Agenda Item No:

Report to: Audit Committee

Date of Meeting: **5 July 2012**

Report Title: Annual Treasury Management Report 2011-12

Report By: Peter Grace
Head of Finance

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 consider 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 last financial year, that Codes of Practice have been complied with and that the Council's strategy has been effective in 2011-12. 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

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.

2. 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.

3. 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. "

4. 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 2011-12.

5. This annual Treasury report covers

   a) capital expenditure and financing 2011-12

   b) overall borrowing need (the Capital Financing Requirement)

   c) treasury position as at 31 March 2012;

   d) performance for 2011-12;

   e) the strategy for 2011-12;

   f) the economy and interest rates in 2011-12;

   g) borrowing rates in 2011-12;

   h) the borrowing outturn for 2011-12;

   i) debt rescheduling;

   j) compliance with treasury limits and Prudential Indicators;

   k) investment rates in 2011-12;

l) investment outturn for 2011-12;

The Council's Capital Expenditure and Financing 2011/12

6. 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.

7. The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

General Fund	2010/11	2011/12	2011/12
	Actual	Estimate	Actual
	£'000	£'000	£'000
Capital Expenditure	£9,137	£3,137	£3,774
Capital Receipts, Grants, Reserves	£7,738	£2,535	£2,184
Loans	£ 1,399	£ 602	£1,590

The Council's Overall Borrowing Need

8. 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 2011/12 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.

9. Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises 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.

10. The Council's 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 borrowing need. 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.

11. 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).

12. The Council's 2011/12 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report for 2011/12 on 16/02/2011.

13. The Council's CFR for the year is shown below, and represents a key prudential indicator. It includes leasing schemes on the balance sheet, which increase the Council's borrowing need. No borrowing is actually required against this scheme.

CFR : General Fund	2010/11	2011/12	2011/12
	Actual	Estimate	Actual
	£'000	£'000	£'000
Opening balance	£ 14,865	£ 15,618	£15,618
Add capital expenditure financed by Loan	£ 1,399	£ 602	£ 1,590
Less MRP	£ 434	£ 462	£ 462
Less finance lease arrangements	£ 212	£ 223	£ 223
Closing balance	£15,618	£ 15,535	£16,523

14. Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

15. 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 2011/12 plus the expected changes to the CFR over 2011/12 and 2012/13 from financing the capital programme. This indicator allows

the Council some flexibility to borrow in advance of its immediate capital needs in 2011/12. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

	2010/11	2011/12	2011/12
	Actual	Estimate	Actual
	£'000	£'000	£'000
Net borrowing position	(£10,142)	(£ 3,500)	(£7,279)
CFR	£ 15,618	£ 16,535	£16,523

Treasury Position as at 31 March 2012

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

Table 1 Debt	31st March 2011 Principal	Rate	Maturity	31st March 2012 Principal	Rate
PWLB Loan1	£7.5m	4.80%	2033	£7.5m	4.80%
PWLB Loan 2				£1.0m	2.02%
	------------			-----------	
	£7.5m			£8.5m	
PWLB Loan 3	£2.0m	0.71%	2019	£2.0m	0.66% (Variable Rate)
Total Debt	£9.5m	3.94%		£10.5m	3.61%

Table 2 Investments	31st March 2011 Principal	31st March 2012 Principal
-In-House	£13.2m	£17.7m
Total Investments	£13.2m	£17.7m

Performance Measurement (2011-12)

17. Table 3 below compares the Estimated Interest Payable and Received and associated fees for the year 2011-12.

Table 3	2010 -11 Actual Outturn £000's	2011 -12 Revised Budget £000's	2011 -12 Actual Outturn £000's
Gross Interest Payable	407	384	373
Gross Interest Received	(185)	(140)	(229)
Fees	43	11	11
Other (e.g. PWLB Discount)	(51)	(55)	(56)
Net Cost	214	200*	99*

* Excludes Local Authority Mortgage (LAM) scheme and interest on the VAT refund.

18. The investment interest received was in excess of budget due the use of internal borrowing to finance capital expenditure resulting in less external interest payments and also due to a higher level of funds to invest in the year. The figure received for interest on the VAT refund was £168,000.

19. The net interest on the LAM scheme for the period 5/1/2012 to 31/3/12 (as below) has been transferred into the mortgage reserve.

Table 4	2011 -12 Actual Outturn £000's
Gross Interest Payable	5
Gross Interest Received	(10)
Net Surplus	(5)

20. The Council's longer term cash balances comprise, primarily, revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources are detailed below, and were in line with budget expectations.

Balance Sheet	31st March 2011	31st March 2012
	£'000	£'000
Balances	£ 500	£ 500
Earmarked Reserves	£12,232	£14,845
Usable capital receipts	£ 3	£ 4
Capital grants unapplied	£ 890	£ 562
Total	£13,626	£15,911

The Strategy for 2011-12

21. The expectation for interest rates within the strategy for 2011/12 was of gradual rises in medium and longer term fixed interest rates over 2011/12. Variable or short-term rates were expected to be the cheaper form of borrowing over the period and this was indeed the case. 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.

22. 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 Economy and Interest Rates

23. The original expectation for 2011/12 was that Bank Rate would start gently rising from quarter 4 2011. However, GDP growth in the UK was disappointing during the year under the weight of the UK austerity programme, a lack of rebalancing of the UK economy to exporting and weak growth in our biggest export market - the EU. The EU sovereign debt crisis grew in intensity during the year until February when an initial refinancing package was eventually agreed for Greece.

24. This weak UK growth resulted in the Monetary Policy Committee increasing quantitative easing by £75bn in October and another £50bn in February. Bank Rate therefore ended the year unchanged at 0.5% while CPI inflation peaked in September at 5.2% but then fell to 3.4% in February 2012, with further falls expected to below 2% over the next two years. (See Graphs – Appendix 2).

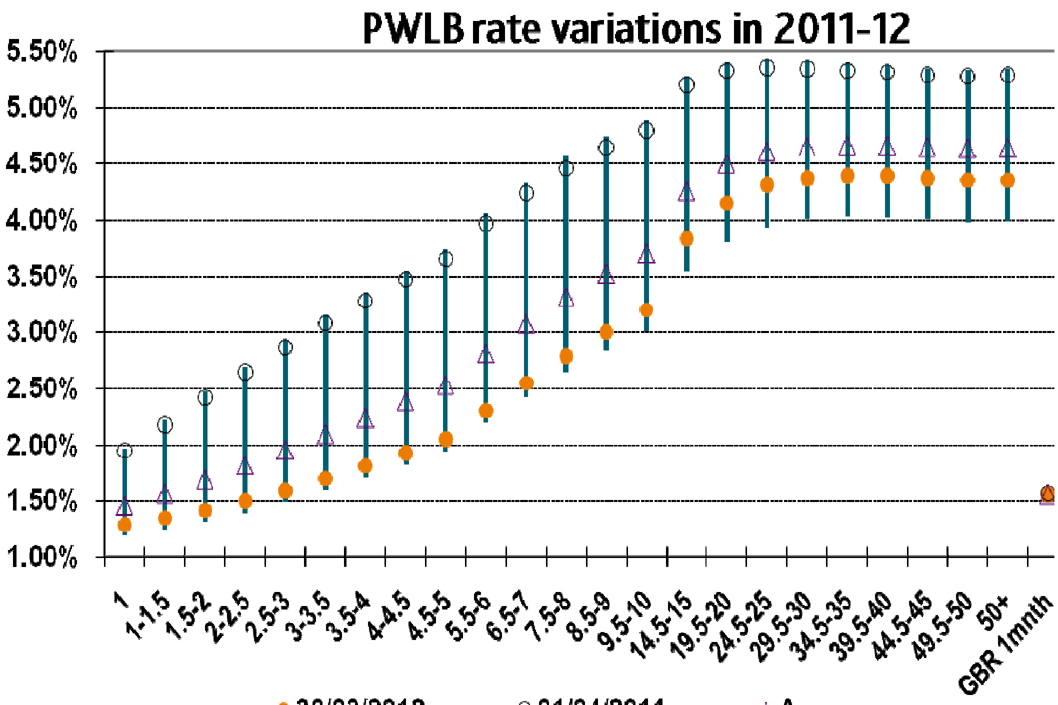
25. Gilt yields fell for much of the year, until February, as concerns continued building over the EU debt crisis. This resulted in safe haven flows into UK gilts which, together with the two UK packages of quantitative easing during the year, combined to depress PWLB rates to historically low levels.

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

Borrowing Rates in 2011-12

27. PWLB borrowing rates - the graphs and table for PWLB maturity rates below show, for a selection of maturity periods, the high and low points in rates, the average rates, spreads and individual rates at the start and the end of the financial year.

28. PWLB rates 2011-12 were:-



	PWLB BORROWING RATES 2011/12 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
01/04/2011	1.950%	2.420%	2.870%	3.280%	3.650%	4.800%	5.360%	5.280%	1.570%
31/03/2012	1.290%	1.420%	1.590%	1.810%	2.050%	3.200%	4.310%	4.350%	1.560%
HIGH	1.970%	2.470%	2.930%	3.350%	3.730%	4.890%	5.430%	5.340%	1.590%
LOW	1.190%	1.320%	1.500%	1.710%	1.940%	3.010%	3.940%	3.980%	1.560%
Average	1.466%	1.693%	1.958%	2.243%	2.533%	3.702%	4.610%	4.635%	1.561%
Spread	0.780%	1.150%	1.430%	1.640%	1.790%	1.880%	1.490%	1.360%	0.030%
High date	06/04/2011	06/04/2011	06/04/2011	06/04/2011	11/04/2011	11/04/2011	11/04/2011	11/04/2011	05/04/2011
Low date	29/12/2011	30/12/2011	30/12/2011	27/02/2012	27/02/2012	30/12/2011	18/01/2012	30/11/2011	15/04/2011

29. 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.

Borrowing Outturn for 2011/12

30. Treasury Borrowing - a £1million, 5 year, maturity loan from the PWLB was drawn to fund the capital expenditure in respect of the Local Authority Mortgage Scheme at a rate of 2.02%. This was borrowed in January 2012 at a rate of 2.02%, which was a very good rate for the year, and then lent out at 4.45%.

Debt Rescheduling

31. 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. No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

Compliance with Treasury Limits

32. 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 2011-12

33. The tight monetary conditions following the 2008 financial crisis continued through 2011/12 with little material movement in the shorter term deposit rates. However, one month and longer rates rose significantly in the second half of the year as the Eurozone crisis grew. The ECB's actions to provide nearly €1 trn of 1% 3 year finance to EU banks eased liquidity pressures in the EU and investment rates eased in quarter 1 of 2012. Bank base rate remained at its historic low of 0.5% throughout the year while market expectations of the imminence of the start of monetary tightening was gradually pushed further and further back during the year to the second half of 2013 at the earliest.

34. Overlaying the relatively poor investment returns were the continued counterparty concerns, most evident in the Euro zone sovereign debt crisis which resulted in a second rescue package for Greece in quarter 1 2012. Concerns extended to the potential fallout on the European banking industry if the crisis ends with Greece leaving the Euro and defaulting.

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

	Money market investment rates 2011/12					
	Overnight	7 Day	1 Month	3 Month	6 Month	1 Year
01/04/2011	0.43688	0.45625	0.49563	0.69563	1.00313	1.47750
31/03/2012	0.43188	0.45719	0.57100	0.90188	1.22063	1.73806
High	0.54625	0.50531	0.65288	0.96456	1.27063	1.77175
Low	0.43000	0.45625	0.49563	0.69438	0.97625	1.45000
Average	0.44868	0.48009	0.56246	0.81756	1.11025	1.59673
Spread	0.11625	0.04906	0.15725	0.27018	0.29438	0.32175
Date	30/06/2011	30/12/2011	11/01/2012	12/01/2012	25/01/2012	25/01/2012
Date	14/03/2012	01/04/2011	01/04/2011	12/04/2011	11/06/2011	22/06/2011

Investment Strategy

36. There have been some changes in strategy during the year :-

(i) A minor relaxation of the investment criteria for short term deposits which aligns the criteria to those of the Council's treasury advisers (Sector).

(ii) The accommodation of the £1m deposit for 5 years with the Lloyds Bank group in respect of the Local Authority Mortgage scheme. The investment being made on the 5 January 2012 at a rate of 4.45%, whilst the matching £1m borrowing from the PWLB was at a rate of 2.02% - the difference being placed in a reserve to meet any costs arising from defaults.

(iii) Investment returns to be lower for a longer than anticipated period.

Investment Outturn for 2011-12

37. Investments held by the Council - the Council maintained an average balance of £20m of internally managed funds. The internally managed funds earned an average rate of return of 1.09% (excludes LAMS scheme). The comparable performance indicator is the average 7-day LIBID rate (uncompounded), which was 0.48%. This compares with a budget assumption of £14m investment balances earning an average rate of 1%.

38. Investments as at 31 March 2012 : the table below provides a snapshot of the investments held at 31 March 2012.

Table 6 Counter Party	Rate/ Return	Start Date	End Date	Principal	Term
Lloyds TSB Group	4.45%	5/1/12	10/1/17	£1.0m	Fixed
Nat. West (60 Day Notice Account)	1.0%	28/07/11		£5.0m	On Call
Nat. West (Call Account)	0.85%	15/6/11		£0.7m	On Call
National Australia Bank	0.57%	16/1/12	16/4/12	£5.0m	Fixed
Nationwide	1.0%	30/1/12	30/4/12	£1.0m	Fixed
Nationwide	1.0%	15/2/12	15/5/12	£2.0m	Fixed
Lloyds TSB Group	0.30%	26/3/12	10/4/12	£3.0m	Fixed

39. No institutions in which investments were made during 2011/12 had any difficulty in repaying investments and interest in full during the year.

Financial Implications

40. 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.

41. However, the return on investments achieved by the Council was greater than 2011/12 budget expectations (a 1.09% return achieved). Against the 7-day LIBID rate, this is the equivalent of an additional £128,000 p.a.

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

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Area(s) Affected

Central Hastings, East Hastings, North St. Leonards, South St. Leonards

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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
Local People's Views	No

Background Information

Treasury Management and Annual Investment Strategy 2011/12, Cabinet, 16 February 2011
CIPFA - Treasury Management Code of Practice (revised 2009)
CIPFA - The Prudential Code (revised 2009)

Officer to Contact

Peter Grace, Head of Finance
pgrace@hastings.gov.uk
01424 451503

Appendix 1: Prudential Indicators

PRUDENTIAL INDICATOR	2010/11	2011/12	2011/12
(1). EXTRACT FROM BUDGET	£'000	£'000	£'000
	Actual	Estimate	Actual
Capital Expenditure	£9,137	£3,137	£3,774
Ratio of financing costs to net revenue stream	1.0%	0.6%	0.53%
Net borrowing requirement	£1,399	£ 602	£ 590
Capital Financing Requirement as at 31 March	£15,618	£15,535	£16,523
Annual change in Capital Financing Requirement	£ 753	£ -83	£905
Incremental impact of capital investment decisions			
Increase in council tax (band D) per annum	£2.38	£0.51	£0.51

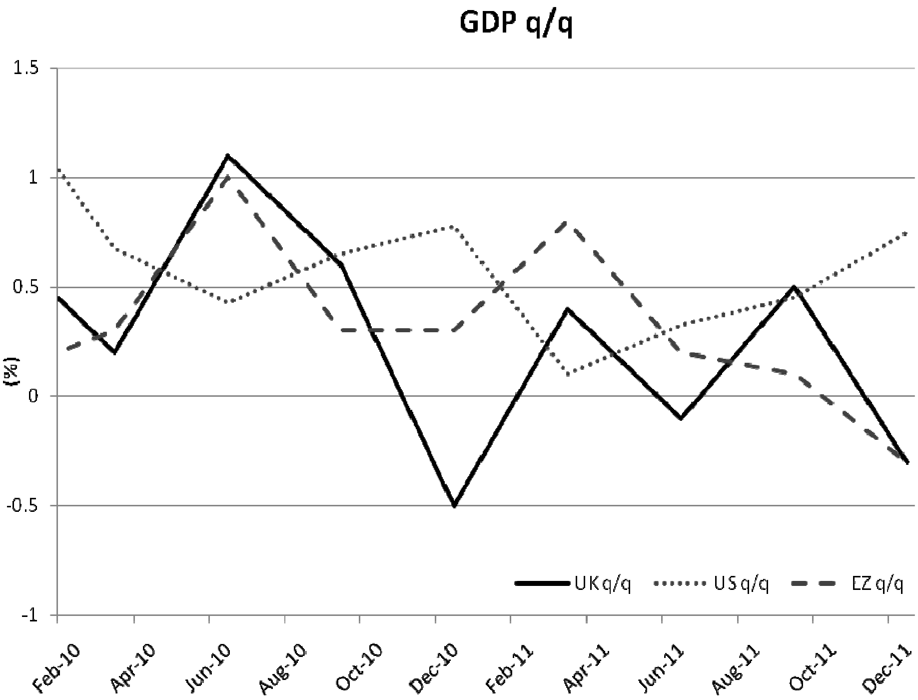
Please note: the CFR figures have been updated to reflect the notional charge for MRP which is now accounted for following the implementation of the new International Financial Reporting Standards

TABLE 7: TREASURY MANAGEMENT INDICATORS	2010/11	2011/12	2011/12
	actual	original	actual
	£'000	£'000	£'000
Authorised Limit for external debt -			
borrowing	£20,000	£20,000	£20,000
other long term liabilities	£0	£10,000	£10,000
TOTAL	£20,000	£30,000	£30,000
Operational Boundary for external debt -			
borrowing	£20,000	£20,000	£20,000
other long term liabilities	£0	£10,000	£10,000
TOTAL	£20,000	£20,000	£30,000
Actual external debt	£ 9,500		£10,500
Other long term liabilities	£ 597		£ 376
TOTAL	£10,097		£10,876
Upper limit for total principal sums invested for over 364 days		£1,000	£1,000

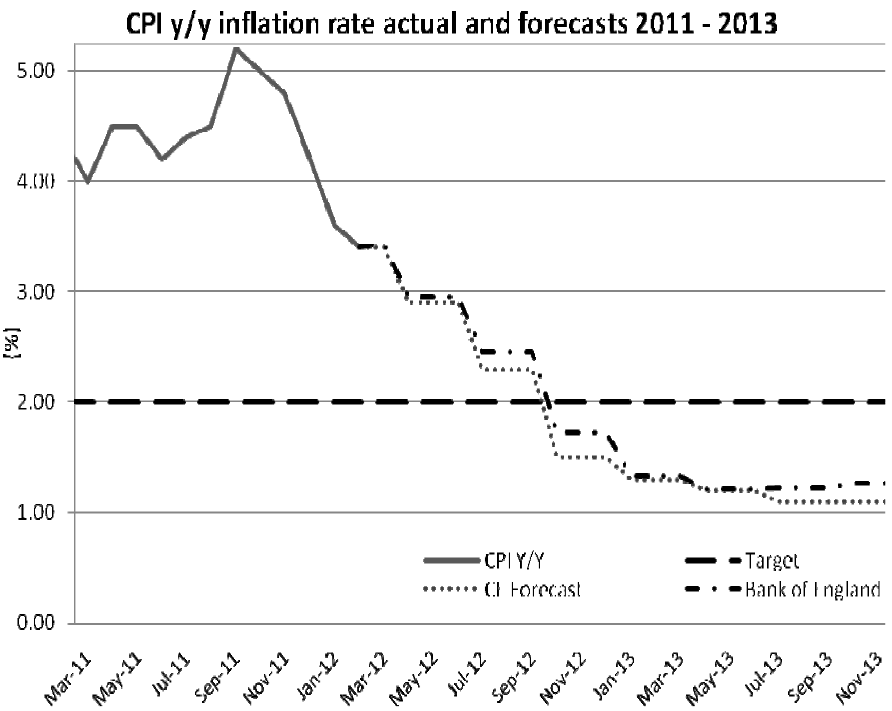
The limits set for exposure to fixed and variable rates of interest in respect of both investments and borrowing were 100%.

TABLE 8: Maturity structure of fixed rate borrowing during 2011/12	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:



GDP q/q
1.5
1
0.5
0
-0.5
-1
(%)
UK q/q
US q/q
EZ q/q
Feb-10
Apr-10
Jun-10
Aug-10
Oct-10
Dec-10
Feb-11
Apr-11
Jun-11
Aug-11
Oct-11
Dec-11



CPI y/y inflation rate actual and forecasts 2011 - 2013
5.00
4.00
3.00
2.00
1.00
0.00
(%)
CPI Y/Y
Target
Forecast
Bank of
Mar-11
May-11
Jul-11
Sep-11
Nov-11
Jan-12
Mar-12
May-12
Jul-12
Sep-12
Nov-12
Jan-13
Mar-13
May-13
Jul-13
Sep-13
Nov-13