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To:	**Value and Performance Scrutiny Committee** **City Executive Board**
Date:	**25th June 2012** **4th July 2012**
	Item No:
Report of:	**Executive Director, Organisational Development and Corporate Services**
Title of Report:	**Treasury Management Annual Report 2011/2012 and Revised Treasury Management Strategy 2012/2013**

Summary and Recommendations

Purpose of report: The report sets out the Council's treasury management activity and performance for 2011/2012. It also sets out a proposed revision to the Treasury Investment Strategy for 2012/2013 -2015/2016 which will be recommended to Council in July.

Key decision No

Executive lead member: Councillor Ed Turner

Policy Framework: Treasury Management Strategy

Recommendation: The Committee are recommended to:

- note the Treasury Management Annual Report for 2011/2012, as set out in sections 1 – 48 below and;
- comment on the proposed changes to the Investment Strategy originally approved by Council in February 2012, as set out in sections 49 - 54 below and make any recommendations to CEB as appropriate.

Executive Summary

1. The average rate of return on the Council's investments has increased significantly during the financial year 2011/2012 from 0.7% in April 2011 to 1.03% at the 31st March 2012. This is above the Council's Performance Indicator target of 1.0% and despite low market 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.

2. The Council has £1.3m outstanding with the failed Icelandic Banks, a total of £1.8m was received in the year, and it is expected that the remaining funds will be received during 2012/13.

3. The Council's outstanding debt was £203.3 million as at 31st March 2012. Approximately £202.2 million is held with the Public Works Loan Board (PWLB) at fixed interest rates and £1.1 million is held with South Oxfordshire District Council (SODC) at a variable rate of interest. The PWLB loans include £198.5 million borrowed in March 2012 relating to the self financing of the Housing Revenue Account (HRA). The debt relates purely to Housing and the maturity profile ranges from 9 - 45 years. Interest paid on this debt during 2011/2012 was £487,000.

4. The Council held investments totalling approximately £32.0 million as at 31st March 2012, including approximately £1.3 million of outstanding Icelandic bank investments. The remaining investment balance is held in accordance with the Council's Investment Strategy. Interest earnt during the year was approximately £347,000.

5. The primary principle governing the Council's investment criteria is the **Security** of its investment, with **Liquidity** and **Yield** being secondary considerations.

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, the type of asset being financed, and the need to borrow.

7. The Council fully complied with its Treasury Management Strategy in relation to both debt and investment management in 2011/2012. A revision to the Treasury Management Strategy was approved by Council in February 2012 to allow the additional borrowing required to buy the Council out of the Housing Revenue Account Subsidy System. The Council has continued to fund all other debt from internal balances due to the high cost of carry (the difference between borrowing rates and investment returns) and borrowing from external sources will be deferred until interest rates become more cost effective, or internal sources are depleted.

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 2011/2012, and are designed to compare the Council's outturn position against the target set.

Economic Backdrop to 2011/2012

10. The financial year 2011/12 continued the challenging investment environment of recent 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 tight fiscal policy stance was maintained 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, within the austerity plan timeframe. 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. The Bank Base 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 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.

11. 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.

12. 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 Eurozone concerns, and the significant funding issues still faced by many financial institutions, meant that investors remained cautious of longer-term commitment.

Financing of the Capital Programme 2011/12

13. Table 1 below shows actual capital expenditure and financing compared to the original plan or budget.

Table 1

Capital Expenditure	2010/11 Actual £'000	2011/12 Budget £'000	2011/12 Actual £'000	Variation £'000
Non-HRA Capital Expenditure	9,952	23,779	12,435	11,344
HRA Capital Expenditure	14,930	11,201	8,577	(2,624)
Total Capital Expenditure	**24,882**	**34,980**	**21,011**	**(13,969)**
Resourced by:				
Capital Receipts	1,497	9,450	6,394	(3,056)
Capital Grants and contributions	12,292	6,234	3,943	(2,291)
Prudential Borrowing	8,394	11,273	650	(10,623)
Revenue	2,455	8,023	10,024	2,001
Total Capital Resources	**24,882**	**34,980**	**21,011**	**(13,969)**

14 The key variations relate to the following:

- slippage on the construction of the Competition Swimming Pool at Blackbird Leys of £7.8 million due to a Judicial Review on the Council's decision to progress the project
- £3 million of variations on HRA related schemes including
  - £1 million underspend on construction of Cardinal House and Lambourne House
  - £0.7 million slippage on tower block refurbishment works
  - £0.55 million slippage on window replacement programme
  - £0.2 million slippage on shop refurbishment
  - £0.55 slippage on other housing related works.
- £0.8 million underspend in respect of 'city development' infrastructure schemes including development fees for land at Barton £0.5 million which were subsequently charged to revenue.
- £0.5 million slippage on repairs and refurbishment of corporate buildings including Rosehill Community Centre of £0.2 million
- £0.8 million underspend on Play Barton and £0.2 million of other play area slippage
- £0.3 million of slippage on ICT related projects

15 The variation in the underlying need to borrow i.e prudential borrowing relates largely to slippage of the Competition Swimming Pool of approximately £7.8 million and underspend within the HRA, The interaction with the Councils underlying need to borrow i.e its Capital Financing Requirement (CFR) is discussed in more detail below

The Council's Overall Borrowing Need

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

17 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.

18 Table 2 below shows the Council's CFR position as at the 31st March, this is a key prudential indicator

Table 2.

CFR	31st March 2011 Actual £'000	31st March 2012 Estimate £'000	31st March 2012 Actual £'000	Variation £000's
Opening Balance	**14,219**	**22,613**	**26,044**	**3,431**
Plus prudential borrowing	9,991	11,273	650	(10,623)
HRA reform borrowing	0	0	198,528	198,528
Minumum Revenue Provision	(294)	(244)	(295)	(51)
Finance Lease	2,128	0	0	0
CFR Closing Balance	**26,044**	**33,642**	**224,927**	**191,285**

19 The CFR position above has been increased by a) the capital expenditure financed by prudential borrowing in 2011/12 of £650k and the HRA self financing debt of £198.5 million. This has in turn been reduced by the Minimum Revenue Provision leaving the closing CFR of £224.9 million.

Treasury Position at 31st March 2012

20 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:

III. Borrowing to the CFR;

IV. Choosing to utilise some temporary cash flow funds, which will reduce our investment balance, instead of borrowing (this is know as "under borrowing");

V. Borrowing for future increases in the CFR (borrowing in advance of need*)*

21 It should be noted that accounting practice requires financial instruments (debt, investments, etc.) to be measured in a method compliant with International 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 for 2011/12.

22 During 2011/2012 approximately £198.5 million of new debt was taken out to finance the transition to self financing of the Housing Revenue Account (HRA). At the end of 2011/2012 the Council's total debt was £203.3 million. This amount of debt is still below the CFR shown in Table 2 above and indicates that the Council continues to 'internally borrow' of the order of £22 million.

23 The Council's treasury position as at the 31st March 2012 for both debt and investments, compared with the previous year is set out in Table 3 below:

Table 3

Treasury Position	**31st March 2011**		**31st March 2012**	
	Principal £'000	**Average Rate** %	**Principal £'000**	**Average Rate** %
Borrowing Fixed Interest Rate Debt	4,376	11.31	202,166	11.33
Other Long-term Liabilities	1,657	0.72	1,158	0.82
Variable Interest Rate Debt	0	0.00	0	0.00
Total Debt	**6,033**	**8.40**	**203,324**	**8.79**
Investments				
Fixed Interest Investments	13,997	0.57	30,315	1.09
Variable Interest Investments	13,000	0.00	1,685	0.69
Total Investments	**26,997**	**0.57**	**32,000**	**1.03**
Net Position	**(20,964)**		**171,324**	

N.B.Variable Interest Rate Investments are the Council's investments in Money Market Funds.

Prudential Indicators and Compliance Issues

24 Some of the prudential indicators provide an overview (paras 25 and 28) others a specific limit on treasury activity (paras 26 and 27). These are detailed below:

25 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 significantly below the limit.

Table 4.

Net Borrowing & CFR	31st March 2011 Actual £'000	31st March 2012 Actual £'000
Total Debt	6,033	203,324
Total Investments	(26,997)	(32,000)
Net Borrowing Position	**(20,964)**	**171,324**
CFR	**26,044**	**224,927**
Under borrowing	**47,008**	**53,603**

26 <u>The Authorised Limit</u> – 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 2011/2012 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 2011		31st March 2012	
	Estimate £'000	Actual £'000	Estimate £'000	Actual £'000
Borrowing	25,000	4,376	245,000	202,166
Other Long-Term Liabilities	1,700	1,657	1,500	1,158
Total Borrowed	**26,700**	**6,033**	**246,500**	**203,324**
Amount Under Limit	**20,667**		**43,176**	

27 <u>The operational Boundary</u> – the operational boundary limit is the expected borrowing position of the Council during the year. It is possible to exceed the operational boundary limit, for a short period of time, providing that the authorised borrowing limit is not breached.

Table 6

Operational Boundaries	31st March 2011 Estimate £'000	31st March 2012 Estimate £'000
Borrowing	23,000	236,000
Other Long-Term Liabilities	1,700	1,500
Totals	**24,700**	**237,500**

28 <u>Actual financing costs as a proportion of net revenue stream</u> – 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. This table is another key indicator of affordability and shows the borrowing to

have been uplifted to reflect the ‘self financing’ debt take on of £198.5 million which has increased both the authorised and operational boundaries. In addition the financing costs as a proportion of net revenue streams shows the general fund changing to a negative figure as investment income starts to exceed interest paid following the repayment of fixed term PWLB loans and the HRA ratio staying relatively constant. Going forward, following self financing the HRA ratio is likely to increase substantially as interest payments will increase by around £8 million per annum.

Table 7

Actual Finance Costs	**2010/11 £’000**	**2011/12 £’000**
<u>Indicators</u>		
Original Indicator – Authorised Limit	26,700	246,500
Original Indicator – Operational Boundary	24,700	237,500
<u>Actuals</u>		
Minimum Gross Borrowing Position	6,033	5,051
Maximum Gross Borrowing Position	6,713	203,324
Average Gross Borrowing Position	0	5,420
Financing Costs As A Proportion Of Net Revenue Stream – General Fund	1.9%	-1.3%
Financing Costs As A Proportion Of Net Revenue Stream – HRA	2.2%	1.9%

Icelandic Banks

29 During the Financial Year 2008/09 the Council invested £4.5 million with two of the now failed Icelandic banks, of which £3.0 million was deposited with Heritable Bank and £1.5 million with Glitnir Bank. These investments, together with accrued interest, are partly overdue their initial repayment.

30 As at the 31st March 2012, we had received approximately £2.0 million of our original Heritable Bank investment plus interest, this equates to approximately 68% of the original investment. Current guidance indicates that the repayment of the Heritable deposits will continue with an eventual total repayment of approx 90% of the original deposits by the end of 2012.

32 On 15th March, the Council received four of the five foreign currency repayments due from Glitnir Bank totalling £1.2 million . Exchange rate losses of approximately 2.8%, (£45k) were incurred on these repayments. The repayment date of the fifth currency (in Icelandic Krona (ISK)) is still to be confirmed and requires the resolution of changes to Icelandic law to allow ISK to be transferred out of Iceland. Once this has been resolved, it is expected that we will receive close to 100% of our initial deposit.

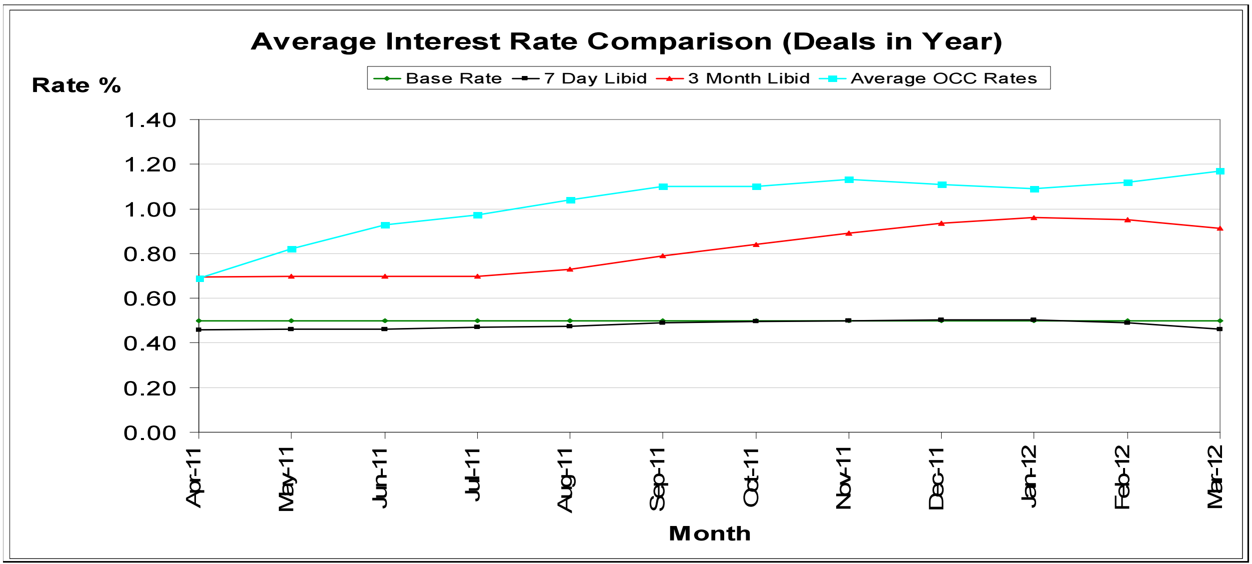
33 Table 8 below shows the original loan terms and the repayments received and outstanding as at 31st March 2012:

Table 8

Counterparty	Original Principal	Interest Rate	Maturity Date	Interest Received	Principal Repaid	Exchange Rate Loss	Total Repaid	Total Outstanding as at 31.03.12
Glitnir	£1.5m	5.51%	28/01 2009	£81,172.63	£1,213,800	(£45,238.57)	£1,249,734.06	£305,339.56
Heritable	£1.0m	6.04%	05/01 2009	£14,714.79	£679,218		£693,932.79	£311,178.44
Heritable	£1.0m	6.18%	30/04 2009	£8,984.95	£679,218		£688,202.95	£332,316.50
Heritable	£1.0m	5.83%	09/12 2008	£3,665.34	£679,218		£682,883.34	£329,645.98
Total				**£108,537.71**	**£3,251,454**	**(£45,238.57)**	**£3,314,753.14**	**£1,278,480.48**

Investment Income

34 The following graph shows the Council's monthly average interest rate in comparison to the base rate and also in comparison to its benchmarks: 3-month Libid and 7-day Libid.



35 As can be seen the Council's average monthly rate of return was above benchmark.

36 Table 9 below shows comparator rates and how they fluctuated during the year

Table 9

	INVESTMENT RATES 2011/12					
	Overnight	7 day LIBID	1 Month	3 Month	6 Month	1 Year
01/04/11	0.44%	0.46%	0.50%	0.70%	1.00%	1.48%
31/03/12	0.43%	0.46%	0.57%	0.90%	1.22%	1.74%
High	0.55%	0.51%	0.65%	0.96%	1.27%	1.77%
Low	0.43%	0.46%	0.50%	0.69%	0.98%	1.45%
Average	0.45%	0.48%	0.56%	0.82%	1.11%	1.60%
Spread	0.12%	0.05%	0.15%	0.27%	0.29%	0.32%
High date	30/06/11	30/12/11	11/01/12	12/01/12	25/01/12	25/01/12
Low date	14/03/12	01/04/11	01/04/11	12/04/11	10/06/11	22/06/11

37 The Council manages its investments in-house and invests with the institutions listed in the Council's approved counterparty list. The Council invests for a range of periods from overnight to 364 days, dependant on cash flow needs, its interest rate view, the interest rates on offer and durational limits set out in the approved investment strategy.

38 During 2011/2012 the Council maintained an average investment balance of £38.1 million and received an average return of 1.03%. This is above the Council's Performance Indicator target of 1.0% (0.5% above the average Bank of England's Base Rate for the year). In comparison, the average rate of return at the beginning of the year was 0.69% (April 2011). It also compares favourably with the Council's benchmark interest rate target, the average 7-day LIBID, which was 0.48%.

39 Actual investment income receivable for 2011/2012 was approximately £393,000. Due to the write off the Icelandic interest accrued in 2010/11 that will not be paid to the Council and the Glitnir exchange rate losses outlined in paragraph 32, the interest reported in the Statement of Accounts will be written down to approximately £347,000. This is significantly higher than the 2011/12 income target of £293,000 and was achieved through the initiation of a rolling programme of lending up to 364 days with highly credit rated, Government backed financial institutions and negotiating higher than expected returns on shorter term investments.

Fluctuations in the Council's balances have been managed through the use of a mix of instant access and notice accounts, money market funds and short term deposits (up to 3 months). This strategy is in line with the Investment Strategy approved by Council for 2011/2012.

40 Due to the economic downturn and the problems facing the Eurozone, midway through the year, lending was temporarily restricted to a maximum of three months for all institutions, with the exception of other local authorities or semi-nationalised banks. This temporary limit is still in place. No changes are required to the overall Treasury Management Strategy as this change is at an operational level. The situation will continue to be reviewed by the treasury team, the Head of Finance and the Executive Director of Organisational Development and Corporate Services.

41 To counteract the effect of losing several counterparties from the lending list, two new money market fund accounts were opened during the year, one with Ignis and the other with Prime Rate. This has helped to diversify the investment spread as each fund spreads its investment over many counterparties and therefore our exposure to each counterparty is minimal. Money market funds have to meet very strict lending criteria in order to retain their coveted AAA credit ratings.

Counterparty Changes During The Year

42 During the year the following counterparties were temporarily removed from the Council's approved Treasury Management Lending List due to a

combination of credit rating downgrades and a deterioration in their credit default swap rates:

i. Clydesdale Bank plc
ii. Santander UK plc
iii. Cater Allen

43 The building societies listed below were also temporarily suspended in light of market turbulence and credit rating downgrades (these suspensions are still in place):

i. Yorkshire Building Society
ii. Leeds Building Society
iii. Coventry Building Society
iv. Skipton Building Society

Housing Revenue Account (HRA) Reform

44 Legislation contained within the Localism Act enabled the introduction of the HRA Self Financing system from 1st April 2012. Self-financing effectively ended the previous subsidy funding system and for a one-off payment covering its allocated share of the national housing debt figure enables the Council to retain all of its HRA dwelling rents going forward.

45 To finance the debt payment the Council borrowed and paid over £198.5 million to the Department for Communities and Local Government (CLG) on 28 March 2012. This additional borrowing required a revision to the Treasury Management Strategy for 2011/2012, which was approved by Council in February 2012.

46 The loans which are with the Public Work Loans Board (PWLB) and set out in Table 10 below incur an average annual interest rate for the first nine years of 3.26%. The loans will be repaid in line with the cashflow expectations of the thirty year HRA business plan.

£m	Period	Maturity Date	Interest Rate	Annual Interest	Total Interest
20	9 years	27/03/2021	2.21%	442,000.00	3,978,000.00
20	14 years	27/03/2024	2.92%	584,000.00	8,176,000.00
40	20 years	27/03/2032	3.30%	1,320,000.00	26,400,000.00
40	25 years	27/03/2037	3.44%	1,376,000.00	34,400,000.00
40	30 years	27/03/2042	3.50%	1,400,000.00	42,000,000.00
0	35 years	27/03/2047	3.52%	-	-
0	40 years	27/03/2052	3.52%	-	-
38.528	45 years	28/09/2057	3.50%	1,348,480.00	60,681,600.00
198.528	**Weighted Average Interest Rate**		**3.26%**	**6,470,480.00**	**175,635,600.00**

47 Compensation was paid by CLG for the interest incurred by the authority for the four days from taking the loans leading to the go live date, of 1st April 2012.

48 To give us greater flexibility in future years, the Authority will use the one pool approach and pool this debt together with the Council's existing debt in one pot.

Treasury Investment Strategy Revision for 2012/2013 – 2015/2016
Increase In Money Market Fund Limits

49 The current Investment Strategy for 2012/2013 – 2015/2016 limits money market fund (MMF) deposits to a maximum of £15 million across the Council's five MMF accounts. Due to the reduction in the number of counterparties on the Council's treasury management lending list, and the need to ensure security and liquidity of our investments, an increase to the overall limit in Money Market Funds is being recommended by officers. This will allow us to manage our cashflow more effectively.

50 The proposal is to increase the overall limit to £20 million across the five MMF accounts, this will provide the Council with ability to place funds in an AAA rated institution that is highly liquid, whilst ensuring our investments are spread equally over our counterparties.

Additional Counterparties

51 The current Investment Strategy allows investment with local authorities for up to £10 million for 364 days. Recently Police Authorities have become more active in the investment markets and in order to give the Council the ability to diversify its investment holdings as wide as possible whilst still maintaining security it is recommended that the counterparty list is extended to include such organisations and other public bodies. These organisations are similar to local authorities in the terms of their security of investment and therefore officers do not believe that extending the counterparty list to include such bodies will open the authority up to undue risk.

Financial Implications

52 These are set out within the body of the report

Legal Implications

53These are covered adequately within the report

Risk Implications

54 A risk analysis has been carried out and there are no risks in connection with the recommendations within the report, risk assessment is a key part of Treasury Management activity especially in the selection of counterparties when investing is being considered. The Council uses external advisors and counterparty credit ratings issued by the rating agencies to assist in this process.

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Background papers:
Treasury Management Strategy 2011/12 – Executive Board February 2011
Treasury Management Strategy 2012/13 – Executive Board February 2012
Treasury Management Mid Year Review Report – Executive Board December 2011

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