Herefordshire Council

MEETING:	**COUNCIL**
DATE:	**20 JULY 2012**
TITLE OF REPORT:	**TREASURY MANAGEMENT OUTTURN REPORT**
PORTFOLIO AREA:	**CORPORATE SERVICES**

CLASSIFICATION: Open

Wards Affected

County-wide

Purpose

To approve the Treasury Management Outturn Report as agreed at Cabinet on 14 June 2012.

Key Decision

This is not a Key Decision.

Recommendation

THAT Council approves the Treasury Management out-turn report.

Key Points Summary

- The Treasury Management out-turn was an under spend of £1.18m on borrowing costs and £226k on interest received.
- The Council complied with the Prudential Indicators agreed as part of the 2011/12 Treasury Management Strategy.

Alternative Options

1. There are no Alternative Options

Reasons for Recommendations

2 At Cabinet on 14 June 2012 it was agreed that Full Council should be requested to approve the Treasury Management Outturn Report.

3 Under section 4.7.23.9 of the Constitution it states that Cabinet will receive an annual treasury management report after the end of the financial year and will recommend to Council for approval.

Further information on the subject of this report is available from
Heather Foster, Head of Corporate Finance on (01432) 260284

Introduction and Background

4 Treasury Management is about managing the Council's cash flow, borrowing and cash investments to support Herefordshire's finances for the benefit of the Council Tax payers and the services that the Council provides. These activities are structured to manage risk foremost, and then optimise performance. The Treasury Management function seeks to ensure stability by sound debt, cash and risk management techniques. The need to minimise risk and volatility is constantly addressed whilst aiming to achieve the treasury management objectives.

5 Throughout 2011/12 the council's revenue, capital and treasury management position has been reported to Cabinet. The reporting is a discrete part of the performance reporting regime and ensured Cabinet was informed of the council's financial position.

6 The reports also conformed to best practice by informing Cabinet on 14th June 2012 of the 2011/12 Treasury Management activities.

7 The Council's treasury management activities are regulated by statute, professional codes and official guidance. The Local Government Act 2003 (the Act) provides the powers to borrow and invest as well as providing controls and limits.

Key Considerations

8 The formal treasury management out-turn report is in line with the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management, which is required to be approved by Council. The Treasury Management 2011/12 out-turn was an under spend of £1.18m on borrowing costs and £226k on interest received. This made a significant contribution to the Council's overall financial position.

9 During the year an internal audit review of the treasury management function was completed as part of the annual audit plan. The audit opinion was the highest classification possible under the framework used by our internal auditors KPMG. The result was Substantial Assurance.

10 To comply with the CIPFA Code of Practice for Treasury Management in the public services, the Chief Officer: Finance & Commercial provides an annual report and mid-year reports to members for information covering this function's activities and performance.

11 Investment of the Council's cash balances is governed by guidance on Local Government Investments issued by Communities and Local Government. The key intention of the guidance is that councils invest prudently and that priority is given to security (protecting the investment from loss), and liquidity (keeping the money readily available for expenditure when needed) before yield.

12 During the 2011/12 financial year the Council's total borrowing fell slightly from £145.6m to £144.5m. This change is not viewed as significant but when comparing the position at the start of the year with the final year end position the average life of borrowing decreased by one year from 22 years to 21 years. The average interest rate fell slightly from 4.02% to 4.01%.

13 The average amount invested in 2011/12 was £39.85m with an average rate of interest received of 1.15%. The interest received exceeded budget by £226,512 due to higher investment balances and higher average interest rates.

14 The attached report confirms the Council complied with its Prudential Indicators for 2011/12.

These were approved by Council on 4 February 2011 as part of the Council's Treasury Management Strategy. None of the Prudential Indicators have been breached and a prudent approach has been taken. Security and liquidity have priority over yield.

Community Impact

15 Not applicable.

Equality and Human Rights

16 The recommendations do not have equality implications.

Financial Implications

17 The Annual Treasury Management Report sets out details of the treasury management activity undertaken in the period 1 April 2011 to 31 March 2012. The financial implications of this activity have been factored into the Council's budget and budget monitoring reports and the medium term financial strategy continues to be revised to reflect the forecast of future interest rates along with other factors.

Legal Implications

18 The Council is required to comply with the requirements of the Local Government Act 2003 and to have regard to guidance from the Department for Communities and Local Government and CIPFA Code when determining its treasury management policy and strategies together with details of practices.

Risk Management

19 The reporting requirements are intended to ensure that treasury management activity has been conducted in accordance with the policy and strategy agreed by the Council and that treasury management operations have been performed within agreed limits.

20 The Council's treasury management advisors have provided officers with additional information in relation to treasury management activity. However it must be recognised that the responsibility for all decisions with regard to policies, strategy and transactions remain with the Council.

Consultees

21 None

Appendices

Annual Treasury Management Report 2011/12.

Background Papers

None

ANNUAL TREASURY MANAGEMENT REPORT 2011/12 **Appendix**

1. Background

1.1 The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which requires local authorities to annually produce Prudential Indicators and a Treasury Management Strategy Statement on the policies and objectives of the council's treasury management activities for the forthcoming year and then an outturn report at the end of the year detailing the actual results for the year.

1.2 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."

1.3 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.

2. Economic Background

2.1 At the time of determining the 2011/12 strategy at the beginning of 2011, there were tentative signs that the UK was emerging from recession with the worst of the financial crisis behind it. Recovery in growth was expected to be slow and uneven as the austerity measures announced in the 2010 Comprehensive Spending Review were implemented in order to bring down the budget deficit and government borrowing and rebalance the economy and public sector finances.

2.2 Inflation
During 2011-12 inflation remained high with CPI (the official measure) and RPI reaching a peak in September at 5.2% and 5.6% respectively, primarily due to escalating utility prices and the January 2011 increase in VAT to 20%. Inflation eased slowly as reductions in transport costs, food prices, intensifying competition amongst retailers and supermarkets and the VAT effect falling out in 2012, pushed February 2012's CPI down to 3.4% and RPI to 3.7%. This, however, was not enough to offset low wage growth and, as a result, the UK suffered the biggest drop in disposable income in more than three decades.

2.3 Monetary Policy
The Bank of England's Monetary Policy Committee maintained the Bank Rate at 0.5%, but increased asset purchases by £75bn in October 2011 and another £50bn in February 2012 taking the Quantitative Easing (QE) total to £325bn.

2.4 The policy measures announced in the March 2012 Budget statement were judged to be neutral. The government stuck broadly to its austerity plans as the economy was rebalancing slowly. The opinion of the independent Office for Budget Responsibility (OBR) was that the government was on track to meet its fiscal targets; the OBR identified oil price shocks and a further deterioration in Europe as the main risks to the outlook for growth and in meeting the fiscal target.

2.5 Europe
In Europe, sovereign debt problems for some peripheral countries became critical. Two bailout packages were required for Greece and one for Portugal, and the contagion spread to Spain and Italy whose sovereign bonds came under increased stress in November. The credit agency Standard & Poor's downgraded nine European sovereigns and the European

Financial Stability Facility bailout fund.

2.6 Gilts

Over the 12-month period from April 2011 to March 2012, 5-year gilt yields more than halved from 2.40% to 1.06%; 10-year gilt yields fell from 3.67% to 2.25%; 20-year yields fell from 4.30% to 3.20% and 50-year yields from 4.20% to 3.35%. PWLB borrowing rates are set approximately 1% higher than gilt yields and so PWLB interest rates also fell but the cost of carry associated with borrowing longer-term loans, whilst investing the monies temporarily until required for capital financing, remained high.

3. The Borrowing Requirement and Debt Management

3.1 Borrowing transactions during the year, and the year end position, were as follows:

	Balance on 01/04/11 £m	Debt Maturing £m	New Borrowing £m	Balance on 31/03/12 £m
Short Term Borrowing	5.50	(5.50)	-	-
Long Term Borrowing	140.1	(6.1)	10.5	144.5
TOTAL BORROWING	**145.6**	**(11.6)**	**10.5**	**144.5**
Other Long Term Liabilities	29.4	(0.9)	0.7	29.2
TOTAL EXTERNAL DEBT	**175.0**	**(12.5)**	**11.2**	**173.7**

The above amounts show the principal outstanding. The figures in the council's annual accounts will be higher as they include accrued interest and other accounting adjustments.

3.2 The council's underlying need to borrow at 31st March 2012, as measured by the Capital Financing Requirement (CFR) was £208 million. The figure for council balances and reserves stood at £38 million and it is the utilisation of these reserves that enabled the council to borrow around £34 million less than the CFR.

3.3 The PWLB remained the Council's preferred source of borrowing given the transparency and control that its facilities continue to provide. In total £10.5m of new loans were raised which included the replacement of maturing debt.

New loans taken out during 2011-12				
Type of loan	**Date**	**Principal £m**	**Interest Rate**	**Period**
PWLB Fixed Rate EIP Loan	14/07/11	7.5	3.59%	15 years
PWLB Fixed Rate EIP Loan	03/11/11	3.0	3.35%	20 years
Total		10.5		
***EIP = Equal Instalments of Principal (with the loan being repaid in equal instalments over the term of the loan)**				

3.4 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 the council's revenue budget, 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 rate loans, PWLB medium-term Equal Instalments of Principal (EIP) loans and temporary borrowing from the market. The council chose EIP loans as variable rate loans are not so attractive following the October 2010 rate increase.

3.5 The changes in the debt portfolio were not significant and had little effect on the overall average life of the loans in the portfolio and the average rate of interest paid. Comparing the position at the start of the year to that at the end the average life decreased by one year from 22 years to 21 years and the interest rate fell slightly from 4.02% to 4.01%.

3.6 The long-term borrowing budget was set in January 2011 at a time when PWLB rates were steadily increasing and there was concern over the interest rates that would need to be paid on future borrowing. At that time the forecast provided by the council's treasury adviser, Arlingclose, was for the 20 year PWLB rate to reach 6% in the third quarter of 2011. In order to set a prudent budget, and give the council flexibility with regard to maturity periods, the budget was set using an interest rate of 5.75%. The budget was also set assuming that, faced with increasing interest rates, the council may take the opportunity to externalise amounts internally borrowed in recent years. However, deteriorating economic conditions in the Eurozone meant that PWLB interest rates actually fell during the year and so the total loans taken out, and the interest rates available, were less than forecast resulting in a surplus for the year. This surplus can be analysed as follows:

	Budget	**Outturn**	**Surplus**
	£m	**£m**	**£m**
Minimum Revenue Provision	9.87	9	0.26
Loan interest paid	6.73	5	0.98
Original budget	**16.60**	**15.**	**1.24**
Agreed budget virement to property disposal costs	**(0.05)**	**-**	**(0.05)**
Budget adjustment relating to a reduction in capital financing contributions from directorates	**(0.12)**	**-**	**(0.12)**
Adjustment for capitalised interest	**-**	**(0.11)**	**0.11**
Budget surplus as at 31 March 2012	**16.43**	**15.**	**1.18**

3.7 The council is able to capitalise interest costs relating to interest paid on borrowing used to fund large capital schemes that take substantial periods of time to get to the point at which the assets may be utilised. Such interest, incurred at the construction or installation phase, may be capitalised and added to the cost of the associated asset. In 2011-12 the council capitalised interest costs totalling £113,000 and this figure has increased the surplus at the end of the year.

4. Investment Activity

4.1 The CLG's Investment Guidance requires local authorities to focus on security and liquidity, rather than yield. The council takes this approach.

4.2 Investments held at the start and end of the year were as follows:

Investments	Balance on 01/04/2011 £m	Investments Made £m	Maturities/ Investments Sold £m	Balance on 31/03/2012 £m
Instant access accounts	15.40	308.26	(322.03)	1.63
Term deposits	11.00	25.50	(27.00)	9.50
Total	**26.40**	**333.76**	**(349.03)**	**11.13**
Decrease in Investments				**(15.27)**

4.3 Security of capital remained the Council's main investment objective. This was maintained by following the council's policy as set out in its Treasury Management Strategy Statement for 2011/12. Investments during the year included:

- Deposits with other Local Authorities
- Investments in AAA-rated Stable Net Asset Value Money Market Funds
- Call accounts and deposits with systemically important UK banks and also with Nationwide Building Society.

4.4 Counterparty credit quality was assessed and monitored with reference to all sources of available information including credit ratings, credit default swaps and share prices. With reference to credit ratings, the minimum acceptable long-term rating specified in the 2011/12 treasury strategy was A+/A1 across all three credit rating agencies (Fitch, Standard & Poor's and Moody's).

4.5 Downgrades in October 2011 to the long-term ratings of Royal Bank of Scotland, National Westminster Bank and Nationwide Building Society resulted in their ratings falling below the minimum threshold. The downgrades were driven principally by the agencies' view of the extent of future government support (flowing from the recommendations to the government from the Independent Commission on Banking) rather than any deterioration in the institutions' creditworthiness. Further use of these counterparties was suspended until a revised criteria was approved for use from 1st April 2012.

4.6 Because of uncertain and deteriorating credit conditions in Europe, the maturity periods for term deposits shortened as the year progressed.

4.7 Investment balances and interest earned during the year was as follows:

Month	Average Invested £m	Average rate of interest earned	Amount of interest earned £
April 2011	40.6	1.08%	36,046
May 2011	47.4	1.15%	46,099
June 2011	47.0	1.17%	45,261
July 2011	48.2	1.17%	47,788
August 2011	48.0	1.23%	49,707
September 2011	42.6	1.28%	44,914
October 2011	38.0	1.30%	42,061
November 2011	40.0	1.27%	40,728
December 2011	36.7	1.24%	39,029
January 2012	36.2	1.17%	36,116
February 2012	32.4	1.11%	28,981
March 2012	21.6	1.10%	20,253
Total treasury interest received			**476,983**
Loan interest received			**12,786**
Interest paid on third party funds etc.			**(14,187)**
Net total interest for year			**475,582**
Budget			**249,070**
Surplus			**226,512**

4.8 The council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate was maintained at 0.50% through the year.

4.9 The average invested during the year was £39.85 million and the average rate of interest achieved was 1.15%. This rate compares favourably with the generally accepted benchmark of the average 7-day London Inter-Bank Bid (LIBID) rate of 0.52%.

4.10 The interest received exceeded budget by £226,512 due to both higher investment balances and higher average interest rates, due principally to a rolling programme of placing term deposits for up to twelve months (and then six months) during the first part of the year.

5. <u>Compliance with Prudential Indicators</u>

5.1 The Council can confirm that it has complied with its Prudential Indicators for 2011/12, which were approved by full council on 4th February 2011 as part of the council's Treasury Management Strategy Statement. Details can be found in Appendix 1.

5.2 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 2011/12. None of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

6. Other Items

6.1 Potential for reduced PWLB borrowing rates

A brief paragraph in the 2012 Budget Report (March 2012) contained HM Treasury's intention to offer a 20 basis points discount on loans from the PWLB "for those principal local authorities providing improved information and transparency on their locally-determined long-term borrowing and associated capital spending plans" and raised the possibility of an independent body facilitating the provision of "a further reduced rate for authorities demonstrating best quality and value for money". More detail is awaited and, given that discussion with relevant bodies will be required, it could be some months before either of these measures is implemented.

Appendix 1

1. Capital Financing Requirement (CFR)

Estimates of the Council's cumulative maximum external borrowing requirement for 2011/12 to 2013/14 are shown in the table below:

	31/3/2012 Estimate £000s	31/3/2012 Actual £000s	31/3/2013 Estimate £000s	31/3/2014 Estimate £000s
Gross CFR	209,550	208,014	213,392	224,524
Less:				
Existing Profile of Borrowing	129,766	144,516	140,532	136,535
Other Long Term Liabilities	27,982	29,204	28,228	27,161
Cumulative Maximum External Borrowing Requirement	**51,802**	**34,294**	**44,632**	**60,828**

2. Usable Reserves

Estimates of the Council's level of Balances and Reserves for 2011/12 to 2013/14 are as follows:

Usable Reserves	31/3/2012 Estimate £000s	31/3/2012 Actual £000s	31/3/2013 Estimate £000s	31/3/2014 Estimate £000s
Earmarked Reserves	12,236	13,459	13,909	13,909
General Fund	6,390	6,113	6,113	6,113
Capital Receipts Reserve	2,228	2,769	1,400	1,500
Capital Grants Unapplied	-	15,679	6,500	1,500
Total	**20,854**	**38,020**	**27,922**	**23,022**

The addition of Capital Grants Unapplied to usable reserves is a change in accounting treatment under International Financial Reporting Standards, having previously been disclosed in the Balance Sheet under liabilities.

3. Prudential Indicator Compliance

3.1 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 Authorised or Affordable Borrowing Limit was set at £230 million for 2011/12 (being borrowing of £190 million and other long-term liabilities of £40 million).
- 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 2011/12 was set at £210 million (being borrowing of £175 million and other long-term liabilities of £35 million).

- There were no breaches to the Authorised Limit and the Operational Boundary during the year.

3.2 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 2011/12	Maximum during 2011/12
Upper Limit for Fixed Rate Exposure	100%	100%
Compliance with Limits:	Yes	Yes
Upper Limit for Variable Rate Exposure	25%	0%
Compliance with Limits:	Yes	Yes

3.3 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	Lower Limit for 2011/12 %	Upper Limit for 2011/12 %	Actual Fixed Rate Borrowing as at 31/03/2012 £m	%	Compliance with Set Limits?
Under 12 months	0%	25%	15.98	11.06%	Yes
12 months and within 24 months	0%	20%	4.00	2.77%	Yes
24 months and within 5 years	0%	30%	19.29	13.35%	Yes
5 years and within 10 years	0%	40%	16.97	11.74%	Yes
10 years and within 20 years	0%	40%	37.28	25.80%	Yes
20 years and within 30 years	25%	100%	18.00	12.45%	Yes
30 years and within 40 years			10.00	6.92%	Yes
40 years and within 50 years			23.00	15.91%	Yes
Total			144.52	100.00%	

The council's two LOBO loans are included as being repayable within twelve months as this is the earliest that the loans could be repaid. However, if the lenders do not increase the interest rates being charged the loans could remain outstanding until 2054.

3.4 Actual External Debt

- This indicator is the closing balance for actual gross borrowing (short and long-term) plus other deferred liabilities.
- The indicator is measured in a manner consistent for comparison with the Operational Boundary and Authorised Limit.

Actual External Debt as at 31/03/2012	£m
Borrowing	144.5
Other Long-term Liabilities	29.2
Total	**173.7**

3.4 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 2011/12 was set at £10 million.
- In May 2011 the council placed £500,000 on deposit with Lloyds TSB for 449 days at an interest rate of 2.65%. However, during the rest of the year credit conditions deteriorated, with maturity limits being reined in, and this was the only investment placed for a period longer than 364 days.

3.5 Capital Expenditure

- This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits, and, in particular, to consider the impact on council tax..

Capital Expenditure	2011/12 Estimate £’000	2011/12 Actual £’000	2012/13 Estimate £’000	2013/14 Estimate £’000
Total	**55,477**	**49,437**	**44,029**	**46,577**

Capital expenditure has been and will be financed or funded as follows:

Capital Financing	2011/12 Estimate £’000	2011/12 Actual £’000	2012/13 Estimate £’000	2013/14 Estimate £’000
Capital receipts	4,260	4,493	2,097	503
Government grants	40,297	34,642	30,027	22,287
Total financing	**44,557**	**39,135**	**32,124**	**22,790**
Prudential borrowing	**10,920**	**10,302**	**11,905**	**23,787**
Total financing and funding	**55,477**	**49,437**	**44,029**	**46,577**

The table shows that the capital expenditure plans of the Authority could not be funded entirely from sources other than external borrowing.

3.6 Ratio of Financing Costs to Net Revenue Stream

- This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs.
- The ratio is based on costs net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2011/12 Estimate %	2011/12 Actual %	2012/13 Estimate %	2013/14 Estimate %
Net Revenue Stream	146,130	146,314	143,356	144,095
Financing Costs	17,520	18,171	18,836	18,480
Percentage	**11.99%**	**12.42%**	**13.14%**	**12.83%**