Agenda Item 6

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To: **City Executive Board**

Date: **21 September 2011**

Report of: **Corporate Director of Finance and Efficiency**

Title of Report: **Treasury Management Annual Report 2010/2011**

Summary and Recommendations

Purpose of report: The Treasury Management Annual report sets out the Council's treasury management activity for 2010/2011, together with its achievement against prudential indicator targets for 2010/2011

Key decision No

Executive lead member: Councillor Ed Turner

Report approved by:

Finance: Nigel Kennedy
Legal: Jeremy Thomas

Policy Framework:

Recommendation:

To note the Treasury Management Annual Report for 2010/2011

Executive Summary

1. The financial year 2010/2011 was another challenging year for the treasury management function. The combined effect of the low interest rates due to the Bank of England's Base Rate remaining at an all time low and restricted lending options due to continuing counterparty risk resulted in low returns on our investments.

2. Icelandic investments remain an issue for the Council. During the year a further £0.45m of our original investment was returned to the Council, leaving the year end balance outstanding at approximately £3.0 million.

3. The Council had outstanding debt of approximately £6.0 million as at 31st March 2011, approximately £4.4 million of this is held with the Public Works Loan Board (PWLB) at fixed interest rates and £1.6 million is held with South Oxfordshire District Council (SODC). The total interest paid on this debt during 2010/2011 was £561k.

4. The Council also had investments totalling approximately £27.0 million as at 31st March 2011, this includes approximately £3.0 million of outstanding Icelandic bank investments. The remaining investments balance is held with highly rated financial institutions, such as other Local Authorities, banks, building societies and Money Market Funds (MMF) for periods less than 90 days. The total interest earned on these investments was approximately £200k.

5. The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return is also a key consideration. After this main principle the Council will ensure:
   I. It has sufficient liquidity in its investments; and that
   II. It maintains a policy covering both the categories of investment and criteria for choosing investment counterparties.

6. In relation to the Council's debt strategy the factors taken into account are prevailing interest rates, the debt profile of the Council's portfolio and the type of asset being financed.

7. The Council fully complied with its Treasury Management Strategy in relation to investment management in 2010/2011. However, due to slippage in the capital programme and the high cost of carry (the difference between borrowing rates and investment returns), the Council decided not to fund new debt through external borrowing of £10 million as stated in the Mid Year Review of 2010/11 Strategy. This debt has been funded by internal balances and the need to borrow externally has been deferred until interest rates become more attractive.

8. The Council has a statutory duty to set, monitor and report on its prudential indicators in accordance with the Prudential Code, which aims to ensure that the capital investment plans of authorities are affordable, prudent and sustainable.

9. The prudential indicators detailed in the body of this report look back at the results for 2010/2011, and are designed to compare the Council's outturn position against the target set.

The Council's Capital Expenditure and Financing 2010/2011

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

I. capital receipts, capital grants, other external funding;
II. Revenue contribution; or
III. borrowing.

11. Part of the Council's treasury function is to address any borrowing need, either through borrowing from external bodies, or utilising temporary cash resources within the Council. The wider treasury activities also include managing the Council's cash flow, its previous borrowing activities and the investment of surplus funds. These activities are structured to manage risk foremost, and then optimise performance.

12. Actual capital expenditure forms one of the required prudential indicators. Table 1 below shows actual spend and how it has been financed compared to what was originally planned.

Table 1

Capital Expenditure	**2009/10 Actual £'000**	**2010/11 Estimate £'000**	**2010/11 Actual £'000**
Non-HRA Capital Expenditure	8,283	14,653	9,952
HRA Capital Expenditure	9,024	21,732	14,930
Total Capital Expenditure	**17,307**	**36,385**	**24,882**
Resourced by:			
Capital Receipts	1,948	20,039	1,497
Capital Grants	9,686	7,729	12,292
Revenue	1,607	2,183	2,455
Total Capital Resources	**13,241**	**29,951**	**16,488**
Unfinanced Capital Expenditure (Additional need to borrow)	**4,066**	**6,434**	**8,394**

The Council's Overall Borrowing Need

13. The underlying need to borrow or Capital Financing Requirement (CFR) is a gauge of the Council's debt position. It represents all prior years' net capital expenditure which has not been financed by other means (revenue, capital receipts, grants etc.).

14. The CFR can be reduced by:
I. The application of additional capital resources, such as unapplied capital receipts; or
II. By holding a voluntary revenue provision (VRP) or depreciation against it.

15. Table 2 below shows the Council's CFR position, this is a key prudential indicator

Table 2.

CFR	31st March 2010 Actual £'000	31st March 2011 Estimate £'000	31st March 2011 Actual £'000
Opening Balance	10,386	14,387	14,219
Plus Unfinanced Capital Expenditure	4,066	6,434	8,394
Minus MRP / VRP	(233)	(244)	(244)
CFR Closing Balance	**14,219**	**21,677**	**22,613**

Treasury Position at 31st March 2011

16. Whilst the Council's gauge of its underlying need to borrow is the CFR, the treasury function manages the Council's actual borrowing position by either:
    I. Borrowing to the CFR;
    II. Choosing to utilise some temporary cash flow funds, which will reduce our investment balance, instead of borrowing (under borrowing);
    III. Borrowing for future increase in the CFR (borrowing in advance of need)

17. It should be noted that accounting practice requires financial instruments (debt, investments, etc.) to be measured in a method compliant with National Financial Reporting Standards. The figures in this report are based on the actual amounts borrowed and invested and therefore may differ slightly to those in the Statement of Accounts.

18. During 2010/2011 no new debt was taken out. At the end of 2010/2011 the Council's total debt was £6.1m. The debt relates wholly to the Housing Revenue Account (HRA) and repayment of it is provided for within our Housing Subsidy. This means there is no financial benefit to the Council in repaying the debt early, as any premiums associated with early repayment are not covered by housing subsidy and will be a charge on the General Fund.

19. The Council's treasury position as at the 31st March 2011 compared with the previous year is set out in Table 3 below:

Table 3

Treasury Position	**31st March 2010**		**31st March 2011**	
	Principal £'000	**Average Rate %**	**Principal £'000**	**Average Rate %**
<u>Borrowing</u> Fixed Interest Rate Debt	5,056	11.25	4,376	11.31
Other Long-term Liabilities	1,657	0.72	1,657	0.72
Variable Interest Rate Debt	0	0.00	0	0.00
Total Debt	**6,713**	**8.65**	**6,033**	**8.40**
<u>Investments</u>				
Fixed Interest Investments	31,376	1.52	26,997	0.57
Variable Interest Investments	0	0.00	0	0.00
Total Investments	**31,376**	**1.52%**	**26,997**	**0.57**
Net Borrowing Position	**(24,663)**		**(20,964)**	

Prudential Indicators and Compliance Issues

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

21. 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 exceed the CFR. Table 4 below highlights the Council's net borrowing position against the CFR, and shows that it is well below the limit.

Table 4.

Net Borrowing & CFR	**31st March 2010 Actual £'000**	**31st March 2011 Actual £'000**
Total Debt	6,713	6,033
Total Investments	31,376	26,997
Net Borrowing Position	**(24,663)**	**(20,964)**
CFR	**14,387**	**22,613**

22. 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 unless it explicitly agrees to do so. Table 5 below demonstrates that during 2010/2011 the Council has maintained gross borrowing within its authorised limit. The authorised limit allows the Council to borrow to the future CFR if required, and this has been reflected in the limit itself, with a little headroom built in.

Table 5

Authorised Borrowing	31st March 2010		31st March 2011	
	Estimate £'000	Actual £'000	Estimate £'000	Actual £'000
Borrowing	10,000	5,056	25,000	4,376
Other Long-Term Liabilities	1,900	1,657	1,700	1,657
Total Borrowed	**11,900**	**6,713**	**26,700**	**6,033**
Amount Under Limit	**5,187**		**20,667**	

23. The operational Boundary – the operational boundary limit is the expected borrowing position of the Council during the year. It is possible to exceed the operational boundary limit providing that the authorised borrowing limit is not breached.

Table 6

Operational Boundaries	31st March 2010 Estimate £'000	31st March 2011 Estimate £'000
Borrowing	8,000	23,000
Other Long-Term Liabilities	1,900	1,700
Totals	**9,900**	**24,700**

24. 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 costs net of investment income) against the net revenue stream.

Table 7

Actual Finance Costs	2009/10 £'000	2010/11 £'000
Indicators		
Original Indicator – Authorised Limit	11,900	26,700
Original Indicator – Operational Boundary	9,900	24,700
Actuals		
Minimum Gross Borrowing Position	6,713	6,033
Maximum Gross Borrowing Position	9,069	6,713
Average Gross Borrowing Position	0	0
Financing Costs As A Proportion Of Net Revenue Stream – General Fund	1.50%	1.90%
Financing Costs As A Proportion Of Net Revenue Stream - HRA	5.20%	4.50%

Economic Background for 2010/2011

25. 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.

26. 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.

27. 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.

28. 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.

29. 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.

30. 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.

31. 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.

Icelandic Banks

32. During the Financial Year 2008/09 the Council invested £4.5 million with two of the now failed Icelandic banks, of which £3 million was

deposited with Heritable Bank and £1.5 million with Glitnir Bank. These investments, together with accrued interest, are overdue repayment. As at the 31st July 2011, we had received approximately £1.8 million of our original Heritable Bank investment, this equates to approximately 60% of the original investment. Current guidance indicates that the repayment of the Heritable deposits will continue with an eventual total repayment of approx 85% of the original deposits by the end of 2012. The Authority has not received any repayment of the deposit with Glitnir Bank. The matter is currently being processed through the Icelandic courts.

33. This issue is being dealt with nationally by the Local Government Association, who consider that prospects for recovery are good. The Authority impaired these deposits in 2009/10 and has used a capitalisation direction to spread the costs in accordance with accounting practice. A prudent approach has been adopted in 2010/11 as a consequence of:

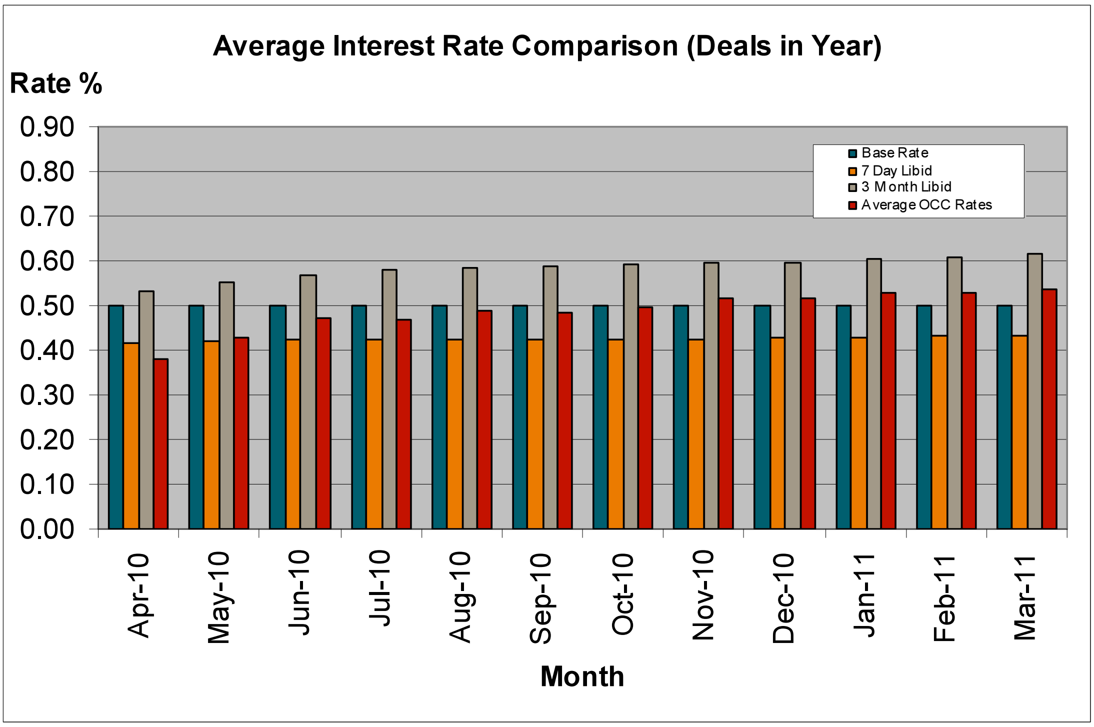
- The preferential creditor status being challenged
- the advice of the Council's Treasury Management advisors, Sector.

34. Consequently, the Council has not followed the accounting treatment recommended by LAAP Bulletin 82 Update 4 released by CIPFA in May 2011.

35. A prudent approach dictates that no revaluation of the financial instrument will take place until a final settlement has been determined and received. This will preserve the benefit of a £1.944 million capitalisation directive to the Authority, until a final settlement is agreed and paid.

Investment Income

36. The following graph shows the Council's achievement of average interest rate in comparison to the base rate and also in comparison to the benchmarks of 3-month Libid and 7-day Libid.



The graph above shows that the average monthly rates for the Councils return were above our benchmark rates, the average Sterling 7 Day LIBID rates.

Table 8 below shows comparator rates and how they fluctuated during the year

Table 8

	INVESTMENT RATES 2010/11					
	Overnight	7 day LIBID	1 Month	3 Month	6 Month	1 Year
01/04/10	0.41%	0.41%	0.42%	0.52%	0.76%	1.19%
31/03/11	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	31/12/10	30/03/11	31/03/11	31/03/11	31/03/11	31/03/11
Low date	01/04/10	01/04/10	01/04/10	01/04/10	01/04/10	01/04/10

37. 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 invests for a range of periods from overnight to 90 days, dependant on the Council's cash flows, its interest rate view, the interest rates on offer and durational limits set out in the approved investment strategy.

38. During 2010/2011 the Council maintained an average investment balance of £40.6 million and received an average return of 0.51%. This compares favourably with the average 7-day LIBID target, which was 0.43%.

39. The original budget for interest receivable in 2010/2011 was £400k. A forecast reduction of £200k was made, with a final forecast of £200k at the end of the year. The Council achieved its final forecast £200k interest.

Counterparty Changes Through out The Year

40. The Mid Year Review amended the approved 2010/11 strategy to allow limited investment in building societies with an asset base of greater than £9 billion. As a result, the following counterparties were added to the approved treasury management lending list:
    i. Yorkshire Building Society
    ii. Leeds Building Society
    iii. Coventry Building Society
    iv. Skipton Building Society

41. The lending duration limits were also increased up to 364 days for the most highly credit rated institutions.

42. During the year all investments were made in full compliance with this Council's treasury management policies and practices.

43. Treasury bills – in order to access high security AAA rated UK Government investments offering higher rates than the Government's Debt Management Office DMADF account, the Council is considering the use of Treasury Bills.

New Guidance

44. In March 2009 the CIPFA Treasury Management Panel issued a bulletin of guidance notes (to be used in conjunction with the CIPFA Treasury Management Code of Practice) for local authorities' treasury management activities after the Icelandic banks collapse. The bulletin suggests that the following should be incorporated:
    I. Diversification between counterparties, countries, sectors and instruments
    II. The involvement of Councillors in the decision making process, regular updates and reviews of the activities and function
    III. Formally reporting on treasury activities, at a minimum twice a year (annual treasury report and treasury strategy) and preferably quarterly
    IV. All three rating agencies should be used, with decisions based on the lowest ratings. The ratings should be kept under regular review and 'ratings watch' notices acted on accordingly

V. Should also systematically review other sources of information. These could include quality financial press, market data and information on government support for banks
VI. Should be clear on the status of service they are receiving from their advisors and satisfy themselves of its appropriateness for their needs
VII. Training of staff should address all of the procedures, practices and processes which are relevant to the Council's treasury management arrangements

45. The Council had already incorporated a number of these recommendations into its treasury management function immediately after the collapse of the Icelandic banks in October 2008. Work has continued to incorporate the remaining recommendations.

46. Prior to the guidance the Council was already using the three major rating agencies and the lowest common denominator (LCD) method, and reviewed the ratings on a daily basis. As well as reviewing individual counterparty limits (amount and period limits) the following limits were also introduced
   I. Counterparty limit of 20% - investments placed with any one counterparty must not exceed 20% of the total amount invested
   II. Country limits: UK – there is no limit in place for the UK
   III. Country limits: Ireland – investments placed with Irish institutions must not exceed 10% of the total amount invested and can only be placed with those institutions covered by the guarantee
   IV. Country limits: Rest of World – currently no investments can be placed with institutions outside the UK or Ireland

47. Councillors have been involved in the decision making process for the strategy for 2010/2011 and 2011/2012, and have received regular reports and updates on key issues as necessary during the year. A training seminar was also held for members in January 2011 to aid understanding of the treasury management function.

Regulatory Framework, Risk and Performance

48. 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, no restrictions were made in 2007/2008;
   - 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 DCLG 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 8th November 2007.

49. 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.

50. 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. The Council is required to comply with both codes through regulations issued under the Local Government Act 2003

51. The primary requirements of the Code are as follows:

I. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
II. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
III. Receipt by the Full Council of an annual treasury management strategy report (including the annual investment strategy report for the year ahead, a midyear review report (as a minimum) and an annual review report of the previous year.
IV. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
V. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body which in this Council is the Value and Performance Scrutiny Committee.

Risk

52. A risk analysis has been carried out and there are no risks to report

HRA Reform

53. During 2010/11 the Government consulted with local authorities on the removal of the Housing Subsidy scheme. The outcome of the consultation was that local authorities will be required to convert to self-financing and buy themselves out of the current scheme on or around 1st April 2012. It is estimated that the Council will be required to pay the Government £200 million. The majority of these funds will need to be borrowed externally and repaid in line with the 30 year Housing Business Plan. The Council is currently investigating funds options.

1. A revised strategy for 2011/12 will need to be produced for approval by Council, to enable us to borrow the funds required to finance the transition to self-financing.

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Background papers:
Treasury Management Strategy 2010/11 – Executive Board March 2010
Treasury Management Mid Year Review Report – Executive Board December 2010