REPORT NO: 135/2011

CABINET

20 SEPTEMBER 2011

Annual Report on Treasury Management and Actual Prudential Indicators 2010/11

Report of the Strategic Director for Resources

STRATEGIC AIM:	**To be a well-managed organisation**		
KEY DECISION	NO	DATE ITEM FIRST APPEARED ON FORWARD PLAN	JUNE 2011

1. PURPOSE OF THE REPORT

1.1 The annual report is a requirement of the Council's reporting procedures. It covers the treasury activity for 2010/11, and the actual Prudential Indicators for 2010/11.

1.2 The report meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. During 2010/11 the minimum reporting requirements were that the Council receive an annual treasury strategy in advance of the year, a mid-year report and an annual report following the year end describing the activity compared to the strategy (this report).

The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003.

2. RECOMMENDATIONS

That the Cabinet:

2.1 Approves the actual 2010/11 prudential indicators within the report.

2.2 Notes the treasury management stewardship for 2010/11.

3. REASONS FOR THE RECOMMENDATIONS

3.1 To comply with the regulations set out in 1.2.

4. INTRODUCTION

4.1 This report summarises:

- The capital activity for the year;
- How this activity was financed;
- The impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- The reporting of the required prudential indicators;
- The Council's overall treasury position;

- A summary of interest rate movements in the year;
- The detailed debt activity; and
- The detailed investment activity

5. CAPITAL EXPENDITURE AND FINANCING FOR 2010/11

5.1 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); or
- through borrowing if insufficient financing is available, or a decision is taken not to apply resources.

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

	2009/10 Actual £000	**2010/11 Estimate* £000**	**2010/11 Actual £000**
General Fund capital expenditure	20,015	27,578	23,337
HRA capital expenditure	479	0	0
Total capital expenditure	**20,494**	**27,578**	**23,337**
Financed by:			
Capital receipts	27	3,956	4,150
Capital grants & contributions	18,028	16,804	13,981
Capital reserves	466	0	0
Revenue	211	0	2
Unfinanced capital expenditure	**1,762**	**6,818**	**5,204**

6. THE COUNCIL'S OVERALL BORROWING NEED

6.1 The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). This figure is a gauge for the Council's debt position. It represents 2010/11 and prior years net capital expenditure which has not yet been paid for by revenue or other resources.

6.2 The Non-HRA element of the CFR is reduced each year by a statutory revenue charge called the Minimum Revenue Provision (MRP). The total CFR can also be reduced by:

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

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

	2008/09 Actual £000	**2010/11 Estimate £000**	**2010/11 Actual £000**
Opening Non-HRA CFR	27,958	22,767	22,767
Opening HRA CFR	(958)	0	0
Total Opening CFR	27,000	22,767	22,767
Plus: capital expenditure financed by borrowing	1,762	6,818	5,204
Less: MRP	(1,122)	(991)	(991)
Application of capital receipts	(4,873)	0	0
Closing Non-HRA CFR	*22,767*	*28,594*	*26,980*
Closing HRA CFR	*0*	*0*	*0*
Total Closing CFR	**22,767**	**28,594**	**26,980**

7. TREASURY POSITION AT 31 MARCH 2011

7.1 Whilst the Council's gauge of its underlying need to borrow is the CFR, the Strategic Director for Resources and the treasury function can manage the Council's actual borrowing position by either:

- Borrowing to the CFR; or
- Choosing to utilise some temporary cash flow funds instead of borrowing (under-borrowing); or
- Borrowing for future increases in the CFR (borrowing in advance of need)

7.2 The figures in this report are based on the principal amounts borrowed and invested and so may differ from those in the published statement of accounts by items such as accrued interest.

7.3 During 2010/11 the Strategic Director for Resources managed the debt position to maximise the income received from temporary investments and minimise the amount of external borrowing required. The treasury position at the 31 March 2011 compared to the previous year is shown in the following table:

	31 March 2010		**31 March 2011**	
	Principal	**Average Rate**	**Principal**	**Average rate**
Total long term debt (all fixed rate debt)	£21.386m	4.56%	£21.386m	4.56%

Capital Financing Requirement	£22.767m		£26.980m	
Over/(under) borrowing	(£1.381m)		(£5,594)	
Total investments	(£20.118m)	0.85%	(£18.159m)	0.66%
Net borrowing position	**£1.268m**		**£3.227m**	

7.4 Early in October 2008, the Icelandic banks Landsbanki, Kaupthing and Glitnir collapsed and the UK subsidiaries of the banks, Heritable and Kaupthing Singer and Friedlander went into administration. The authority deposited £1m with Heritable Bank on 15 July 2008 at an interest rate of 6.09%, which should have matured on 15 January 2009.

7.5 The latest creditor progress report issued by the administrators Ernst and Young was in July 2011. This report noted that current projections suggest a best case return to creditors of 86 to 90 pence in the pound.

7.6 To date, the Council has received repayments totaling £0.613m and is expecting further repayments of £0.1m during the current financial year.

8. PRUDENTIAL INDICATORS AND COMPLIANCE ISSUES

8.1 Some of the prudential indicators provide either an overview or specific limits on treasury activity. These are shown below:

8.2 **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. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2010/11 plus the changes expected to the CFR over 2011/12 and 2012/13. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this indicator.

	31 March 2010 Actual	**31 March 2011 Actual**
Net borrowing position	£1.268m	£3.228m
CFR	£22.767m	£26.980m

8.3 **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 2010/11 the Council has maintained gross borrowing within its Authorised Limit.

8.4 **The Operational Boundary** – The Operational Boundary is the expected borrowing position of the Council during the year, and periods where the actual position is either below or above the Boundary are acceptable, subject to the Authorised Limit not being breached.

8.5 **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.

	2010/11
Original indicator - Authorised Limit	£26.000m
Original Indicator - Operational Boundary	£32.100m
Maximum gross borrowing position in year	£21.386m
Minimum gross borrowing position in year	£21.386m
Weighted Average gross borrowing position in year	£21.386m
Financing costs as a proportion of net revenue stream	10.63%

9. ECONOMIC BACKGROUND FOR 2010/11 (Provided by Sector, the Council's Treasury Advisors)

9.1 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.

9.2 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.

9.3 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.

9.4 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 to start raising Bank Rate earlier than previously expected.

9.5 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.

9.6 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.

9.7 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.

10. DEBT MANAGEMENT ACTIVITY DURING 2010/11

10.1 There was no activity during the year

11. INVESTMENT POSITION

11.1 The Council’s investment policy is governed by CLG Guidance, which has been implemented in the Treasury Management Strategy approved by

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

11.2 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.

11.3 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.

11.4 Investment interest of £0.153m was received during the year, which was slightly more than the £0.136m that was budgeted for but £0.085m less than had been received in previous year. This is due to the fall in interest rates from an average of 0.85% at 31/3/10 to 0.66% at 31/3/11.

12. REGULATORY FRAMEWORK, RISK AND PERFORMANCE

12.1 The Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance:

- The Local Government Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity;
- The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (although no restrictions were made in 2010/11);
- Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act;
- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities;
- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services;
- Under the Act the CLG has issued Investment Guidance to structure and regulate the Council's investment activities.
- Under section 238(2) of the Local Government and Public Involvement in Health Act 2007 the Secretary of State has taken powers to issue guidance on accounting practices. Guidance on Minimum Revenue Provision was issued under this section on 8 November 2007.

12.2 The Council has complied with all of the above relevant statutory and regulatory requirements which limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means both that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

12.3 The Council is aware of the risks of passive management of the treasury portfolio and, with the support of Sector, the Council's advisers, has proactively managed its treasury position. The Council has continued to utilise historically low borrowing costs and has complied with its internal and external procedural requirements. There is minimal risk of volatility of costs in the current debt portfolio as the interest rates are fixed, utilising long-term loans.

13. RISK MANAGEMENT

RISK	IMPACT	COMMENTS
Time	Low	We are required to report by 30 September each year.
Viability	Low	We have complied with the Treasury Management Strategy and the Prudential Code.
Finance	High	This is a critical activity of the Finance Department.
Profile	Low	This is a 'back office' function therefore has a low profile in the public eye.
Equalities and Diversities	Low	An initial Impact Assessment indicates no further assessment is required.

Background Papers
Statement of accounts 2010/11
Treasury Management Strategy 2010/11
Cabinet reports as referred.

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A Large Print or Braille Version of this Report is available upon request – Contact 01572 722577.