Report to: **Cabinet**

Subject: **Annual Treasury Activity Report 2010/11**

Date: **2 June 2011**

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1. PURPOSE OF REPORT

The council is required by the Local Government Act 2003 to produce an annual treasury report reviewing treasury management activities and the actual prudential and treasury indicators for 2010/11. 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).

Treasury management activities for the year are detailed at appendix 1, and Prudential and treasury indicators may be found at appendix 2. The Head of Corporate Services also confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit (the authorised limit), was not breached during 2010/11.

2. BACKGROUND

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009 was adopted by the council on 3 March 2010, and the council fully complies with its requirements.

The primary requirements of the code are as follows:

a. The creation and maintenance of a treasury management policy statement which sets out the policies and objectives of the council's treasury management activities.

b. The 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. The receipt by full council of an annual treasury management strategy report (TMSS) 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 at Gedling Borough Council is the audit committee.

The regulatory environment now places 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.

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. "

Members have already received quarterly monitoring statements, which exceed the minimum CIPFA code requirement for a mid-year statement. The purpose of this report is to meet the requirement for an annual review report in respect of 2010/11.

The code of practice requires performance measurement relating to investments, debt and capital financing activities. Whilst investment performance criteria are well developed and universally accepted, debt performance indicators continue to be more problematic, with the traditional average portfolio rate of interest acting as the main guide. The use of benchmarks such as the 12-month LIBID for investments may be inappropriate for local authorities with relatively small cash balances, as they are generally able to place funds for only short periods and often at lower rates. The 7-day LIBID rate is considered more appropriate as the relevant benchmark for Gedling's investments. The 7 day uncompounded LIBID rate for 2010/11 was 0.43% and the council's in-house managed funds achieved an overall equated rate of 1.14%, out-performing the benchmark by 0.71%. As a further comparison, the 3 month uncompounded LIBID rate was 0.61%. This achievement was the result combining highly liquid call-account investments with a small number of fixed term deposits, timed in accordance with advice from the council's treasury advisers.

During 2010/11, remaining core balances together with the active management of day to day cash-flows resulted in no temporary borrowing being required. Gedling's very limited number of borrowing transactions and the absence of average borrowing rates for model portfolios, means that the council may in the future need to develop benchmarks in this area. As for investments, the market produces a 7-day "LIBOR" rate for the annual cycle, and it is suggested that this is used as the benchmark against which any temporary borrowing is measured.

The council's treasury management borrowing performance is in reality dominated by its long-term borrowing activity. The amount to be borrowed is directed by the council's capital expenditure plans approved as part of the annual budget, therefore, performance is best measured by looking at the timing of long-term borrowing, which can be controlled by use of temporary treasury activity.

During 2010/11, a total of £3m of new long-term borrowing with the Public Works Loan Board (PWLB) was undertaken. The council takes advice with regard to the nature and timing of its long-term borrowing activity from its advisers, Sector.

3. ANNUAL TREASURY ACTIVITY REPORT 2010/11

3.1 The Council's overall borrowing need

The council undertakes capital expenditure on long-term assets. Such expenditure 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, it will give rise to a 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 2010/11 unfinanced capital expenditure, 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, the council's cash position is managed to ensure sufficient cash is available to meet capital plans and cash flow requirements. This may be sourced through borrowing from external bodies, for example the PWLB or money markets, or utilising temporary cash resources within the council.

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, the minimum revenue provision (MRP), to reduce the CFR. This is effectively a repayment of the borrowing need, and differs from 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 2010/11 MRP Policy, as required by CLG Guidance, was approved as part of the Treasury Management Strategy Report for 2010/11 on 3 March 2010

Borrowing activity is constrained by prudential indicators for "net borrowing and the CFR", and by the "authorised limit". 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 capital purposes, ie. the Council must not borrow to support revenue expenditure. Net borrowing should not therefore, except in the short term, exceed the CFR for 2010/11 plus the expected changes to the CFR over 2011/12 and 2012/13. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs, and the council has complied throughout the year.

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. During 2010/11 the council maintained gross borrowing within its authorised limit.

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 identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

The outturn in respect of all these key indicators may be found at appendix 2.

3.2 The Council's current treasury position

The council's debt and investment position at the beginning and end of the year 2010/11 is shown at Appendix 1.

3.3 The treasury strategy for 2010/11

The expectation for interest rates within the strategy for 2010/11 anticipated low but rising bank rate with similar 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. The actual movement in interest rates broadly followed the expectations in the strategy, as detailed in the following section.

Given this scenario, the 2010/11 treasury strategy was to postpone borrowing to avoid costs associated with holding high levels of investments at unfavourable rates, and reduce counterparty risk. In the event, some borrowing in advance of need was undertaken in order to take advantage of particularly favourable rates. In one case a small cost to carry the debt was incurred, however this was considered prudent in order to secure the very low borrowing rate. In the second case, the transaction was neutral, with the borrowed funds invested pending their use at the same rate as that paid on the debt.

3.4 The Economy and Interest Rates in 2010/11

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. Local authorities were also presented with changed circumstances following the unexpected change of policy on 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, and 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 (MPC) 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 until 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.

3.5 Borrowing rates in 2010/11

Variations in most PWLB rates have been distorted by the October 2010 decision by the PWLB to raise it borrowing rates by about 0.75 – 0.85%. For example, 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.

3.6 The Borrowing outturn for 2010/11

The council undertook £3m of new borrowing during 2010/11, timed in accordance with advice received from Sector. The average debt portfolio interest rate accordingly fell from 4.07% at 1 April to 3.72% at 31 March.

An underlying need to borrow can still be demonstrated by the Capital Financing Requirement, and advice will continue to be taken from Sector with regard to the timing of any future borrowing.

No temporary borrowing was required during the year 2010/11.

3.7 Investment rates in 2010/11

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.

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 on-going need for caution in treasury investment activity.

3.8 Investment activity and outturn for 2010/11

The council's investment policy is governed by CLG guidance, which was been implemented in the annual investment strategy approved by the council on 3 March 2010. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.). The investment activity during the year conformed to the approved strategy, and the council had no liquidity difficulties.

The council manages all its investments in-house, and invests only with the institutions listed in its approved lending list. The council's "specified" investments are for a range of periods from overnight to 364 days, dependent on cash flows, its interest rate view, the interest rates on offer and durational limits set out in the approved investment strategy. “Non-specified” investments are also permitted, and these include deals with terms over 364 days. During the year all investments were made in full compliance with the council’s treasury management policies and practices, and details of the investment activity for the year can be found at Appendix 1.

In view of market conditions, enhanced priority was given to the security and liquidity of the council’s funds in order to reduce counterparty risk to the minimum consistent with an adequate return. In order to counter poor investment rates, and in line with advice from Sector, a substantial 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 for short term fixed deposits.

Longer term cash balances comprise primarily revenue and capital resources, although these are influenced by cash flow considerations. A small number of fixed term deposits were made with these balances, including one with a two year term at 2.4%. This represents a “non-specified” investment, being in excess of 364 days. These fixed deposits contributed significantly to the council’s in-house equated investment rate of 1.14% for 2010/11, which outperformed the 7 day uncompounded LIBID rate of 0.43% by 0.71%, and the 3-month uncompounded LIBID rate of 0.61% by 0.53%.

3.9 Debt Rescheduling

On 1st November 2007 the PWLB imposed two rates for each period, one for new borrowing and a new, significantly lower rate for early repayment of debt. The differential between the two rates ranged from 26bp (basis points) in the shorter dated maturities to over 40bp in the longer ones. They also introduced daily movements of 1bp instead of 5 bps and rates in half year periods throughout the maturity range (previously had been mainly in 5 year bands).

As discussed at paragraph 3.5 above, a change of policy on Public Works Loan Board (PWLB) lending arrangements in October 2010 made 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. Accordingly, no debt rescheduling was undertaken during 2010/11.

3.10 Icelandic bank defaults

The council had no investments in any Icelandic bank at the time of the banking collapse in October 2008.

3.11 Compliance with treasury limits and Prudential Indicators

During the financial year the council operated within the treasury limits and Prudential Indicators set out in its Treasury Policy Statement and annual Treasury Management Strategy Statement (TMSS). The outturn for the Prudential Indicators for 2010/11 is shown at appendix 2.

3.12 Other Issues

No other significant treasury management issues arose during the year 2010/11.

RECOMMENDATION

Members are asked to:

Note the Annual Treasury Activity Report for 2010/11 together with the appendices, and to refer it to Council for approval.

Appendix 1

Annual Report on Treasury Activity 2010/11

For the year ended 31 March 2011

	Balance BFwd 1 April 10	New Loans 2010/11	Loans Repaid 2010/11	Balance CFwd 31 March 11
Long Term Borrowing:				
PWLB	6,811,577	3,000,000	0	**9,811,577**
Temporary Borrowing:				
Banks and other Institutions	0	0	0	**0**
TOTAL BORROWING	**6,811,577**	**3,000,000**	**0**	**9,811,577**
Temporary Investment:				
Barclays	0	(3,000,000)	3,000,000	**0**
Halifax/Bank of Scotland	(1,100,000)	(17,835,000)	13,935,000	**(5,000,000)**
HSBC Treasury	0	(15,401,000)	15,401,000	**0**
Royal Bank of Scotland	(1,395,000)	(36,640,000)	36,025,000	**(2,010,000)**
Santander	(1,010,000)	(32,160,000)	33,170,000	**0**
Sub Total Banks	**(3,505,000)**	**(105,036,000)**	**101,531,000**	**(7,010,000)**
Nationwide Building Society	0	0	0	**0**
Debt Management Office	0	0	0	**0**
TOTAL INVESTMENT	**(3,505,000)**	**(105,036,000)**	**101,531,000**	**(7,010,000)**
Net Borrowing/(Investment)	**3,306,577**	**(102,036,000)**	**(101,531,000)**	**2,801,577**

Analysis of Investment:				
Fixed Rate	0	27,401,000	22,401,000	**5,000,000**
Variable Rate	3,505,000	77,635,000	79,130,000	**2,010,000**
TOTAL INVESTMENT	**3,505,000**	**105,036,000**	**101,531,000**	**7,010,000**

Investment Statistics:

Proportion of fixed rate investment	71.33%
Proportion of variable rate investment	28.67%
Temporary investment interest receivable	£132,801
Equated temporary investment	£11,699,950
Weighted average interest rate received	1.14%
7 day LIBID	0.43%
3 Month LIBID	0.61%

Borrowing Statistics:

Weighted average interest rate on PWLB debt	3.72%

Appendix 2

Outturn Prudential and Treasury Indicators for 2010/11

Prudential Indicators	2010/11 Original Estimate	2010/11 Outturn
a) Ratio of Financing Costs to Net Revenue Stream	4.76%	6.15%
b) Capital Expenditure	£3,819,000	£2,712,585
c) Capital Financing Requirement (CFR)	£11,288,260	£9,779,449
d) Net Borrowing and CFR	£13,258,526	£2,801,577
e) Incremental impact of new 2010/11 capital investment decisions	£0.52	Not applicable

Treasury Management Indicators	2010/11 Original Estimate	2010/11 Outturn
a) Authorised Limit for External Debt:		
Borrowing	£15,000,000	£9,811,577
Other Long Term Liabilities	£1,500,000	£0
Total Authorised Limit	**£16,500,000**	**£9,811,577**
b) Operational Boundary for External Debt:		
Borrowing	£14,000,000	£9,811,577
Other Long Term Liabilities	£1,500,000	£0
Total Operational Boundary	**£15,500,000**	**£9,811,577**
c) Upper limit for fixed interest exposure (Max o/s net Borrowing)	£13,500,000	£4,811,577
Local indicator-Investment only	100%	71.33%
Local indicator-Borrowing only	100%	100%
d) Upper limit for variable interest exposure (Max o/s net Borrowing)	£2,000,000 Net Borrowing	(£2,010,000) ie. Net Investment
Local indicator-Investment only	100%	28.67%
Local indicator-Borrowing only	50%	0%
e) Upper limits for maturity structure of outstanding borrowing during 2010/11 (Lower limit 0% in all cases)		
Under 1 year	20%	0%
1-2 years	25%	0%
2-5 years	40%	20.4%
5-10 years	50%	10.2%
Over 10 years	100%	69.4%
f) Upper limits for principal sums invested for periods **over** 364 days		
Maturing beyond 31 March 2011	£5,000,000	£1,500,000
Maturing beyond 31 March 2012	£5,000,000	£1,500,000
Maturing beyond 31 March 2013	0	0