Audit Committee		Agenda Item:
Meeting Date	19 September 2012	
Report Title	Annual Treasury Management Report 2011/12	
Portfolio Holder	Cabinet Member for Finance: Cllr Duncan Dewar-Whalley	
SMT Lead	Nick Vickers, Head of Finance	
Head of Service	Nick Vickers, Head of Finance	
Lead Officer	Deborah Walton, Senior Accountant	
Key Decision	No	
Classification	Open	
Forward Plan	Reference number	
Recommendations	1. To note the actual 2011/12 prudential indicators within the report.	
	2. To note the Treasury Management stewardship report for 2011/12.	

1 Purpose of Report and Executive Summary

1.1 The Council's treasury management activity is underpinned by the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management ("the Code"), which requires local authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities at least twice a year.

1.2 Treasury Management is defined as "the management of the local Council's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks".

1.3 Overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

1.4 This report:

- is prepared in accordance with the revised CIPFA Treasury Management Code and the revised Prudential Code;
- details the implications of treasury decisions and transactions;
- gives details of the outturn position on treasury management transactions in 2011/12; and

- confirms compliance with Treasury limits and Prudential Indicators.

1.5 This report was submitted to Cabinet on 5 September and Council on 12 September.

2 Background

Economic Background

2.1 At the time of determining the strategy in February 2011, there were tentative signs that the UK was emerging from recession with the worst of the financial crisis behind it. Recovery in growth was expected to be slow and uneven as the austerity measures announced in the 2010 Comprehensive Spending Review were implemented in order to bring down the budget deficit and government borrowing and rebalance the economy and public sector finances. Inflation measured by the Consumer Price Index (CPI) had remained stubbornly above 3%; unemployment was at a 16-year high at 2.5 million, and was expected to rise further as the public and private sector contracted. There was also a high degree of uncertainty surrounding Eurozone sovereign debt sustainability.

2.2 During 2011/12 inflation remained high, with CPI (the official measure) and the Retail Price Index (RPI) rising in September to 5.2% and 5.6% respectively, primarily due to escalating utility prices and the January 2011 increase in VAT to 20%. Inflation eased slowly as reductions in transport costs, food prices, intensifying competition amongst retailers and supermarkets and the VAT effect falling out in 2012 pushed February 2012's CPI down to 3.4%, and RPI to 3.7%. This, however, was not enough to offset low wage growth and, as a result, Britons suffered the biggest drop in disposable income in more than three decades.

2.3 It was not surprising that the Bank of England's Monetary Policy Committee maintained the status quo on the Bank Rate, which has now been held at 0.5% since March 2009, but increased asset purchases by £75bn in October 2011, and another £50bn in February 2012, taking the Quantitative Easing (QA) total to £325bn.

2.4 The policy measures announced in the March 2012 Budget Statement were judged to be neutral. The government stuck broadly to its austerity plans as the economy was rebalanced slowly. The opinion of the independent Office for Budget Responsibility (OBR) was that the government was on track to meet its fiscal targets - the OBR identified oil price shocks and a further deterioration in Europe as the main risks to the outlook for growth and in meeting the fiscal target.

2.5 In Europe, sovereign debt problems for some peripheral countries became critical. Several policy initiatives were largely ineffectual; two bailout packages were required for Greece and one for Portugal, and the contagion spread to Spain and Italy whose sovereign bonds came under increased stress in November. Standard & Poor's downgraded nine European sovereigns and the European Financial Stability Fund. The successful Greek sovereign bond swap in March 2012, shortly after its second bailout package, allowed it to avoid bankruptcy later that month, but it was not a long-term solution. The European Central Bank's €1.3 trillion Long-Term Refinancing Operations (LTROs) flooded the financial markets with ultra-cheap three-year liquidity and relieved much of the immediate funding pressure facing European banks in 2012, but markets ultimately took the view that the LTROs simply served to delay a resolution of, rather than addressed, the fundamental issues underpinning Euroland's problems.

2.6 Market sentiment oscillated between 'risk on / risk off' modes, this swing becoming the norm for much of 2011/12 as investors shifted between riskier assets and the relative safety of higher quality government bonds. Gilts, however, were a principal beneficiary of the 'risk-off' theme, which helped push yields lower. There was little market reaction to or impact on gilts by the decision by Fitch and Moody's to change the outlook on the UK's AAA rating from stable to negative. Over the 12-month period from April 2011 to March 2012, five-year gilt yields more than halved from 2.40% to 1.06%, ten-year gilt yields fell from 3.67% to 2.25%, 20-year yields fell from 4.30% to 3.20% and 50-year yields from 4.20% to 3.35%. The Public Works Loan Board (PWLB) borrowing rates fell commensurately, but the cost of carry associated with borrowing longer-term loans whilst investing the monies temporarily until required for capital financing, remained high, in excess of 4.1% for 20-year PWLB maturity borrowing.

2.7 Europe's banking sector was inextricably linked with the sovereign sector. Sharp moves in sovereign Credit Default Swaps and bond yields were fairly correlated with the countries' banking sector performance. The deterioration in the prospects for real growth had implications for earnings and profit growth and bank creditworthiness. The European Banking Council's banking stress tests of 70 EU banks undertaken in October 2011 identified a collective €106 billion shortfall to banks' Core Tier 1 ratio of 9%. The slowdown in debt and equity capital market activity also had implications for banks' funding and liquidity. These principal factors, as well as a reassessment by the ratings agencies of future sovereign support for banks, resulted in downgrades to the long-term ratings of several UK and non-UK financial institutions in autumn 2011.

Borrowing Requirement and Debt Management

2.8 The overall borrowing position is summarised below:

	Balance 31/3/2011 £000's	Debt Maturing £000's	New Borrowing £000's	Balance 31/3/2012 £000's
Capital Funding Requirement	8,044			7,170
Short Term Borrowing	0	0	0	0
Long Term Borrowing	0	0	0	0
TOTAL EXTERNAL BORROWING				
Other Long Term Liabilities	2,526			1,935
TOTAL EXTERNAL DEBT	**2,526**			**1,935**

2.9 All ‘borrowing’ is internally financed, and the council endorsed its approach to remain free from external borrowing as part of its Budget approval in February 2012.

Investment Activity

2.10 The Council held average cash daily balances of £13.0m during the year. These represented working cash balances / capital receipts, and the Council’s reserves.

2.11 The Communities and Local Government’s (CLG) Guidance on Investments, revised during 2009/10, reiterated security and liquidity as the primary objectives of a prudent investment policy. Although the Guidance became operative on 1 April 2010, its principal recommendations run parallel to the credit risk management requirements in the revised Treasury Management Code. In the revised Guidance, Specified Investments are those made with a body or scheme of “high credit quality”. Both the Guidance and the revised Treasury Management Code emphasise that counterparty credit criteria should not rely on credit ratings alone, but should include a wider range of indicators. The revised Code nonetheless requires that ratings assigned by all three rating agencies – Fitch, Moody’s and Standard & Poor’s – be taken into account and the lowest rating be used.

2.12 The criteria applied by the Head of Finance for the approval of a counterparty are:

- a strong likelihood of Government intervention in the event of liquidity issues based on systematic importance to the UK economy (for individual financial institutions);
- credit rating (Council’s minimum long term counterparty rating of A- across all three rating agencies, Fitch, Standard & Poor’s and Moody’s;
- credit default swaps;
- share price;
- reputational Issues;
- exposure to other parts of the same banking group; and
- country exposure.

2.13 The Council only makes Specified Investments i.e. deposits with a duration that does not exceed 364 days, and there is no facility for making Non-Specified Investments, i.e. with a duration of over 364 days. This reflects both the continuing lack of stability in financial markets and the need to keep the duration of funds short for cash flow purposes.

2.14 The specified investments permissible are:

Specified Investment Instrument (in sterling)	**Limits and Maturity dates**
Term deposits with: Government backed deposits ▪ The UK government ▪ Gilt Edged Securities	 Unlimited amount and maturity up to 364 days Unlimited amount and maturity up to 364 days
Banking deposits ▪ Money Market Funds	 £2m limit for AAA rated funds as defined by Fitch, Moody's and Standard and Poor (funds are held on call).
▪ UK Banks and building societies	£2m limit for F1 / minimum A- rated institutions as defined by Fitch and/or equivalent ratings by Moody's and Standard & Poor's for a maximum period of 364 days.

2.15 The UK financial institutions used were:

- Lloyds TSB Bank Plc;
- Barclays Bank Plc;
- HSBC Bank Plc;
- Royal Bank of Scotland Plc;
- National Westminster Bank; and
- Nationwide Building Society.

2.16 Santander UK Plc has been suspended since November 2010 due to underlying issues arising from it's Spanish ownership. At the end of July 2012 Arlingclose extended their maximum duration for Santander UK from overnight to 35 days. In light of this the Council recommenced use of Santander UK for overnight monies on 9 August 2012.

2.17 Since June, RBS no longer meets the Council's short term credit rating whilst still meeting the long term rating requirement, and Arlingclose recommend a maximum duration of 35 days. Cabinet is asked to agree to recommencing use of RBS for overnight money despite not reaching our minimum short term credit rating. The position of RBS will continue to be closely monitored.

2.18 The deposits for the year are summarised below:

Investments	Balance on 31/3/2011 £'000	Investments Made £'000	Maturities £'000	Balance on 31/03/2012 £'000	Average Rate %	Average Life (days)
Short Term Investments	1,910	168,101	(154,588)	15,423	0.69	28
Long Term Investments	8	0	5	3	3.15	undated
TOTAL INVESTMENTS	1,918			15,426		
Increase in Investments £'000				13,508		

2.19 **Liquidity:** In keeping with the CLG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds / overnight deposits / the use of call accounts.

2.20 **Yield:** The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate was maintained at 0.5% through the year. Short term money market rates remained at very low levels which has a significant impact on investment income.

2.21 The Council's budgeted investment income for the year was estimated at £75,000, and actual income received was £84,000.

2.22 The Council has a very cautious treasury policy – we need at all costs to preserve our principal sums. As interest rates increase we will benefit from higher returns in the second half of 2012/13.

2.23 The Council subscribes to the CIPFA Treasury Management Benchmarking and we receive quarterly benchmarking from Arlingclose. This will be explained further at the Treasury Management training session which is being arranged for the Committee.

Compliance with Prudential Indicators

2.24 The Council has complied with its Prudential Indicators for 2011/12, which were set as part of the Treasury Management Strategy agreed by Council on 23 February 2011.

2.25 In Appendix I the outturn position for the year against each Prudential Indicator is set out.

Treasury Advisers

2.26 Arlingclose has been the Council's treasury advisers since May 2009. Officers of the Council meet with them regularly and high quality and timely information is received from them.

3. Proposal

3.1 Members are asked to approve the report.

4. Alternative Proposals

4.1 No alternative proposals have been considered, and compliance with the CIPFA Code is mandatory

5. Consultation Undertaken

5.1 Arlingclose have been consulted.

6. Implications

Issue	Implications
Corporate Plan	Supports delivery of the Councils objectives.
Financial, Resource and Property	The Council's Treasury Strategy is agreed annually as part of the budget process.
Legal and Statutory	Need to comply with CLG guidance on treasury management.
Crime and Disorder	Not relevant to this report.
Risk Management and Health and Safety	Not relevant to this report.
Equality and Diversity	Not relevant to this report.
Sustainability	Not relevant to this report.

7. Appendices

7.1 Appendix I: Prudential Indicators.

8. Background Papers

8.1 Treasury Strategy report, Council 23 February 2011.

8.2 Treasury Strategy report, Council 22 February 2012.

Prudential Indicators for 2011/12

1. Background

There is a requirement under the Local Government Act 2003 for local authorities to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the "CIPFA Prudential Code") when setting and reviewing their Prudential Indicators.

2. Net Debt and the Capital Financing Requirement (CFR)

This is a key indicator of prudence. In order to ensure that over the medium term net debt will only be for a capital purpose, the local authority should ensure that the net debt does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional increases to the capital financing requirement for the current and next two financial years.

The Head of Finance reports that the authority had no difficulty meeting this requirement in 2011/12, nor is there any difficulties envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the approved budget.

Net Debt and the Capital Financing Requirement	**31/03/11 Actual £'000**	**31/03/12 Original Estimate £'000**	**31/03/12 Actual £'000**	**31/03/13 Original Estimate £'000**	**31/03/14 Original Estimate £'000**
Gross CFR	8,044	6,871	7,170	6,326	5,502
Less: Other Long Term Liabilities	(2,526)	(2,274)	(1,935)	(1,719)	(3,643)
Borrowing CFR	**5,518**	**4,597**	**5,235**	**4,607**	**1,859**
Less: Existing Profile of Borrowing	0	0	0	0	0
Cumulative Maximum External Borrowing Requirement	**5,518**	**4,597**	**5,235**	**4,607**	**1,859**

3. Actual Capital Expenditure

This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits and, in particular, to consider the impact on Council Tax.

Capital Expenditure	**2010/11 Actual £'000**	**2011/12 Original Estimate £'000**	**2011/12 Actual £'000**	**2012/13 Original Estimate £'000**	**2013/14 Original Estimate £'000**
Total	**4,469**	**1,235**	**1,748**	**1,068**	**941**

Capital expenditure will be financed follows:

Capital Financing	2010/11 Actual £'000	2011/12 Original Estimate £'000	2011/12 Actual £'000	2012/13 Original Estimate £'000	2013/14 Original Estimate £'000
Capital receipts	294	97	97	97	0
Government Grants	3,613	1,033	1,540	906	906
Revenue contributions	562	105	111	65	35
Total Financing	**4,469**	**1,235**	**1,748**	**1,068**	**941**

4. Ratio of Financing Costs to Net Revenue Stream

This is an indicator of affordability, highlighting the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs. The definition of financing costs is set out in the Prudential Code.

The ratio is based on costs net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2010/11 Actual %	2011/12 Original Estimate %	2011/12 Actual %	2012/13 Original Estimate %	2013/14 Original Estimate %
Total	**4.13**	**3.19**	**4.87**	**5.09**	**4.90**

5. Capital Financing Requirement

The Capital Financing Requirement measures the Council's underlying need to borrow for a capital purpose. The calculation of the CFR is taken from the amounts held in the Balance Sheet relating to capital expenditure and it's financing.

Capital Financing Requirement	31/03/11 Actual £'000	31/03/12 Original Estimate £'000	31/03/12 Actual £'000	31/03/13 Original Estimate £'000	31/03/14 Original Estimate £'000
Total CFR	**8,044**	**6,871**	**7,170**	**6,326**	**5,502**

6. Actual External Debt

This indicator is obtained directly from the Council's balance sheet. It is the closing balance for actual gross borrowing plus other long-term liabilities. This Indicator is measured in a manner consistent for comparison with the Operational Boundary and Authorised Limit.

Actual External Debt as at 31/03/2012	£'000
Borrowing	0
Other Long-term Liabilities	1,935
Total	**1,935**

7. Incremental Impact of Capital Investment Decisions on Council Tax

This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax. The incremental impact is calculated by comparing the total revenue budget requirement of the current approved capital programme with an equivalent calculation of the revenue budget requirement arising from the proposed capital programme.

Incremental Impact of Capital Investment Decisions	2010/11 Actual £	2011/12 Original Estimate £	2011/12 Actual £	2012/13 Original Estimate £	2013/14 Original Estimate £
Increase / (Decrease) in Band D Council Tax	0.18	(0.14)	(0.14)	(0.01)	(0.02)

8. Authorised Limit and Operational Boundary for External Debt

The Authorised Limit sets the maximum level of external borrowing on a gross basis (i.e. not net of investments) for the Council. It is measured on a daily basis against all external borrowing items on the Balance Sheet (i.e. long and short term borrowing, overdrawn bank balances and long term liabilities). This Prudential Indicator separately identifies borrowing from other long term liabilities such as finance leases. It is consistent with the Council's existing commitments, its proposals for capital expenditure and financing, and its approved treasury management policy statement and practices.

The Authorised Limit has been set on the estimate of the most likely, prudent but not worst case scenario with sufficient headroom over and above this to allow for unusual cash movements.

The Authorised Limit is the statutory limit determined under Section 3(1) of the Local Government Act 2003 (referred to in the legislation as the Affordable Limit).

Authorised Limit for External Debt	2011/12 Original Estimate £'000	2012/13 Original Estimate £'000	2013/14 Original Estimate £'000
Borrowing	5,000	5,000	5,000
Other Long-term Liabilities	2,000	2,000	4,000
Total	**7,000**	**7,000**	**9,000**

The Operational Boundary links directly to the Council's estimates of the CFR and estimates of other cash flow requirements. This indicator is based on the same estimates as the Authorised Limit reflecting the most likely, prudent but not worst case scenario but without the additional headroom included within the Authorised Limit.

Operational Boundary for External Debt	**2011/12 Original Estimate £'000**	**2012/13 Original Estimate £'000**	**2013/14 Original Estimate £'000**
Borrowing	4,000	4,000	4,000
Other Long-term Liabilities	1,537	1,719	3,643
Total	**5,537**	**5,719**	**7,643**

The Head of Finance confirms that there were no breaches to the Authorised Limit and the Operational Boundary during 2011/12.

9. Adoption of the CIPFA Treasury Management Code

This indicator demonstrates that the Council has adopted the principles of best practice.

Adoption of the CIPFA Code of Practice in Treasury Management
The Council approved the adoption of the CIPFA Treasury Management Code at its Council meeting on 24 July 2002.

The Council has incorporated the changes from the revised CIPFA Code of Practice into its treasury policies, procedures and practices.

10. Gross and Net Debt

The purpose of this treasury indicator is to highlight a situation where the Council is planning to borrow in advance of need.

Upper Limit on Net Debt compared to Gross Debt	**2010/11 Actual £'000**	**2011/12 Original Estimate £'000**	**2011/12 Actual £'000**	**2012/13 Original Estimate £'000**	**2013/14 Original Estimate £'000**
Outstanding Borrowing	0	0	0	0	0
Other Long-term Liabilities	2,526	2,274	1,935	1,719	3,643
Gross Debt	**2,526**	**2,274**	**1,935**	**1,719**	**3,643**
Less: Investments	(1,910)	(10,000)	(15,423)	(6,000)	(6,000)
Net Debt	**346**	**(7,726)**	**(13,488)**	**(4,281)**	**(2,357)**

11. Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates. This Council calculates these limits on net principal outstanding sums, (i.e. fixed rate debt net of fixed rate investments).

Upper Limits	2011/12 Original Estimate %	2011/12 Actual %	2012/13 Original Estimate %	2013/14 Original Estimate %
Interest on fixed rate borrowing	100	0	100	100
Interest on fixed rate investments	-100	-50	-100	-100
Upper Limit for Fixed Interest Rate Exposure	**0**	**-50**	**0**	**0**
Interest on variable rate borrowing	100	0	100	100
Interest on variable rate investments	-100	-50	-100	-100
Upper Limit for Variable Interest Rate Exposure	**0**	**-50**	**0**	**0**

As the Council has no borrowing, these calculations have resulted in a negative figure.

12. Maturity Structure of Fixed Rate borrowing

This indicator highlights the existence of any large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates. It is designed to protect against excessive exposures to interest rate changes in any one period, in particular in the course of the next ten years.

Maturity structure of fixed rate borrowing	Existing level at 31/03/12 %	Lower Limit for 2012/13 %	Upper Limit for 2012/13 %
Under 12 months	0	0	100
12 months and within 24 months	0	0	0
24 months and within 5 years	0	0	0
5 years and within 10 years	0	0	0
10 years and above	0	0	0

The Council does not have any external borrowing for capital purposes, and did not need to borrow for cash flow purposes during 2011/12.

13. Credit Risk

The Council considers security, liquidity and yield, in that order, when making investment decisions.

Credit ratings remain an important element of assessing credit risk, but they are not a sole feature in the Council's assessment of counterparty credit risk.

The Council also considers alternative assessments of credit strength, and information on corporate developments of and market sentiment towards counterparties. The following key tools are used to assess credit risk:

- published credit ratings of the financial institution (minimum A- or equivalent) and its sovereign (minimum AA+ or equivalent for non-UK sovereigns);
- sovereign support mechanisms;
- credit default swaps (where quoted);
- share prices (where available);
- economic fundamentals, such as a country's net debt as a percentage of its GDP;
- corporate developments, news, articles, markets sentiment and momentum; and
- subjective overlay.

The only indicators with prescriptive values remain to be credit ratings. Other indicators of creditworthiness are considered in relative rather than absolute terms.

The Head of Finance confirms that there were no breaches to counterparty limits or credit ratings at the time if placing investments.

14. Upper Limit for total principal sums invested over 364 days

There are currently no proposals for the Council to invest sums for periods longer than 364 days.

15. Investment Benchmarking

Average Actual Return on Investments 2011/12	Original Estimate Return on Investments 2011/12	Average Bank Rate 2011/12	Average 7 day LIBID Rate 2011/12
0.69%	0.83%	0.50%	0.52%