Gedling Borough Council

Report to: **Cabinet**

Subject: **Annual Treasury Activity Report 2011-12**

Date: **7 June 2012**

Author: **Chief Financial Officer**

1. PURPOSE OF REPORT

The council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of its activities, and the actual prudential and treasury indicators for 2011-12. 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 Chief Financial Officer also confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit (the authorised limit), was not breached during 2011-12.

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.

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."

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.

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.

   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 2011-12.

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. At Gedling this delegation is to the Chief Financial Officer.

e. Delegation by the council of the role of scrutiny of treasury management strategy and policies to a specific named body, which at Gedling is the audit committee.

The Code also 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 (see appendix 3 for definitions) 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, and as a further comparison, the 3 month uncompounded LIBID is also used. (See paragraph 3.8 and appendix 1.)

During 2011-12, remaining core balances together with the active management of day to day cash-flows resulted in minimal 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 determined by the capital expenditure plans, approved as part of the annual budget. Performance is measured by demonstrating that the timing of long-term borrowing coincides with the lowest point in the interest rate cycle consistent with the need for financing.

3. ANNUAL TREASURY ACTIVITY REPORT 2011-12

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 2011-12 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). No VRP was made in 2011-12. The Council's MRP Policy for 2011-12, as required by CLG Guidance, was approved by Full Council on 2 March 2011, as part of the Treasury Management Strategy Report for 2011-12.

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 2011-12 plus the expected changes to the CFR over 2012-13 and 2013-14. 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 2011-12 the council maintained gross borrowing within its authorised limit at all times.

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 2011-12 is shown at Appendix 1.

3.3 The treasury strategy for 2011-12

The expectation for interest rates within the strategy for 2011-12 anticipated low but rising Bank Rate (starting in Q4 of 2011) with similar gradual rises in medium and longer term fixed borrowing rates. 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.

In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

The actual movement in gilt yields meant that PWLB rates fell sharply during the year and to historically very low levels. This was caused by a flight to quality into UK gilts from EU sovereign debt and from shares as investors became concerned about the potential for a Lehmans type crisis of financial markets if the Greek debt crisis were to develop into a precipitous default and exit from the Euro.

3.4 The Economy and Interest Rates in 2011-12

The original expectation for 2011-12 was that Bank Rate would start gently rising from Q4 2011. However, economic growth (GDP) in the UK was disappointing during the year due to the UK austerity programme, a lack of rebalancing of the UK economy to exporting and weak growth in our biggest export market - the European Union (EU). The EU sovereign debt crisis grew in intensity during the year until February when a refinancing package was eventually agreed for Greece. 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, with further falls expected to below 2% over the next two years.

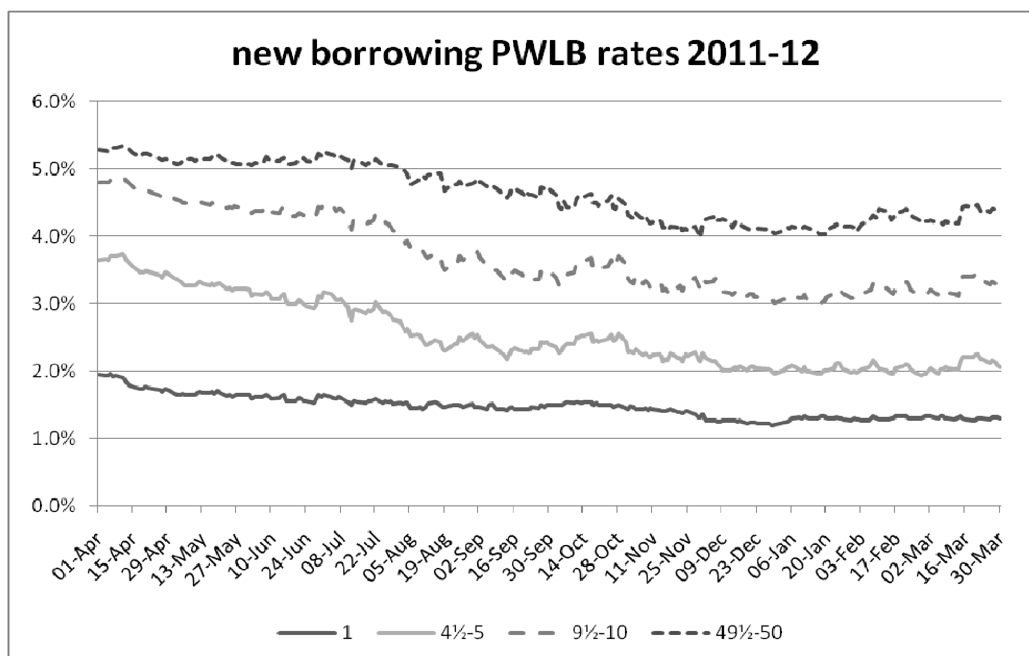
Gilt yields fell for much of the year, until February, as concerns continued building over the EU debt crisis. This resulted in safe haven flows into UK gilts which, together with the two UK packages of QE during the year, combined to depress PWLB rates to historically low levels.

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 credit 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.

The UK coalition Government maintained its tight fiscal policy stance against a background of warnings from two credit rating agencies that the UK could lose its AAA credit rating. Key to retaining this rating will be a return to strong economic growth in order to reduce the national debt burden to a sustainable level, within the austerity plan timeframe. The USA and France lost their AAA ratings from one rating agency during the year.

3.5 Borrowing rates in 2011-12

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.



3.6 The Borrowing outturn for 2011-12

The council undertook £1m of new PWLB borrowing during 2011-12, timed in accordance with advice received from Sector. The average debt portfolio interest rate accordingly fell from 3.72% at 1 April 2011 to 3.62% at 31 March 2012, however there is no real benchmark for the long-term portfolio. All councils are different, both

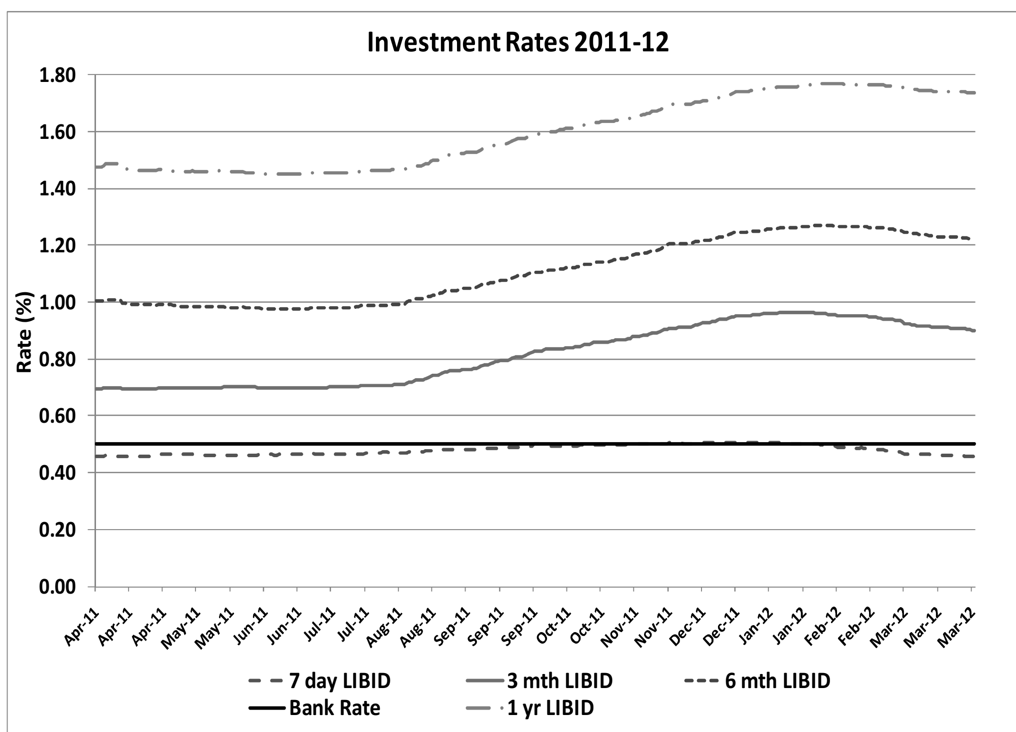
in terms of their underlying need to borrow, and the reason for the borrowing. The key when managing debt is to ensure that the debt servicing costs are affordable at the point of borrowing. Gedling's underlying need to borrow can still be demonstrated by the Capital Financing Requirement, and advice will continue to be taken from Sector with regard to the timing of any future borrowing.

Temporary borrowing was required on one occasion during the year 2011-12, with the sum of £240,000 being taken overnight only at a rate of 1%, compared with an average 7 day LIBOR rate of 0.61%.

3.7 Investment rates in 2011-12

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 European Central Bank's (ECB) actions to provide nearly €1 trn of 1% 3 year finance to EU banks eased liquidity pressures in the EU and investment rates eased back somewhat in Q1 of 2012. This action has also given EU banks time to strengthen their balance sheets and liquidity positions on a more permanent basis. Bank 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.

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 Q1 2012. Concerns extended to the potential fallout on the European banking industry if the crisis could have ended with Greece leaving the Euro and defaulting.



3.8 Investment activity and outturn for 2011-12

The council's investment policy is governed by CLG guidance, which was implemented by the council in 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 those arranged with an initial term of 364 days or less, 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.

Longer term cash balances comprise primarily revenue and capital resources, although these are influenced by cash flow considerations. A number of fixed term deposits were made with these balances, including three at rates of 2.5% or above. These fixed deposits contributed significantly to the council's in-house equated investment rate of 1.37% for 2011-12, which outperformed the 7 day uncompounded LIBID rate of 0.48% by 0.89%, and the 3-month uncompounded LIBID rate of 0.82% by 0.55%.

3.9 Debt Rescheduling

Since November 2007, PWLB has operated two rates for each period, one for new borrowing and a significantly lower rate for the early repayment of debt. The differential between the two rates initially ranged from 26bp (basis points) in the shorter dated maturities to over 40bp in the longer ones. However, a change of policy on PWLB lending arrangements in October 2010 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 2011-12.

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 & Treasury Indicators for 2011-12 is shown at appendix 2.

3.12 Other Issues

No other significant treasury management issues arose during the year 2011-12.

RECOMMENDATION

Members are asked to:

Note the Annual Treasury Activity Report for 2011-12 together with the appendices, and to refer it to Council for approval.

Appendix 1

Annual Report on Treasury Activity 2011-12

For the year ended 31 March 2012

	Balance BFwd 1 April 11	New Loans 2011-12	Loans Repaid 2011-12	Balance CFwd 31 March 12
Long Term Borrowing:				
PWLB	9,811,577	1,000,000	0	**10,811,577**
Temporary Borrowing:				
Banks and other Institutions	0	240,000	(240,000)	**0**
TOTAL BORROWING	**9,811,577**	**1,240,000**	**240,000**	**10,811,577**
Temporary Investment:				
Barclays	0	(1,000,000)	0	**(1,000,000)**
Halifax/Bank of Scotland	(5,000,000)	(12,850,000)	11,850,000	**(6,000,000)**
HSBC Treasury	0	(7,670,000)	7,670,000	**0**
Royal Bank of Scotland	(2,010,000)	(46,475,000)	47,985,000	**(500,000)**
Santander		(28,705,000)	27,705,000	**(1,000,000)**
Sub Total Banks	**(7,010,000)**	**(96,700,000)**	**95,210,000**	**(8,500,000)**
Nationwide Building Society	0	(1,200,000)	1,200,000	**0**
Debt Management Office	0	0	0	**0**
TOTAL INVESTMENT	**(7,010,000)**	**(97,900,000)**	**96,410,000**	**(8,500,000)**
Net Borrowing/(Investment)	**2,801,577**	**(96,660,000)**	**96,170,000**	**2,311,577**

Analysis of Investment:				
Fixed Rate	(5,000,000)	(30,870,000)	27,870,000	**(8,000,000)**
Variable Rate	(2,010,000)	(67,030,000)	68,540,000	**(500,000)**
TOTAL INVESTMENT	**(7,010,000)**	**(97,900,000)**	**96,410,000**	**(8,500,000)**

Investment Statistics:

Proportion of fixed rate investment	94.12%
Proportion of variable rate investment	5.88%
Temporary investment interest receivable	£170,357
Equated temporary investment	£12,446,051
Weighted average interest rate received	1.37%
7 day LIBID	0.48%
3 Month LIBID	0.82%

Borrowing Statistics:

Temporary investment interest payable	£7
Equated temporary borrowing	£658
Weighted average interest rate paid	1.0%
7 day LIBOR	0.61%
Weighted average interest rate on PWLB debt	3.62%

Appendix 2

Outturn Prudential and Treasury Indicators for 2011-12

Prudential Indicators	**2011-12 Estimate**	**2011-12 Outturn**
a) Ratio of Financing Costs to Net Revenue Stream	5.75%	4.95%
b) Capital Expenditure	£2,501,900	£2,075,231
c) Capital Financing Requirement (CFR)	£11,128,162	£10,197,098
d) Net Borrowing and CFR	£12,981,529	£2,311,577
e) Incremental impact of new 2010/11 capital investment decisions	£0.41	Not applicable

Treasury Management Indicators	**2011-12 Estimate**	**2011-12 Outturn**
a) Authorised Limit for External Debt:		
Borrowing	£15,000,000	£10,811,577
Other Long Term Liabilities	£1,500,000	£0
Total Authorised Limit	**£16,500,000**	**£10,811,577**
b) Operational Boundary for External Debt:		
Borrowing	£14,000,000	£10,811,577
Other Long Term Liabilities	£1,500,000	£0
Total Operational Boundary	**£15,500,000**	**£10,811,577**
c) Upper limit for fixed interest exposure (Max o/s net Borrowing)	£13,000,000	£2,811,577
Local indicator-Investment only	100%	94.12%
Local indicator-Borrowing only	100%	100%
d) Upper limit for variable interest exposure (Max o/s net Borrowing)	£2,000,000 Net Borrowing	(£500,000) ie. Net Investment
Local indicator-Investment only	100%	5.88%
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%	37%
5-10 years	50%	0%
Over 10 years	100%	63%
f) Upper limits for principal sums initially invested for periods OVER 364 days		
Maturing beyond 31 March 2012	£5,000,000	£4,000,000
Maturing beyond 31 March 2013	£3,000,000	£1,000,000
Maturing beyond 31 March 2014	0	0

APPENDIX 3

LIBOR - the London Interbank Offered Rate

LIBOR is the interest rate at which the London banks are willing to offer funds in the inter-bank market. It is the average of rates which five major London banks are willing to lend £10 million for a period of three or six months, and is the benchmark rate for setting interest rates for adjustable-rate loans and financial instruments.
e. the London banks are LENDING to each other, which affects the rate at which the banks will lend to other parties eg. local authorities, ie. Gedling are BORROWING money

LIBID - the Interbank BID (LIBID) rate

LIBID is the interest rate at which London banks are willing to borrow from one another in the inter-bank market. It is the average of rates which five major London banks willing to bid for a £10 million deposit for a period of three or six months.

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