on quarter before moving back into negative territory (-0.2%) in quarter 4. The year finished with prospects for the UK economy being decidedly downbeat due to a return to negative growth in the EU in quarter 4, our largest trading partner, and a sharp increase in world oil prices caused by Middle East concerns. However, there was also a return of some economic optimism for growth outside the EU and strong comments from the major western central banks: the Federal Reserve in America may even be considering a third dose of quantitative easing to boost growth.

UK CPI inflation started the year at 4.5% and peaked at 5.2% in September. The fall out of the January 2011 VAT hike from the annual CPI figure in January 2012 helped to bring inflation down to 3.6%, falling further to 3.4% in February. Inflation is forecast to be on a downward trend to below 2% over the next year.

The Monetary Policy Committee agreed an increase in quantitative easing (QE) of £75bn in October on concerns of a downturn in growth and a forecast for inflation to fall below the 2% target. QE was targeted at further gilt purchases. The MPC then agreed another round of £50bn of QE in February 2012 to counter the negative impact of the EU debt and growth crisis on the UK.

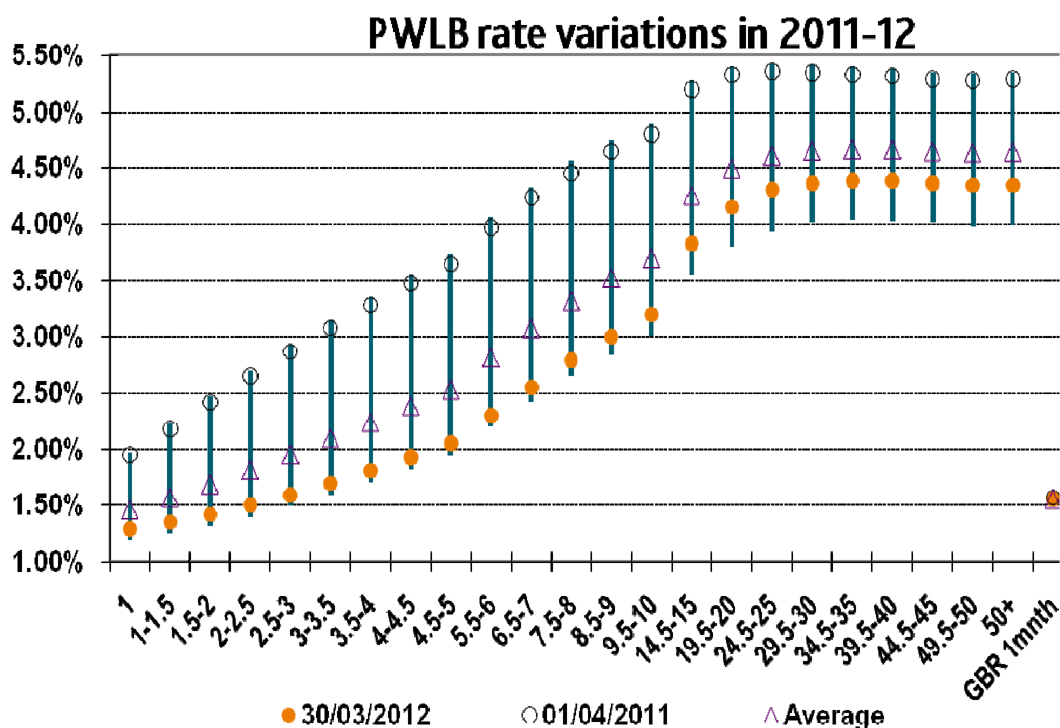
Gilt yields fell for much of the year, until February, as concerns continued building over the EU debt crisis. This resulted in safe haven flows into UK gilts which, together with the two UK packages of QE during the year, combined to depress PWLB rates to historically low levels.

Bank Rate was unchanged at 0.5% throughout the year while expectations of when the first increase would occur were steadily pushed back until the second half of 2013 at the earliest. **Deposit rates** picked up in the second half of the year as competition for cash increased among banks.

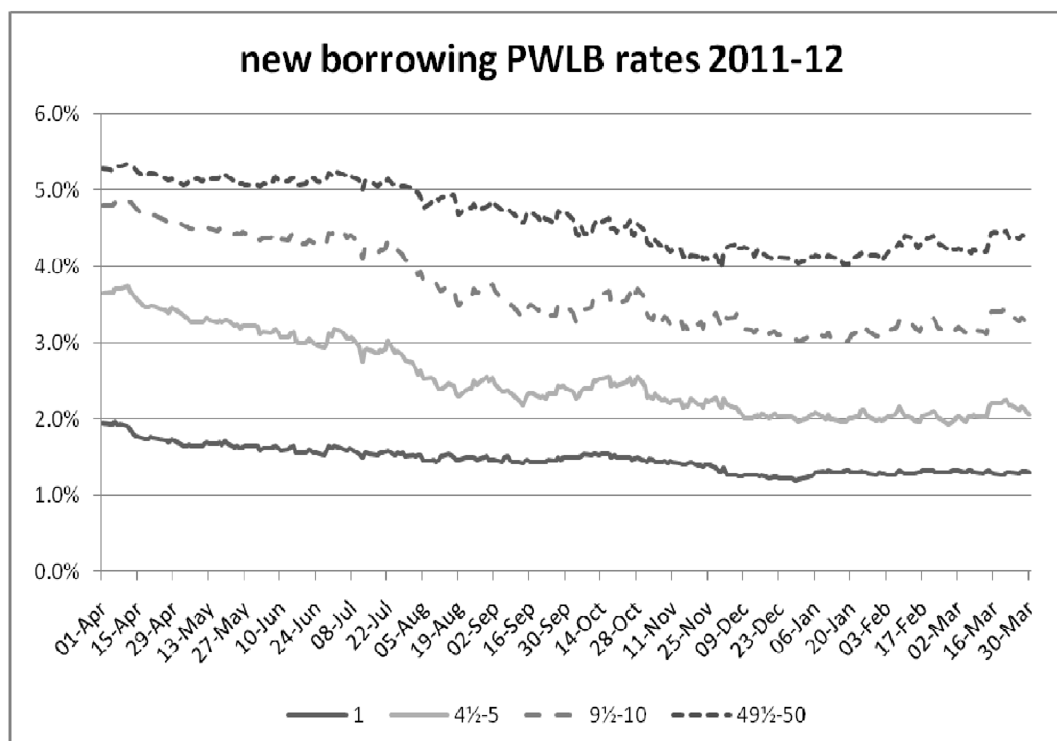
Risk premiums were also a constant factor in raising money market deposit rates for periods longer than 1 month. Widespread and multiple downgrades of the ratings of many banks and sovereigns, continued Euro zone concerns, and the significant funding issues still faced by many financial institutions, meant that investors remained cautious of longer-term commitment.

6. Borrowing Rates in 2011/12

PWLB borrowing rates - the graphs and table for PWLB maturity rates below show, for a selection of maturity periods, the high and low points in rates, the average rates, spreads and individual rates at the start and the end of the financial year.



PWLB BORROWING RATES 2011/12 for 1 to 50 years									
	1	1.5-2	2.5-3	3.5-4	4.5-5	9.5-10	24.5-25	49.5-50	1 month variable
01/04/2011	1.950%	2.420%	2.870%	3.280%	3.650%	4.800%	5.360%	5.280%	1.570%
31/03/2012	1.290%	1.420%	1.590%	1.810%	2.050%	3.200%	4.310%	4.350%	1.560%
HIGH	1.970%	2.470%	2.930%	3.350%	3.730%	4.890%	5.430%	5.340%	1.590%
LOW	1.190%	1.320%	1.500%	1.710%	1.940%	3.010%	3.940%	3.980%	1.560%
Average	1.466%	1.693%	1.958%	2.243%	2.533%	3.702%	4.610%	4.635%	1.561%
Spread	0.780%	1.150%	1.430%	1.640%	1.790%	1.880%	1.490%	1.360%	0.030%
High date	06/04/2011	06/04/2011	06/04/2011	06/04/2011	11/04/2011	11/04/2011	11/04/2011	11/04/2011	05/04/2011
Low date	29/12/2011	30/12/2011	30/12/2011	27/02/2012	27/02/2012	30/12/2011	18/01/2012	30/11/2011	15/04/2011



7. Borrowing Outturn for 2011/12

Treasury Borrowing – there was no requirement for any short term borrowing during the year.

Borrowing – No loans were drawn to fund the net unfinanced capital expenditure and naturally maturing debt.

Housing finance reform - on 28th March 2012 the Council borrowed £26.323m at an average rate of 3.46% as a result of making a payment to the Department of Communities and Local Government in respect of housing debt it was taking on.

The loans drawn were:

Lender	Principal £m	Type	Interest Rate %	Maturity	Average for 2011/12 %
PWLB	0.448	Fixed	0.75	28 March 2015	3.46
PWLB	5	Fixed	3.50	28 March 2042	3.46
PWLB	5	Fixed	3.52	28 March 2047	3.46

PWLB	5	Fixed	3.52	28 March 2052	3.46
PWLB	5	Fixed	3.50	28 March 2057	3.46
PWLB	5.875	Fixed	3.48	28 March 2062	3.46
Market	0	Variable interest rate	N/A	N/A	N/A

This compares with a budget assumption of borrowing at an interest rate of 3.7%

Rescheduling
No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

Repayments

1. **Other** - on 28 October 2011 the Council repaid £1.45m at an average rate of 4.21% with no breakage costs.

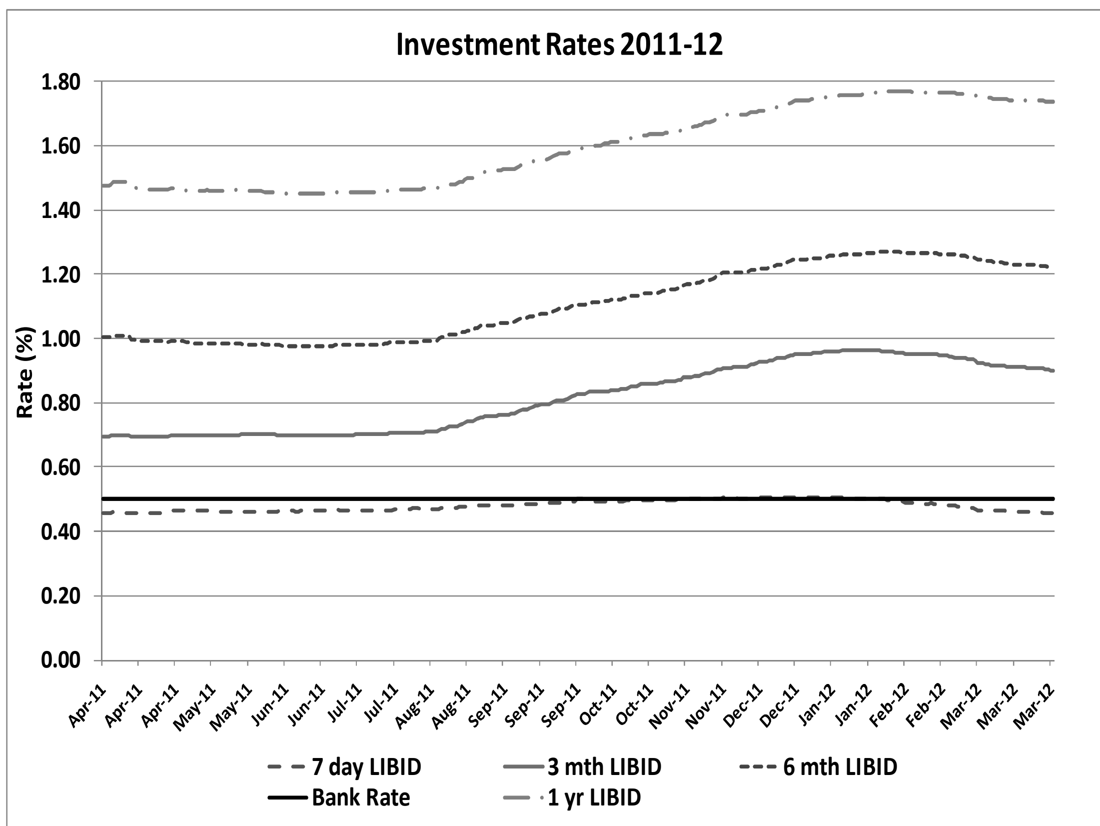
Summary of debt transactions – management of the debt portfolio resulted in a fall in the amount of interest paid of approximately £60,000 (due to repayment of two loans), representing net General Fund savings.

8. Investment Rates in 2011/12

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 the second half of the year as the Eurozone crisis grew. The ECB's actions to provide nearly €1 trn of 1% 3 year finance to EU banks eased liquidity pressures in the EU and investment rates eased back somewhat in the quarter 1 of 2012. This action has also given EU banks time to strengthen their balance sheets and liquidity positions on a more permanent basis. Bank Rate remained at its historic low of 0.5% throughout the year while market expectations of the imminence of the start of monetary tightening was gradually pushed further and further back during the year to the second half of 2013 at the earliest..

Overlaying the relatively poor investment returns were the continued counterparty concerns, most evident in the Euro zone sovereign debt crisis which resulted in a second rescue package for Greece in quarter 1 2012. Concerns extended to the potential fallout on the European banking industry if the crisis could have ended with Greece leaving the Euro and defaulting.

	Money market investment rates 2011/12					
	Overnight	7 Day	1 Month	3 Month	6 Month	1 Year
01/04/2011	0.43688	0.45625	0.49563	0.69563	1.00313	1.47750
31/03/2012	0.43188	0.45719	0.57100	0.90188	1.22063	1.73806
High	0.54625	0.50531	0.65288	0.96456	1.27063	1.77175
Low	0.43000	0.45625	0.49563	0.69438	0.97625	1.45000
Average	0.44868	0.48009	0.56246	0.81756	1.11025	1.59673
Spread	0.11625	0.04906	0.15725	0.27018	0.29438	0.32175
Date	30/06/2011	30/12/2011	11/01/2012	12/01/2012	25/01/2012	25/01/2012
Date	14/03/2012	01/04/2011	01/04/2011	12/04/2011	11/06/2011	22/06/2011



9. Investment Outturn for 2011/12

Investment Policy – the Council's investment policy is governed by CLG guidance, which was been implemented in the annual investment strategy approved by the Council on 2 February 2011. This policy sets out the approach for choosing investment counterparties, 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, bank share prices etc.). A revised investment strategy was approved by Full Council on 12 October 2011.

The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

Resources – the Council's longer term cash balances comprise, primarily, revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources comprised as follows, and met the expectations of the budget:

Balance Sheet Resources	31 March 2011 £m	31 March 2012 £m
Balances	1.087	1.417
Earmarked reserves	1.77	2.24
Provisions	0	0
Usable capital receipts	0.942	10.133
Total	**3.799**	**13.79**

Investments held by the Council - the Council maintained an average balance of £7,652,000 of internally managed funds. The internally managed funds earned an average rate of return of 0.49%. The comparable performance indicator is the average 7-day money market rate, which was 0.35%. This compares with a budget assumption of £400,000 average balances earning an average rate of 0.35%.

10. Performance Measurement

One of the key requirements in the Code is the formal introduction of performance measurement relating to investment activities. The Council's performance indicators were set out in the Annual Treasury Management Strategy.

This service has set the following performance indicators

- Investments – to achieve a return on external investments in excess of the seven day money market rate. In 2011-12 the rate of return was 0.49% (+£11,212) compared to the money market rate of 0.35%.This compares to a gain of £445 (0.34%) in the previous year.

11. Icelandic Bank Defaults

The Council has no investment(s) frozen in Icelandic banks.

12. Other Issues

During the financial year the Council received a large capital receipt relating to the sale of land at Nottingham Road which resulted in an increased level of balances detailed in the report and enabled funds to be invested in Money Market Funds in order to obtain a higher rate of interest.