MEETING:	**AUDIT COMMITTEE**
DATE:	**27 SEPTEMBER 2012**
TITLE:	**TREASURY MANAGEMENT 2011/12**
PURPOSE:	**CIPFA’s Code of Practice requires that a report on the results of the Council’s actual Treasury Management is produced.**
RECOMMENDATION:	**RECEIVE THE REPORT FOR INFORMATION**
AUTHOR:	**DAFYDD L EDWARDS, HEAD OF FINANCE**

Executive Summary

During 2011/12 the Council's borrowing remained well within the limits originally set: total interest received on deposits was £941,479, which was above the budgeted level of £699,850. There were no new defaults by banks in which the Council deposited money.

---

1. Introduction and Background

CIPFA’s revised Code of Practice on Treasury Management was adopted by the Council on 1st March 2011 and the Council fully complies with its requirements. The Code requires that I report on the results of the Council's actual treasury management in the previous financial year against that which was expected. It is considered that the Audit Committee is the appropriate body to consider this report.

This report compares our actual performance in 2011/12 against the strategy which was set out for the financial year (approved by the full Council at its meeting on 03/03/2011). The report looks at:

- the economic background;
- the borrowing requirement and debt management;
- investment activity; and
- compliance with Prudential Indicators.

2. Economic Background

At the time of determining the strategy for 2011/12, 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. Inflation measured by the Consumer Price Index (CPI) had remained stubbornly above 3%. Unemployment was at a 16-year high at 2.5 million and was expected to rise further as the public and private sector contracted. There was also a high degree of uncertainty surrounding Eurozone sovereign debt sustainability.

During 2011-12 inflation remained high with CPI (the official measure) and RPI rising in September to 5.2% and 5.6% respectively, primarily due to escalating utility prices and the January 2011 increase in VAT to 20%. Inflation eased slowly with reductions in transport costs and food prices, intensifying competition amongst retailers and supermarkets and the VAT effect falling out in 2012, pushing 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, Britons suffered the biggest drop in disposable income in more than three decades.

Growth, on the other hand, remained elusive. The Bank's Quarterly Inflation Reports painted a bleak picture as the outlook was downgraded to around 1% in 2011 and 2012 alongside. The unresolved problems in the Eurozone weighed negatively on global economic prospects. UK GDP was positive in only the first and third calendar quarters of 2011; annual GDP to December 2011 registered just 0.5%. Unemployment rose to 2.68 million and, worryingly, youth unemployment broke through the 1 million barrier. House prices struggled to show sustained growth and consumer confidence remained fragile.

It was not surprising that the Bank of England's Monetary Policy Committee maintained the status quo on the Bank Rate which has now been held at 0.5% since March 2009, but increased asset purchases by £75bn in October 2011 and another £50bn in February 2012 taking the Quantitative Easing total to £325bn.

The policy measures announced in the March 2012 Budget statement were judged to be neutral. The Westminster Government stuck broadly to its austerity plans as the economy was rebalancing slowly. The opinion of 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.

The US economy continued to show tentative, positive signs of growth alongside a gradual decline in the unemployment rate. The US Federal Reserve (the Fed) committed to keeping policy rates low until 2014, although a modest shift in the Fed's language in March, alongside an improvement in economic activity, cast doubts about the permanence of the Fed's policy commitment.

In Europe, sovereign debt problems for some peripheral countries became critical. Several policy initiatives were largely ineffectual; two bailout packages were required, one for Greece and one for Portugal, and the contagion spread to Spain and Italy whose sovereign bonds came under increased stress in November. Standard & Poor's downgraded nine European sovereigns and the EFSF bailout fund. The successful Greek sovereign bond swap in March 2012, shortly after its second bailout package, allowed it to avoid bankruptcy later that month, but it was not a long-term solution. The ECB's €1.3 trillion Long-Term refinancing Operations (LTROs) flooded the financial markets with ultra-cheap 3-year liquidity, relieving much of the immediate funding pressure facing European banks in 2012, but markets ultimately took the view the LTROs simply served to delay a resolution of, rather than addressed, the fundamental issues underpinning Euroland's problems.

Market sentiment oscillated between 'risk on'/'risk off' modes, this swing becoming the norm for much of 2011/12 as investors shifted between riskier assets and the relative safety of higher quality government bonds. Gilts, however, were a principal beneficiary of the 'risk-off' theme which helped push yields lower. There was little market reaction to or impact on gilts by the decision by Fitch and Moody's to change the outlook on the UK's triple-A rating from stable to negative. 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 fell commensurately, but the cost of carry associated with borrowing longer-term loans whilst investing the monies temporarily until required for capital financing remained high, in excess of 4.1% for 20-year PWLB Maturity borrowing.

Europe's banking sector was inextricably linked with the sovereign sector. Sharp moves in sovereign CDS and bond yields were fairly correlated with the countries' banking sector performance. The deterioration in the prospects for real growth had implications for earnings and profit growth, and banks' creditworthiness. The European Banking Authority's banking stress tests of 70 EU banks undertaken in October 2011 identified a collective €106 billion shortfall to banks' Core Tier 1 ratio of 9%. The slowdown in debt and equity capital market activity also had implications for banks' funding and liquidity. These principal factors, as well as a reassessment by the rating agencies of future sovereign support for banks, resulted in downgrades to the long-term ratings of several UK and non-UK financial institutions in autumn 2011.

3. The Borrowing Requirement and Debt Management

	Balance on 01/04/2011 £m	Debt Maturing £m	Debt Prematurely Repaid £m	New Borrowing £m	Transfer to Short Term	Balance on 31/03/2012 £m
CFR	150					152
Short Term Borrowing	5	(5)	0	0	1	1
Long Term Borrowing	114				(1)	113
TOTAL BORROWING	**119**	**(5)**	**0**	**0**	**0**	**114**
Other Long Term Liabilities	0	0	0	0	0	0
TOTAL EXTERNAL DEBT	**119**	**(5)**	**0**	**0**	**0**	**114**
Increase/ (Decrease) in Borrowing £m						5

The Council's underlying need to borrow, as measured by the Capital Financing Requirement (CFR) as at 31/3/2012, was estimated at £152m. The Council's (additional) borrowing requirement during the year was £0m.

The Council funded £8.9m of its capital expenditure through internal borrowing. This has, for the time being, lowered overall treasury risk by reducing both external debt and temporary investments. Whilst this position is expected to continue in 2012/13, it will not be sustainable over the medium term. The Council expects it will need to borrow £5m for capital purposes by 2013/14.

4. 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 the potential for an independent body to facilitate the provision of "a further reduced rate for authorities demonstrating best quality and value for money". During 2012/13, the Council has provided the required information, with a view to receiving this discount off probable future borrowing in subsequent years.

5. Investment Activity

The Welsh Government's Investment Guidance requires local authorities to focus on security and liquidity, rather than yield.

Investments	Balance on 01/04/2011 £m	Investments made £m	Maturities/ Investments sold £m	Balance on 31/03/2012 £m
Short Term Investments	63.1	319.0	(329.5)	52.6
Investments in Pooled Funds	5.0	98.8	(103.8)	0
TOTAL INVESTMENTS	**68.1**	**417.8**	**(433.3)**	**52.6**
Increase/ (Decrease) in Investments £m				(15.5)

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 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 banks and building societies systemically important to each country's banking system (UK, Australia, Canada, Finland, France, Germany, Netherlands, Spain, Switzerland and the US).

Credit Risk

Counterparty credit quality was assessed and monitored with reference to credit ratings; 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. The minimum long-term counterparty credit rating determined for the 2011/12 treasury strategy was A+/A1 across rating agencies Fitch, S&P and Moody's.

This particular criterion was amended on 15 December 2011 by the full Council to A-/A3, in response to downgrades in credit ratings below A+ of many institutions considered to be systemically important to the financial system. The downgrades were driven principally by the agencies' view the extent of future Government support (flowing from the recommendations to the Government from the Independent Commission on Banking) rather than a deterioration in the individual institutions' creditworthiness.

Counterparty credit quality has progressively reduced as demonstrated by the Credit Score Analysis summarised below. This is due to the amendment of the minimum credit quality of counterparties to A-/A3. The table in Appendix 2 explains the credit score.

Date	Value Weighted Average Credit Risk Score	Value Weighted Average Credit Rating	Time Weighted Average Credit Risk Score	Time Weighted Average Credit Rating	Average Life (days)
31/03/2011	3.69	AA-	2.26	AA+	109
30/06/2011	3.49	AA	2.70	AA	152
30/09/2011	3.07	AA	2.50	AA+	80
31/12/2011	3.57	AA-	3.58	AA-	64
31/03/2012	4.98	A+	4.93	A+	27

Liquidity

In keeping with the WG Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds, overnight deposits and the use of call accounts.

Yield

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.

The Council considered an appropriate risk management response to uncertain and deteriorating credit conditions in Europe was to shorten maturities for new investments. Short term money market rates also remained at very low levels, which had a significant impact on investment income.

Update on the Council's Investment with Heritable Bank

It is expected that at least 88p/£ will be recovered overall. 67.9% has been recovered to date, a further 14.3% is expected in 2012/13, and 5.8% or more is expected in 2013/14.

6. Compliance with Prudential Indicators

The Council can confirm that it has complied with its Prudential Indicators for 2011/12, which were approved on 3rd March 2011 as part of the Council's Treasury Management Strategy Statement. Details are as follows in Appendix 1.

7. Recommendation

The Audit Committee is asked to receive the report for information.

<u>Appendix 1</u>

<u>Prudential Indicators 2011-12</u>

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	153,800	152,241	155,904	160,361
Less: Other Long Term Liabilities	(47)	(29)	0	0
Borrowing CFR	**153,753**	**152,212**	**155,904**	**160,361**
Less: Existing Profile of Borrowing	(113,870)	(114,341)	(113,085)	(111,969)
Cumulative Maximum External Borrowing Requirement	**39,883**	**37,871**	**42,819**	**48,392**

Usable Reserves

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

	31/3/2012 Estimate £000s	31/3/2012 Actual £000s	31/3/2013 Estimate £000s	31/3/2014 Estimate £000s
Usable Reserves	63,140	68,920	63,456	57,023

<u>Prudential Indicator Compliance</u>

(a) Authorised Limit and Operational Boundary for External Debt

The Local Government Act 2003 requires the Council to set an Authorised Borrowing Limit, irrespective of their indebted status. This is a statutory limit which should not be breached. The Council's Authorised Borrowing Limit was set at £190m for 2011/12.

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 £170m.

There were no breaches to the Authorised Limit or the Operational Boundary during the year; borrowing at its peak was £120m.

(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 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	50%	0%
Compliance with Limits:	Yes	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 31/03/2012 £'000**	**% Fixed Rate Borrowing as at 31/03/2012**	**Compliance with Set Limits?**
Under 12 months	25%	0%	1,256	1.10%	Yes
12 months and within 24 months	25%	0%	17,317	15.21%	Yes
24 months and within 5 years	50%	0%	2,761	2.42%	Yes
5 years and within 10 years	75%	0%	6,924	6.08%	Yes
10 years and within 20 years	100%	0%	23,661	20.78%	Yes
20 years and within 30 years	100%	0%	34,594	30.38%	Yes
30 years and within 40 years	100%	0%	0	0.00%	Yes
40 years and above	100%	0%	27,352	24.03%	Yes
TOTAL			**113,865**	**100.00%**	

(d) Actual External Debt

This indicator is obtained directly from the Authority's balance sheet. It 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	115.050
Other Long-term Liabilities	0.029
Total	**115.079**

(e) 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 £40m.
The Council's policy response since the onset of the credit crunch in 2007 has been to keep investment maturities to a maximum of 1 year. No investments were made for a period greater than 1 year during this period.

(f) 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 £m**	**2011/12 Actual £m**	**2012/13 Estimate £m**	**2013/14 Estimate £m**
Non-HRA	38.65	35.97	41.99	38.87
HRA*	0.06	0.00	0.04	0.00
Total	**38.71**	**35.97**	41.99	38.87

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

Capital Financing	**2011/12 Estimate £m**	**2011/12 Actual £m**	**2012/13 Estimate £m**	**2013/14 Estimate £m**
Capital receipts	4.20	2.79	3.22	2.35
Government Grants	15.66	16.11	16.58	15.07
Revenue contributions	9.04	8.17	9.24	7.50
Total Financing	**28.90**	**27.07**	**29.04**	**24.92**
Supported borrowing	5.44	5.44	4.86	4.04
Unsupported borrowing	4.37	3.46	5.63	10.18
Total Funding	**9.81**	**8.90**	**12.95**	**16.69**
Total Financing and Funding	**38.71**	**35.97**	**41.99**	**41.61**

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

(g) 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.

	2011/12 Estimate %	2011/12 Actual %	2012/13 Estimate %	2013/14 Estimate %
Ratio of Financing Costs to Net Revenue Stream	**5.68**	**5.31**	**5.65**	**5.55**

(h) Incremental Impact of Capital Investment Decisions

This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax and Housing Rent levels. The incremental impact is calculated by comparing the total revenue budget requirement of the current approved capital programme with an equivalent calculation of the revenue budget requirement arising from the proposed capital programme.

Incremental Impact of Capital Investment Decisions	2011/12 Approved £	2012/13 Estimate £	2013/14 Estimate £
Increase in Band D Council Tax	10.08	6.66	27.72

(i) Adoption of the CIPFA Treasury Management Code

This indicator demonstrates that the Authority adopted the principles of best practice.

Adoption of the CIPFA Code of Practice in Treasury Management
The Council approved the adoption of the CIPFA Treasury Management Code at its full Council meeting on 3rd March 2011.

(j) Gross and Net Debt

The purpose of this treasury indicator is to highlight a situation where the Authority is planning to borrow in advance of need.

Upper Limit on Net Debt compared to Gross Debt	**2011/12 Actual £m**	**2012/13 Estimate £m**	**2013/14 Estimate £m**
Outstanding Borrowing (at nominal value)	114	113	112
Other Long-term Liabilities (at nominal value)	0	0	0
Gross Debt	114	113	112
Less: Investments	47	36	15
Net Debt	**67**	**77**	**97**

CIPFA has acknowledged that the upper limit does not work as was intended and is working on a revised indicator. This indicator will be amended once revised guidance has been received from CIPFA.

(k) Upper Limit for Total Principal Sums Invested Over 364 Days

The purpose of this limit is to contain exposure to the possibility of loss that may arise as a result of the Authority having to seek early repayment of the sums invested.

	2011/12 Approved £m	**2011/12 Revised £m**	**2012/13 Estimate £m**	**2013/14 Estimate £m**	**2014/15 Estimate £m**
Upper Limit for total principal sums invested over 364 days	**40**	**40**	**40**	**40**	**40**

No principal sums were invested over 364 days.

<u>Appendix 2</u>

Credit Score Analysis

<u>Scoring</u>:

Long-Term Credit Rating	**Score**
AAA	1
AA+	2
AA	3
AA-	4
A+	5
A	6
A-	7
BBB+	8
BBB	9
BBB-	10
Not rated	11
BB	12
CCC	13
C	14
D	15

The value weighted average reflects the credit quality of investments according to the size of the deposit. The time weighted average reflects the credit quality of investments according to the maturity of the deposit.

Originally the Council aimed to achieve a score of 5 or lower, reflecting the Council's overriding priority of security of monies invested (and the minimum credit rating of threshold of A+ for investment counterparties) although this target reduced to 7 or lower following the reduction of the minimum credit rating of threshold of A- for investment counterparties.