Agenda Item No:

Report to: Audit Committee

Date of Meeting: 26th September 2011

Report Title: **Annual Treasury Management Report 2010-11, and Quarter 1 Performance 2011-12**

Report By: Deputy Chief Executive and Director of Corporate Services

Purpose of Report

This report provides the opportunity for the Audit Committee to scrutinise the Treasury Management activities and performance of the last financial year. A similar report will be considered by Cabinet along with any recommendations made by the Audit Committee.

Recommendation(s)

1. **To note the report and comment on any areas that it wishes to draw to the attention of Cabinet.**

Reasons for Recommendations

To ensure that members are fully aware of the activities undertaken in the year, that Codes of Practice have been complied with and that the Council's strategy has been effective in 2010-11. As delegated by Council the Audit Committee is tasked with scrutinising these activities and to draw to Cabinet's attention any matters it considers important.

Introduction and Background

1. The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009 was adopted by this Council on 15th February 2010 and this Council fully complies with its requirements.

   The primary requirements of the Code are as follows:

   a) Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
   b) Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
   c) Receipt by the Full Council of an annual treasury management strategy report (including the annual investment strategy report for the year ahead, a mid-year review report (as a minimum) and an annual review report of the previous year.
   d) 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.
   e) 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 Audit Committee.

2. Treasury management in this context is defined as:

   "The management of the local authority'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. "

3. The purpose of this report is to meet one of the above requirements of the CIPFA Code, namely the annual review report of treasury management activities, for the financial year 2010-11 and the first quarter of 2011-12 (period ending 30 June 2011).

4. This annual Treasury report covers

   a) the Council's treasury position as at 31 March 2011;
   b) performance for 2010-11;
   c) the strategy for 2010-11;
   d) the economy and interest rates in 2010-11;
   e) borrowing rates in 2010-11;
   f) the borrowing outturn for 2010-11;
   g) debt rescheduling;
   h) compliance with treasury limits and Prudential Indicators;
   i) investment rates in 2010-11;
   j) investment outturn for 2010-11;
   k) performance for 1st Qtr 2011-12;

Treasury Position as at 31 March 2011

5. The Council's debt and investment position at the beginning and the end of the year was as follows:

Table 1 **Debt**	31st March 2010 Principal	Rate	Maturity	31st March 2011 Principal	Rate
PWLB Loan1	£7.5m	4.80%	2033	£7.5m	4.80%
PWLB Loan2	£2.5m	1.54%	2011	£0.0m	
Market	£2.0m	0.45%	Temp.	£0.0m	
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	£12.0m	4.07%		£7.5m	4.80%
PWLB Loan 3	£2.0m	0.60%	2019	£2.0m	0.71% (Variable Rate)
Total Debt	£14.0m	3.00%		£9.5m	3.94%

Table 2 **Investments**	31st March 2010 Principal	31st March 2011 Principal
-In-House	£3.2m	£13.2m
-With Managers	£16.6m	£ 0.0m
Total Investments	£19.8m	£13.2m

6. In House investments as at 31 March 2011

The table below provides a snapshot of the investments held at 31 March 2011. T

Table 3 Counter Party	Rate/ Return	Start Date	End Date	Principal	Term
Lloyds TSB Group	2.10%	16/3/11	14/3/12	£5.0m	Fixed
Barclays Group	0.95%	21/3/11	12/9/11	£2.0m	Fixed
Nationwide	0.89%	21/3/11	09/8/11	£2.0m	Fixed
Nationwide	0.48%	21/3/11	21/4/11	£2.0m	Fixed
Santander	0.80%	N/A	N/A	£2.2m	On Call
				£13.2m	

Performance Measurement (2010-11)

7. The £16.6m Investments with Fund Managers provided a net return of 0.4% (0.58% gross) from 1 April 2010 to 15 March 2011. On 15 March 2011 the investments were called back In-house and £11m was placed on term deposits. The remaining funds were used to offset temporary borrowing at the year end with the residue placed in Call Accounts.

8. Table 4 below compares the Estimated Interest Payable and Received and associated fees for the year 2010 – 11.

Table 4	2010 -11 Estimate £000's	2010 -11 Revised Budget £000's	2010 -11 Actual Outturn £000's
Gross Interest Payable	505	435	407
Gross Interest Received	(185)	(188)	(185)
Fees	47	40	43
Other (e.g. PWLB Discount)	(64)	(64)	(51)
Net Cost	303	223	214

9. From the above it can be seen that the costs of borrowing were significantly reduced by not refinancing the fixed rate PWLB loan (£2,500,000) which matured in January 2011 and the continued low levels of interest on the variable rate loan.

10. The investment interest received was in line with the budget, and fees were significantly reduced by not borrowing externally and moving to in-house management of investments.

The Strategy for 2010-11

11. The expectation for interest rates within the strategy for 2010/11 was of gradual rises in medium and longer term fixed interest rates over 2010/11. Variable or short-term rates were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

12. In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and reduce counterparty risk. The actual movement in interest rates broadly followed the expectations in the strategy, as detailed in the following section.

13. The Council operated both borrowing and investment portfolios and as a consequence was at lower risk from being impacted by a sharp, unexpected rise in short-term variable interest rates. The strategy for the year was therefore to maintain a balance of funding at shorter-term rates to match short-term investments thus maintaining balanced treasury risk.

The Economy and Interest Rates

14. At the beginning of 2010/11 the market anticipated marginal increases of the Bank Rate on the back of expectation that the UK economy would start to grow again. However, chances of a rise in 2010/11 ebbed away following a steady flow of downbeat news on the British economy and worsening prospects for the Euro zone. 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.

15. Forecasts for the first rate rise were constantly put back throughout 2010. The view on longer-term fixed interest rates, 50 years, was that they would fluctuate between 5.30 – 5.40% during 2010/11. At the same time, medium-term rates, 25 years, were expected to be around 5.40%.

16. Following the Comprehensive Spending Review in October 2010 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% above gilt prices, without an associated increase in early redemption rates. This made new borrowing more expensive and repayment relatively less attractive.

17. 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.

18. 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.

19. 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.

20. 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 (see Graphs – Appendix 2). 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.

21. 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.

Borrowing Rates in 2010 -11

22. PWLB borrowing rates - the graph and table for PWLB maturity rates below show, for a selection of maturity periods, the range (high and low points) in rates, the average rates and individual rates at the start and the end of the financial year.

23. Variations in most PWLB rates have been distorted by the October 2010 decision by the PWLB to raise it borrowing rates e.g. if it had not been for this change, the 25 year PWLB at 31 March 2011 (5.32%) would have been only marginally higher than the position at 1 April 2010.

PWLB rates 2010-11 were:-

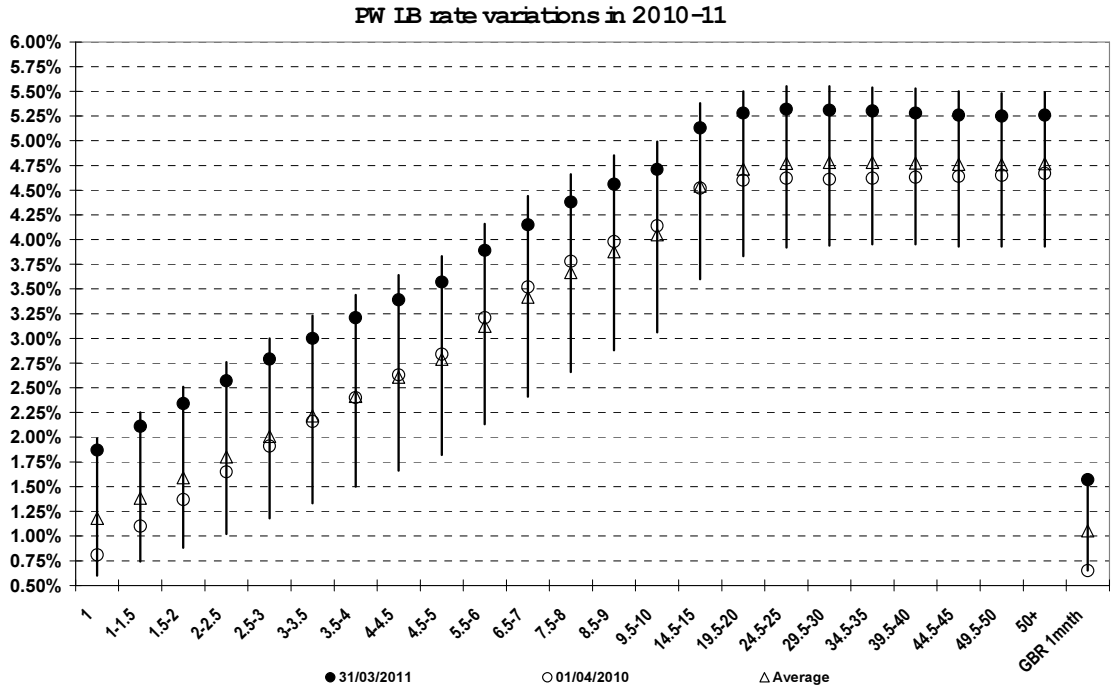


Table 5

PWLB BORROWING RATES 2010/11 for 1 to 50 years

	1	1.5-2	2.5-3	3.5-4	4.5-5	9.5-10	24.5-25	49.5-50	1 month variable
01/04/2010	0.810%	1.370%	1.910%	2.400%	2.840%	4.140%	4.620%	4.650%	0.650%
31/03/2011	1.870%	2.340%	2.790%	3.210%	3.570%	4.710%	5.320%	5.250%	1.570%
HIGH	1.990%	2.510%	3.000%	3.440%	3.830%	4.990%	5.550%	5.480%	1.570%
LOW	0.600%	0.880%	1.180%	1.500%	1.820%	3.060%	3.920%	3.930%	0.650%
Average	1.177%	1.590%	2.009%	2.413%	2.788%	4.050%	4.771%	4.756%	1.052%
Spread	1.390%	1.630%	1.820%	1.940%	2.010%	1.930%	1.630%	1.550%	0.920%
High date	07/02/2011	07/02/2011	07/02/2011	07/02/2011	09/02/2011	09/02/2011	09/02/2011	09/02/2011	07/03/2011
Low date	15/06/2010	12/10/2010	12/10/2010	12/10/2010	12/10/2010	31/08/2010	31/08/2010	31/08/2010	01/04/2010

24. The graph and table above highlight the fluctuation in borrowing rates throughout the year for different borrowing periods (in years). Members are able to scrutinise the timing of any borrowing decisions with this information.

Debt Rescheduling

25. The expectation was that longer-term PWLB rates would be on a rising trend during the year and that shorter term rates would remain considerably cheaper. However, moving from long term to short term debt would mean taking on a greater risk exposure to having to re-borrow longer term in later years at considerably higher rates than most of the long term debt currently in the debt portfolio. Short term savings could be achieved by internally financing new capital expenditure and replacing maturing debt by running down existing cash balances which were only earning minimal rates of interest due to the fact that Bank Rate was kept at 0.5% all year. Running down cash balances also meant reduced counterparty risk on the investment portfolio.

26. The Council examined the potential for making premature debt repayments in order to reduce borrowing costs as well as reducing counterparty risk by reducing investment balances. However, the cost of the early repayment premiums that would have been incurred and the increase in risk exposure to significantly higher interest rates for new borrowing, made this option unattractive.

Compliance with Treasury Limits

27. During the financial year the Council operated within the treasury limits and Prudential Indicators set out in the Council's annual Treasury Strategy Statement. The outturn for the Prudential Indicators is shown in Appendix 1.

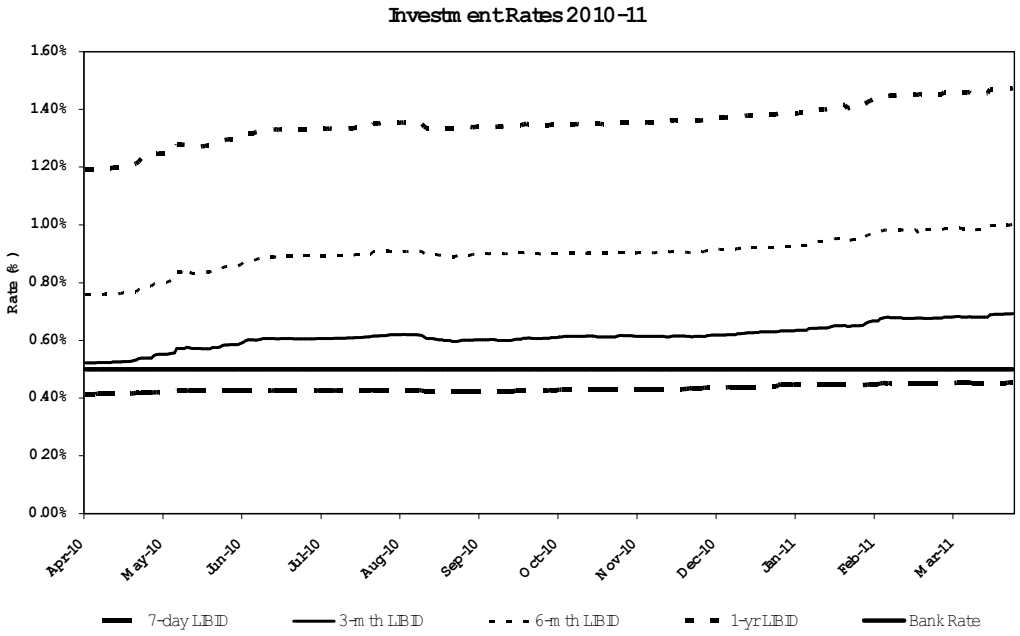
Investment Rates in 2010-11

28. The tight monetary conditions following the 2008 financial crisis continued through 2010/11 with little material movement in the shorter term deposit rates. Bank Rate remained at its historical low of 0.5% throughout the year, although growing market expectations of the imminence of the start of monetary tightening saw 6 and 12

month rates picking up.

29. 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.

30. The table below shows the bank base rate and the benchmark investment rates for the year.



Investment Strategy

31. In the light of continuing stresses on the world banking system, enhanced priority was given to security and liquidity in order to reduce counterparty risk to the maximum possible extent.

32. In order to counter the downturn in investment rates part of the investment portfolio was held in liquidity accounts with main UK banks. These accounts offered both instant access and rates which were often double those available in the money markets through brokers for overnight money and higher than for most periods up to six months.

33. Externally Managed Investments - the Council had investments managed externally by Aviva. The fund management agreement between the Council and the Fund Manager defined the limits for maximum weighting in gilts/bonds and maximum duration of the fund. Counterparty criteria and exposure limits are also pre-defined therein. The agreement terminated on 15 March 2011 and the funds were then managed in house.

34. The Council makes maximum use of the credit rating service offered by Sector as detailed in the Treasury Management Strategy. Updates on credit worthiness of counterparties are received on a daily basis.

Investment Performance for 2010 -11

35. Detailed below is the result of the investment strategy undertaken by the Council.

TABLE 6	Average Investment	Rate of Return (gross of fees)	Rate of Return (net of fees)	Benchmark Return based on 7 day LIBID
Internally Managed	£7.29m	0.95%	0.95%	0.43%
Externally Managed	£16.56m	0.58%	0.40%	0.43%

36. No institutions in which investments were made during 2010/11 had any difficulty in repaying investments and interest in full during the year.

Performance Measurement – First Quarter 2011-12

37. Following the transfer to in-house management a number of new direct dealing arrangements have been made with the banks. The table below provides a snapshot of where the now In-house investments are placed (as at 30 June 2011)

Table 7 Counter Party	Rate/ Return	Start Date	End Date	Principal	Term
Lloyds TSB Group	2.10%	16/03/11	14/03/12	£5.0m	Fixed
Barclays Group	0.95%	21/03/11	12/09/11	£2.0m	Fixed
Nationwide	0.89%	21/03/11	9/08/11	£2.0m	Fixed
Clydesdale	0.85%	N/A	N/A	£4.0m	30 Day Notice
Nat. West	0.85%	N/A	N/A	£3.5m	On Call
Santander	0.80%	N/A	N/A	£2.1m	On Call
				£18.6m	

38. The performance for the period 1 April 2011 to 30 June 2011 provided an average investment return of 1.15%. The investment held by the Lloyds TSB Group contributing significantly to this higher average return.

    There has been no new long term borrowing in the quarter.

Financial Implications

39. The security of the Council's monies remain the top priority within the strategy. The past year has seen the continuing historically low level of interest rates available to investors, but an effective1% hike in the costs of new borrowing for local authorities. The Council has ended the management agreement with Aviva and this appears to be a good decision to date, given the lower investment returns being achieved once fees were included.

The return on investments in 2011/12 is currently in line with budgetary expectations (to achieve a 1% return).

Wards Affected
Ashdown, Baird, Braybrooke, Castle, Central St. Leonards, Conquest, Gensing, Hollington, Maze Hill, Old Hastings, Ore, Silverhill, St. Helens, Tressell, West St. Leonards, Wishing Tree

Area(s) Affected
Central Hastings, East Hastings, North St. Leonards, South St. Leonards

Policy Implications
Please identify if this report contains any implications for the following:

Equalities and Community Cohesiveness	No
Crime and Fear of Crime (Section 17)	No
Risk Management	Yes
Environmental Issues	No
Economic/Financial Implications	Yes
Human Rights Act	No
Organisational Consequences	No

Background Information
Treasury Management and Annual Investment Strategy 2010/11, Cabinet, 15 February 2010
CIPFA - Treasury Management Code of Practice (revised 2009)
CIPFA - The Prudential Code (revised 2009)

Officer to Contact
Peter Grace, head of Financial Services
pgrace@hastings.gov.uk
01424 451503

Appendix 1: **Prudential Indicators**

TABLE 6: PRUDENTIAL INDICATORS	2009/10	2010/11	2010/11
Extract from budget and rent setting report	Actual	Original	Actual
	£'000	£'000	£'000
Capital Expenditure	£6,449	£10,165	£9,137
Ratio of financing costs to net revenue stream	0.871%	1.18%	1.021%
Net borrowing requirement - in year borrowing requirement	£1,015	£1,399	£1,741
Capital Financing Requirement as at 31 March	£14,865	£15,503	£15,618
Annual change in Cap. Financing Requirement	£1,700	£638	£753
Incremental impact of capital investment decisions	£ p	£ p	£ p
Increase in council tax (band D) per annum	£0.93	£1.92	£0.82

Please note: the CFR figures have been updated to reflect the notional charge for MRP which is now accounted for following the implementation of the new International Financial Reporting Standards

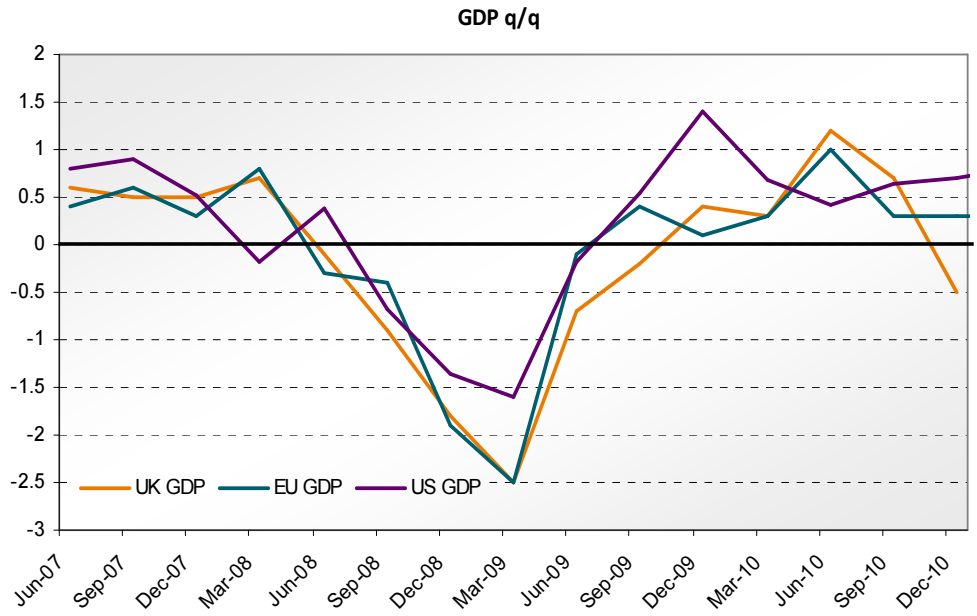
TABLE 7: TREASURY MANAGEMENT INDICATORS	2009/10	2010/11	2010/11
	actual	original	actual
	£'000	£'000	£'000
Authorised Limit for external debt -			
borrowing	£20,000	£20,000	£20,000
other long term liabilities	£0	£0	£0
TOTAL	£20,000	£20,000	£20,000
Operational Boundary for external debt -			
borrowing	£20,000	£20,000	£20,000
other long term liabilities	£0	£0	£0
TOTAL	£20,000	£20,000	£20,000
Actual external debt	£12,000	£12,000	£ 9,500
Upper limit for total principal sums invested for over 364 days	£0	£0	£0

The limits set for exposure to fixed and variable rates of interest in respect of both investments and borrowing were 100%.

TABLE 8: Maturity structure of fixed rate borrowing during 2010/11	upper limit	lower limit
under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%

Appendix 2:

Graph 1 – Gross Domestic Product (quarterly)



Graph 2 – Inflation (Consumer Price Index)