ITEM NO	

REPORT TO EXECUTIVE

DATE	**26th July 2011**
PORTFOLIO	**Resources**
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Annual Treasury Management Report
Review of 2010/2011 Activity

PURPOSE

1. To inform members of the Council's treasury management activity during 2010/2011.

RECOMMENDATION

2. (1) That the Executive note the annual treasury management activity for the year ended 31 March 2011 ; and

   (2) That the Executive recommend Full Council to approve the actual 2010/2011 prudential and treasury indicators detailed within this report.

REASONS FOR RECOMMENDATION

3. To comply with the regulations issued under the Local Government Act 2003 to produce an annual treasury report reviewing treasury management activities and the actual prudential and treasury indicators for 2010/2011. 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 2010/2011 the minimum reporting requirements were that both the Executive and subsequently Full Council should receive the following reports:

   - an annual treasury strategy in advance of the year (Full Council 24/02/2010)
   - a mid year (minimum) treasury update report (Full Council 28/10/2010)
   - an annual report following the year describing the activity compared to the strategy (this report)

   In addition, the Executive received quarterly treasury management update reports on 24/08/2010 and 08/02/2011.

   Recent changes in the regulatory environment place a much greater onus on members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

During 2010/2011, the Council complied with its legislative and regulatory requirements, as set out in both the Treasury Management Strategy and the Prudential & Treasury Indicators for 2010//2011 – 2012/2013, approved by Full Council on the 24th February 2010.

The financial year 2010/2011 continued the reflect the impact that Local Authorities are facing regarding the challenging economic environment of previous years; low investment returns and counterparty risk continued.

Prudential and treasury indicators are found within the main body of the report and the Director of Resources confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit [the authorised limit] was not breached, as outlined in detail in paragraph 6 to this report.

SUMMARY OF KEY POINTS

4. INTRODUCTION

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
- Summary of interest rate movements in the year
- Analysis of Investment Deposits
- Economic Update and Interest Rates
- Comparison of Investment Deposits
- Icelandic Bank Defaults

5. THE COUNCILS CAPITAL EXPENDITURE AND FINANCING 2010/2011

Capital spending relates to the cost of the provision of, or enhancement of, assets or other expenditure where the benefits last beyond the financial year in question.

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.

£m	2009/10 Actual	2010/11 Estimate	2010/11 Actual
Non-HRA capital expenditure	21.6	19.6	11.8
HRA capital expenditure	-	-	-
Total capital expenditure	**21.6**	**19.6**	**11.8**
Resourced by:			
• Capital receipts	1.3	1.6	1.5
• Capital grants	18.9	17.1	9.3
• Capital reserves	-	-	0
• Revenue	0.1	0.1	0.3
Unfinanced capital expenditure	**1.3**	**0.8**	**0.7**

6. 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 2010/2011 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, finance staff organise 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 2010/2011 MRP Policy (as required by CLG Guidance) was approved on 24/02/2010.

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

CFR (£m)	31 March 2010 Actual	31 March 2011 Original Indicator	31 March 2011 Actual
Opening balance	28.5	28.1	28.6
Add unfinanced capital expenditure (as above)	1.3	0.8	0.7
Add adjustment for the inclusion of on-balance sheet PFI and leasing schemes (not applicable)	-	-	-
Less MRP	(1.2)	(1.2)	(1.2)
Less PFI & finance lease repayments	-	-	-
Closing balance	28.6	27.7	28.1

The 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 2010/2011 plus the expected changes to the CFR over 2011/2012 and 2012/2013. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2010/2011. The table below highlights the Council's net borrowing position against the CFR.

£m	31 March 2010 Actual	31 March 2011 Original	31 March 2011 Actual
Net borrowing position	33.1	33.3	23.0
CFR	28.6	27.7	28.1

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 2010/2011 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.

£m	2010/11
Authorised limit	37
Maximum gross borrowing position	34
Operational boundary	33
Average gross borrowing position	24
Financing costs as a proportion of net revenue stream	12.4%

7. TREASURY POSITION AS AT 31ST MARCH 2011

The Council's debt and investment position is organised by finance staff 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.

£m	31 March.2010 actual	2010/11 original limits	31 March.2011 actual
Under 12 months	0.4	9.2	2.0
12 months and within 24 months	2.0	2.0	3.0
24 months and within 5 years	6.1	6.1	4.1
5 years and within 10 years	4.4	4.4	6.4
10 years and above	9.4	9.4	7.4

8. ECONOMIC UPDATE

(provided by the Council's external service providers, Sector Treasury Services):

2010/2011 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.

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.

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.

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.

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.

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.

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.

9. <u>HISTORICAL INTEREST RATES</u>

The table below identifies a number of key interest rate bands and the rates available as at

31 March 2011, 30 September 2010, 1 April 2010 and one year ago.

Historical Interest Rates	Mar 11	Sept 10	Apr 10
Bank Base Rate	0.50%	0.50%	0.50%
7 Day Money Market Borrowing Rate	0.35%	0.35%	0.35%
PWLB Quota Rates – 5 Years			
- Maturity	3.57%	2.04%	2.84%
- Equal Instalments of Principal	2.69%	1.22%	1.78%
- Annuity	2.71%	1.23%	1.80%
PWLB Quota Rates – 10 Year			
- Maturity	4.71%	3.22%	4.14%
- Equal Instalments of Principal	3.65%	2.04%	2.94%
- Annuity	3.73%	2.10%	3.03%

Members will note that rates pertaining to the base rate and the 7 day money market borrowing rate remain unchanged since 1st April 2010. However the PWLB quota rates generally fluctuated, each quartile.

10. INVESTMENT RATES IN 2010/2011

The tight monetary conditions following the 2008 financial crisis continued through 2010/2011 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.

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. ANALYSIS OF INVESTMENT DEPOSITS DURING 2010/2011

There have been a total of 86 market investments made during the period 1 April 2010 to 31 March 2011 totalling £101.05 million. Comprising of 64 with HSBC Sterling Line totalling £69.2m, 4 with individual counter parties [Ulster Bank] through the brokerage facility, and 18 with our Call / Instant Access Accounts [with Yorkshire, Santander Bank & Lancashire County Council].

Appendix 1 shows the maximum amount invested with any of the counter parties and at any one time during the period April to end of March 2011. The maximum limit per counterparty is shown in brackets.

12. ICELANDIC BANK DEFAULTS

Background:

An amount of £1m was deposited by the Council in September 2008 in an Icelandic bank, Landsbanki Islands HF. As a consequence of the collapse of the Icelandic banking system, this short-term deposit was not repaid on the due date of 8th October 2008 and remains unpaid.

Current Position:

It is estimated that 95% of the £1m deposit and interest due (after accounting for inflation) will ultimately be recovered as the current legal position is that the Council's claim will enjoy priority status. It is however not expected that the final payment will be made until 2018. An impairment of this deposit has been charged to the accounts in 2010/11 as was the case in 2008/09 and 2009/10. The total of the impairment to the end of 2010/11 (£318k) reflects the difference between the £1m plus interest due and the present value of the amount expected to be recovered.

Sector Treasury Services Update:

The Icelandic Government has stated its intention to honour all its commitments as a result of their banks being placed into receivership. The U.K. Government is working with the Icelandic Government to help bring this about. At the current time, the process of recovering assets is still ongoing with the administrators. The Local Government Association is co-ordinating the efforts of all UK authorities with Icelandic investments. Members will be periodically updated on the latest developments on these efforts.

FINANCIAL IMPLICATIONS AND BUDGET PROVISION

13. None arising as a direct result of this report.

POLICY IMPLICATIONS

14. All transactions are in accordance with the Council's approved Treasury Policy Statement

DETAILS OF CONSULTATION

15.

BACKGROUND PAPERS

16. Treasury Management Strategy Report & Prudential Indicators Report for 2010/2011. External Borrowing & Investment Files. PWLB Transactions & Interest Files. Guidance from Sector Treasury Services.

FURTHER INFORMATION

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