Annual Treasury Report 2010/11

1. Background

The Council's treasury management activity is underpinned by CIPFA's 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.

Treasury management 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."

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.

The report has been compiled using advice from our independent financial advisers.

2. Economic Background

At the time of determining the strategy for 2010/11, interest rates were expected to remain low in response to the fragile state of the UK economy. Spending cuts and tax increases seemed inevitable post the General Election if the government had a clear majority. The markets had, at the time, viewed a hung parliament as potentially disruptive particularly if combined with a failure to articulate a credible plan to bring down government borrowing. The outlook for growth was uncertain due to consumers and corporates trimming their spending and financial institutions exercising restraint in new lending.

The economy's two headline indicators moved in opposite directions – growth was lacklustre whilst inflation spiked sharply higher. The economy grew by just 1.3% in calendar year 2010; the forecast for 2011 was revised down to 1.7% by the Office of Budget Responsibility in March. Higher commodity, energy and food prices and the increase in VAT to 20% pushed the February 2011 annual inflation figure to 4.4%. The Bank Rate was held at 0.5% as the economy grappled with uneven growth and the austerity measures set out in the coalition government's Comprehensive Spending Review. Significant cuts were made to public expenditure, in particular local government funding.

The US Federal Reserve (the Fed) kept rates on hold at 0.25% following a slowdown in American growth. The European Central Bank maintained rates at 1%, with the markets expecting a rate rise in early Spring.

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The credit crisis migrated from banks to European sovereigns. The ratings of Ireland and Portugal were downgraded to the 'triple-B' category whilst the rating of Greece was downgraded to sub-investment (or 'junk') grade. The sovereign rating of Spain was also downgraded but remained in the 'double-A' category. The results from the EU Bank Stress Tests, co-ordinated by the Committee of European Banking Supervisors, highlighted that only 7 out of the 91 institutions failed the 'adverse scenario' tests. The tests were a helpful step forward, but there were doubts if they were far-reaching or demanding enough. The main UK banks' (Barclays, HSBC, Lloyds and RBS) Tier 1 ratios all remained above 9% under both the 'benchmark scenario' and the 'adverse scenario' stress tests. The tests will be repeated in the Spring of 2011.

Gilts benefitted from the decisive Comprehensive Spending Review (CSR) plans as well as from their relative 'safe haven' status in the face of European sovereign weakness. 5-year and 10-year gilt yields fells to lows of 1.44% and 2.83% respectively. However yields rose in the final quarter across all gilt maturities on concern that higher inflation would become embedded and greatly diminish the real rate of return for fixed income investors.

During the year money market rates increased marginally at the shorter end (overnight to 3 months). 6 - 12 month rates increased between 0.25% to 0.30% over the 12 month period reflecting the expectation that the Bank Rate would be raised later in 2011.

3. The Borrowing Requirement and Debt Management

Following the CSR on 20th October 2010, on instruction from HM Treasury, the PWLB increased the margin for new borrowing to average 1% above the yield on the corresponding UK Government Gilt. New fixed rate borrowing increased by approximately 0.87% across all maturities and new variable rate borrowing by 0.90%. Premature repayment rates did not benefit from the increase in the margin which potentially makes future rescheduling of PWLB loans more challenging. Despite this the PWLB remained the Council's preferred source of borrowing given the transparency and control that its facilities continue to provide.

The Council's variable rate loans were borrowed prior to 20/10/2010 (the date of change to the PWLB's lending arrangements post CSR) are not subject to the higher post-CSR margin.

The extent of variable rate borrowing the Council can potentially undertake is influenced by the level of Reserves and Balances. Any upward move in interest rates and interest paid on variable rate debt is 'hedged' by a corresponding increase in interest earned on variable rate investments

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Given the large differential between short and longer term interest rates, which is likely to remain a feature for some time in the future, as well as the pressure on Council finances, the debt management strategy sought to lower debt costs within an acceptable level of volatility (interest rate risk). Loans that offered the best value in the prevailing interest rate environment were PWLB variable interest rates loans, PWLB medium-term Equal Instalments of Principal (EIP) loans and temporary borrowing from the market.

	Balance on 31/3/2010 £000s	Debt Maturing £000s	Debt Prematurely Repaid £000s	New Borrowing £000s	Balance on 31/3/2011 £000s
Short Term Borrowing	5,006	25,506	0	20,500	646
Long Term Borrowing	156,253	0	16	0	155,591
TOTAL BORROWING	161,259	25,506	16	20,500	156,237

During 2010/11 the Council used of internal resources in lieu of borrowing and bridge any cash flow requirement for short periods using temporary borrowing from the market as it has been the most cost effective means of funding of capital expenditure. This has lowered overall treasury risk by reducing both external debt and temporary investments. However, this position will not be sustainable over the medium term.

The Council continues to benefit from the debt rescheduling it did in 2009/10 which consisted of repaying £35.6m of PWLB fixed rated loans averaging 4.72% to variable rated debt averaging 0.7% this has generated a revenue saving of £1.2m in 2010/11. The interest rate risk associated with the Council's strategic exposure is regularly reviewed with our treasury advisor against clear reference points, this being a narrowing in the gap between short and longer term interest rates by 0.5%. When appropriate this exposure will be reduced by replacing the variable rate loans with fixed rate loans.

The Council's budgeted cost of financing for the year had been set at £6.9m. Due to the use of internal resources in lieu of borrowing the actual net cost of financing was £5.7m.

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4. Investment Activity

The CLG's revised Investment Guidance came into effect on 1st April 2010 and reiterated the need to focus on security and liquidity, rather than yield. It also recommended that strategies include details of assessing credit risk, reasons for borrowing in advance of need and the use of treasury advisers,

Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2010/11. Restricting Investments to the following.

- Deposits with the Debt Management Office
- Deposits with other Local Authorities
- Investments in AAA-rated Stable Net Asset Value Money Market Funds
- Call accounts and deposits with Banks and Building Societies systemically important to that country's banking system (UK, Australia, Canada, Finland, France, Germany, Netherlands, Spain, Switzerland and the US).
- Bonds issued by Multilateral Development Banks
- Pooled funds (collective investment schemes) meeting the criteria in SI 2004 No 534 and subsequent amendments.

Credit Risk: Counterparty credit quality was assessed and monitored with reference to credit ratings (Council's minimum long-term counterparty rating of A+ across all three rating agencies, Fitch, S&P and Moody's); credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; any potential support mechanisms and share price.

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

Investments	Balance on 31/3/2010 £000's	Investments Made £000's	Maturities/ Investments Sold £000's	Movement in fund value** £000's	Balance on 31/03/2011 £000's
Short Term Investments*	59,350	480,160	494,035	0	45,475
Long Term Investments	0	0	0	0	0
Investments in Pooled Funds Lime Fund	4,530	0	0	72	4,602
Bonds issued by	0	0	0	0	0

Multilateral Development Banks					
Corporate Bonds	0	0	0	0	0
Funds Managed Externally	5,749	0	5,782	33	0
TOTAL INVESTMENTS	69,629	480,160	499,817	105	50,077

* Includes Liquidity account
** Due to market valuation / re-investment of interest

Internal Investments

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. Consequently short-term money market rates have remained at very low levels. Despite this the council has made new deposits for periods up to one year between 0.8% to 2.2%. For internally managed funds the Council has been able to able to obtain a rate of return over its set benchmark of 3 month LIBID 0.67%, the Council's average rate of return being 1.51%.

The Council's budgeted investment income for the year had been set at £1.5m. Due to the use of internal resources in lieu of borrowing the actual investment income achieved was £1.4m

Long term Investments

The Council continues to hold its units in The Lime Fund an investment in a property fund. This continues to generate a good return for the council. Quarter 4 return is due to be distributed at the end of May but the first three quarters return saw a return on the investment of 5.8% before fees and 5.07% after fees.

As the property market picks up the fund has also continued to grow in value be it slowly. In the year it has increased by £72k in capital terms (which is unrealised) the current value of the fund is £4.6m which is below its initial investment value but it should be noted that the nature of the investment is long term.

Externally Managed Funds:

During the year following an ongoing review of the externally managed fund the Council with its advisors, decided to withdraw its fund from Investec and bring the money in-house. The reasons for this change were twofold.

Firstly the fund was structured in a way which although historically generated a good return due to changes in the market the performance of the fund over the last

few years deteriorated significantly, and any restructuring of the funds would not be cost effective bearing in mind the size of the fund.

Secondly the increase in liquid internal funds would allow the council to use the funds in lieu of borrowing which was the most cost effective means of using the funds.

5. Compliance with Prudential Indicators

The Council can confirm that it has complied with its Prudential Indicators for 2010/11, which were set in Feb 2010 as part of the Council's Treasury Management Strategy Statement

In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2010/11. None of the Prudential Indicators has been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

6. Reform of Council Housing Finance

In its publication Implementing self-financing for council housing issued in February 2011 the CLG set out the rationale, methodology and financial parameters for the initiative.

Subject to the Localism Bill receiving Royal Assent and a commencement order being passed, the proposed transfer date is Wednesday 28th March 2012 (this fits with PWLB timetables on the payment/receipt of funds to clear by 31st March 2012.)

The self-financing model provides an indicative sustainable level of opening housing debt. As the Council's debt level generated by the model is higher than the Subsidy Capital Financing Requirement (SCFR), the Council will be required to pay the CLG the difference between the two, which is approximately £158m. This will require the Council to fund this amount in the medium term through internal resources and/or external borrowing. The Council has the option of borrowing from the PWLB or the market.

The treasury management implications of HRA reform and an appropriate strategy to manage the process are being actively reviewed with the Council's Treasury Advisor including the issues surrounding any early prefunding of the significant settlement payment (primarily the powers to borrow and the cost of carry).

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7. Outlook up to 2011/14

Outlook for Interest Rates

	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14
Official Bank Rate													
Upside risk		0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	0.50	0.50	0.75	1.00	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.00
Downside risk			-0.25	-0.25	-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50

The Bank Rate is expected to remain at it current level of 0.5% for up until the end of September 2011 when it is expected to rise to 0.75%

Consumer Price Inflation remains persistently high and surged to 4.5% in April. The Bank's Inflation Report projects higher commodity prices and weakened sterling to push inflation to 5% in 2011. CPI is forecast to remain above the Bank's 2% inflation target for the whole of 2012.

The UK economy is growing but only modestly. The outlook for exports remains positive but household purchasing power is constrained b a much needed adjustment of personal balance sheets (seen through a higher savings ratio and debt reduction) and the effect of higher consumer prices.

Consumer confidence and spending continues to be affected by modest wage increases, weak house price growth and a dearth of cheap credit. Unemployment is just under 2.5million and will increase as the public sector shrinks but private sector employment grows at only a modest pace.

The 2011 Budget is neutral in impact and maintains the Comprehensive Spending Review's framework of fiscal consolidation, reduction in the deficit and the debt-to-GDP ratio. The Office for Budget Responsibility (OBR) is positive on these objectives being achieved. Gilt issuance of £169bn in 2011-12 should be easily absorbed by high investor demand.

Euro zone growth of 0.8% in the first quarter allowed the European Central Bank to raise rates in April. The ECB is likely to put up rates again in response to rising inflation despite the growing divergence in the business cycles and GDP outlook for the core and peripheral countries. Questionmarks will remain over Greek sovereign debt despite last year's bail out; reprofiling its debt maturities remains an option.

S&P has revised its outlook on the long-term rating for the US to negative amidst fears that the government will not agree a medium-and long-term strategy to tackle their fiscal challenges. This has the potential to negatively impact US yields.

8. Prudential Indicator Compliance

(a) Authorised Limit and Operational Boundary for External Debt

- The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of their indebted status. This is a statutory limit which should not be breached.
- The Council's Affordable Borrowing Limit was set at £221m for 2010/11.
- The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit.
- The Operational Boundary for 2010/11 was set at £211m.
- There were no breaches to the Authorised Limit and the Operational Boundary during the year; borrowing at its peak was £169.3m.

(b) 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.
- The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of investments.

	Limits for 2010/11 %
Upper Limit for Fixed Rate Exposure	100
Compliance with Limits:	Yes
Upper Limit for Variable Rate Exposure	35
Compliance with Limits:	Yes

(c) Maturity Structure of Fixed Rate Borrowing

- This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

Maturity Structure of Fixed Rate Borrowing	Upper Limit %	Lower Limit %	Actual Fixed Rate Borrowing as at 31/03/2011 £000's	% Fixed Rate Borrowing as at 31/03/2011	Compliance with Set Limits?
under 12 months	20	0	646	0.41	Yes
12 months and within 24 months	20	0	5,038	3.22	Yes
24 months and within 5 years	40	0	23,930	15.32	Yes
5 years and within 10 years	100	0	16,058	10.28	Yes
10 years and within 20 years	100	0	32,128	20.56	Yes
20 years and within 30 years	100	0	2,521	1.61	Yes
30 years and within 40 years	100	0	646	0.41	Yes
40 years and within 50 years	100	0	68,973	44.15	Yes
50 years and above	100	0	6,297	4.03	Yes

(d) Total principal sums invested for periods longer than 364 days

- This indicator allows the Council to manage the risk inherent in investments longer than 364 days.
- The limit for 2010/11 was set at £20m.
- The Council's policy response since the onset of the credit crunch in 2007 was to keep investment maturities to a maximum of 12 months. No investments were made for a period greater than 364 days during this period.