EAST HERTS COUNCIL

AUDIT COMMITTEE - 21 SEPTEMBER 2011

REPORT BY EXECUTIVE MEMBER FOR RESOURCES AND INTERNAL SUPPORT

TREASURY MANAGEMENT STRATEGY STATEMENT 2010/11 AND PRUDENTIAL CODE REVIEW

WARDS AFFECTED: ALL

Purpose/Summary of Report

- This report reviews the Council's 2010/11 Treasury Management and Prudential Code arrangements and updates the current year position.

RECOMMENDATION FOR AUDIT COMMITTEE:	
(A)	**that the 2010/11 Treasury Management and Prudential Indicator Out-turn be approved; and**
(B)	**the current year position to the 31 July 2011 be noted.**

1.0 Background

1.1 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).

1.2 During 2010/11 the minimum reporting requirements were that the relevant committee should receive the following reports:

- an annual treasury strategy in advance of the year (Council 24/2/2010)
- an annual report following the year describing the activity compared to the strategy (this report)

1.3 Recent changes in the regulatory environment place 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.

1.4 This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the relevant Committee before they were reported to the full Council.

2.0 Report

2.1 This annual treasury report covers:

- Capital spending and financing during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- Reporting of the required prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity
- The Council's current treasury positions as at 31/7/2011.

2.2. The Council's Capital Expenditure and Financing 2010/11

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.

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

£m	2009/10 Actual	2010/11 Estimate	2010/11 Actual
Non-HRA capital expenditure	7.173	6.426	5.909
Total capital expenditure	**7.173**	**6.426**	**5.909**
Resourced by:			
• Capital receipts	6.579	5.711	5.182
• Capital grants	0.569	0.690	0.702
• Capital reserves			
• Revenue	0.025	0.025	0.025

2.3 The Council's overall 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.

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.

The Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are charged to revenue at a rate broadly in line with the life of the asset. To achieve this the Council is required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to. 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.

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 24/2/2010.

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

To ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must be for capital purposes. The Council requires specific approval by the Secretary of State to borrow for revenue purposes. Net borrowing should not therefore, except in the short term, have exceeded 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 in 2010/11. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2010 Actual	31 March 2011 Original	31 March 2011 Actual
Net borrowing position	£(65.57)m	£(64.00)m	£(61.198)m
CFR	£(47.282)m	£(44.50)m	£(47.281)m

The authorised limit - 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. The table below demonstrates that during 2010/11 the Council has maintained gross borrowing within its authorised limit.

The operational boundary – 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 - this indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

Authorised limit February 2010	£20.3m
Maximum gross borrowing position outturn	£9 m
Operational boundary February 2010	£13.3m
Average gross borrowing position outturn	£7.6m
Financing costs as a proportion of net revenue stream – anticipated February 2010 budget	(6.25%)
Financing costs at outturn	(1.21%)

2.4 Treasury Position as at 31 March 2011

The Council's treasury management service manages debt and investment to ensure adequate liquidity for revenue and capital activities, security of investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the beginning and the end of 2010/11 the Council's treasury position was as follows:

TABLE 1	31 March 2011 Principal		Rate/ Return	Average Life yrs	31 March 2010 Principal	Rate/ Return	Average Life yrs
Fixed rate funding:							
-PWLB	£1.5m				£1.5m		
-Market	£6.0m	£7.5m	8.8%		£6.0m	8.8%	
Variable rate funding:							
-PWLB	£nil				£nil		
-Market	£nil	£0.0m			£nil	0%	
Total debt		***7.5m***	***8.8%***		***£7.5m***	***8.8%***	
Investments:							
- in house	£1.99m		0.9%		£2.15m	0.9%	
- with managers	£66.91m		1.19%		£71.09m	2.44%	
Total investments		***£68.9m***	***1.18%***		***£73.24m***	***2.4%***	

The maturity structure of the debt portfolio was as follows:

	31 March.2010 actual	2010/11 original limits	31 March.2011 actual
5 years and within 10 years	£0.0m	£6.0m	£6.0m
10 years and above	£7.5m	£1.5m	£1.5m

Investments - no fixed deposits held as at 31st March 2011 exceed 1 year.

3.0 The Strategy for 2010/11

The strategy for 2010/11 anticipated low but rising Bank Rate (starting in quarter 4 of 2010) 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 strategy adopted in the original Treasury Management Strategy Report for 2010/11 approved by the Council on 24/02/2010 was revised during the year due to permit, within limits, longer term structured deposits to improve returns.

4.0 The Economy and Interest Rates

The first half of 2010 saw the economy outperform expectations then decline in the final quarter of 2010 in part due to inclement weather conditions. The year finished with expectations for the UK economy being downgraded over the short to medium term.

The down grade reflected the new coalition Government's public spending cuts announced in the October Comprehensive Spending Review, and the lack of any "giveaway" in the March 2011 Budget. There was external support for the priority given to managing the spending deficit notwithstanding impact on economic growth. The government's view was that its spending reduction plans proved timely at a time when 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 Public Works Loan Board (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. This made new borrowing more expensive and repayment relatively less attractive.

Deposit rates picked up modestly in the second half of the year as rising inflationary concerns, and strong first half growth, fed through to market expectations of increases in Bank Rate. However, by March 2011 consensus expectations of the first UK rate rise moved back from May to August 2011 despite high inflation. The mix of slow domestic economic growth and above target 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.

5.0 Borrowing Rates in 2010/11

PWLB borrowing rates – the table for PWLB maturity rates below show a selection of maturity periods, and individual rates at the start and the end of the financial year.

5 Yr	01/04/10	2.84%	31/3/11	3.57%
10 Yr	01/04/10	4.14%	31/3/11	4.71%
25 Yr	01/04/10	4.62%	31/3/11	5.32%

The decision by the PWLB to raise its lending rates by about 0.75 – 0.85% did not reflect the market and underlying rates were generally unchanged from the position at 1 April 2010.

6.0 Borrowing Outturn for 2010/11

6.1 Due to the high rates of interest payable on the outstanding £1.5 million PWLB loans and the continuing low level of the corresponding discount rates for 5 year and 30 year + maturities any potential restructuring or premature repayment of the two loans was considered to be too expensive as their repayment would attract heavy premia.

6.2 The £6 million loan stock is part of a 'club' deal. Any move to prematurely redeem the stock would require the consent of all members of the deal and hereto any early redemption would attract a costly premium.

6.3 No new borrowings to finance capital expenditure were undertaken. and capital receipts were applied (thereby reducing investments).

7.0 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 ongoing need for caution in treasury investment activity.

8.0 Investment 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 24/02/2010. 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 policy originally approved was amended in December 2010 to reconsider the balance between risks & returns. The approval was given to invest £30m of funds in fixed term structure deposits with UK banks.

8.1 Funds coming available from day to day cash flow were placed with our bankers when needed immediately or placed on short term deposit with SWIP (Scottish Widows).

8.2 Analysts' consideration of counterparty risks gave more weight to countries as a whole and their ability to underwrite their banks and less to individual institutions. This tightened the lending lists further because of the banks' exposure to foreign governments. The return was 0.9% on the balance held with our bank.

8.3 The Council has investments managed externally by Investec and Scottish Widows (SWIP). The fund management agreements between the Council and the Fund Manager defines the limits for maximum weighting in gilts/bonds and maximum duration of the fund. Counterparty criteria and exposure limits are also pre-defined therein.The stance/diversity of the two different types of funds can be seen in the returns for the year.

SWIP has outperformed the 7 day Libid benchmark by 0.76%. Although it has been a difficult year for the industry with many changes in market conditions, nonetheless this was a good performance. Benefiting from the assets traded and held in the Money Market Fund. SWIP made a strategic decision to steer clear of the gilt market.

This has been a challenging year for Investec, with them staying out of the gilt markets and consequently failing to benefit from short dated gilts when they traded well due to liquidity issues and capital requirements. Alternatively they invested in CDs but failed to make significant gains. However with the expectation of the commencement of the withdrawal of funds (for structured deposits) ,

this curtailed activity in the last months. After following a cautious approach at the beginning of the year, they under performed the 1-3 year gilt index benchmark by 0.68%.

The table below sets out a summary of the investment returns achieved compared to benchmarks.

	Average Investment	**Rate of Return (gross of fees)**	**Rate of Return (net of fees)**	Benchmark Return %
Internally Managed	2.461m	0.9%	N/A	7 day LIBID 0.4% (not compounded)
Externally Managed				
SWIP	39.49m	1.24%	1.2%	7 day LIBID 0.42%
Investec	34.52m	1.14%	0.95%	1-3 year Gilt Index 1.63%

9.0 Current Position 2011/12

9.1 Prudential Indicators

As at the end of July 2011 the data suggests that no changes are required to the current indicators that were approved by Council on 24 February 2010.

9.2 In-House Funds

Further as stated in the report, the policy to move funds into structured deposits commenced with £10m being invested with Lloyds Bank P L C (April 2011). This has a minimum return of 3.72% and a maximum of 6.5% dependent on 3 month LIBOR rates for 4 years. It was intended to complete a 2nd tranche by now but the movement in market conditions and the uncertainty that exists has not made this feasible at returns which are attractive to lock in.

9.3 Fund Managers

Annualised returns for the first quarter for the fund managers are: Scottish Widows Investment Partnership 0.44% and Investec 0.30% per annum. The current projections indicate an overall return of between £975k and £1,025k indicating a budget shortfall of £150 - £200k. Impact on performance against budgeted assumption is

being reported through the monthly healthcheck report.

The lower rate of return being achieved by Investec is partly due to the expectation of all the funds being withdrawn and placed in structured deposits. Other alternative short term deposits (say 3 months) are being investigated. Going forward changes to the CIPFA code may make it possible to invest in more wide ranging funds that could be more productive, if the structured deposit market does not stabilise.

9.4 MRP Policy

Under new regulations the Council are required to determine appropriate provisions for repayment of debt (MRP) on a prudent basis. The Regulations allow for an approach in line with previous provisions which for this Council resulted in no provision needing to be made given the Council's "negative" capital financial requirements (set aside receipts significantly in excess of outstanding debt). The Annual Treasury Management Strategy proposals will consider the ongoing position and approve any changes to this approach.

10.0 Implications/Consultations

10.1 Information on corporate issues and consultation associated with this report can be found within **Essential Reference Paper A**

Background Papers

None

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ESSENTIAL REFERENCE PAPER A

Contribution to the Council's Corporate Priorities/Objectives:	**Fit for purpose, services fit for you** *Deliver customer focused services by maintaining and developing a well managed and publicly accountable organisation.*
Consultation:	None
Legal:	There are no legal implications in the report.
Financial:	As set within the report.
Human Resource:	There are no Human Resources implications in the report.
Risk Management:	The current low returns on investments will impact on MTFP. Discussions are still ongoing about any options to improve returns.