

CABINET

DATE OF COMMITTEE
5th September 2012

REPORT OF THE PORTFOLIO HOLDER FOR CORE SERVICES AND ASSETS

ANNUAL REPORT ON THE TREASURY MANAGEMENT SERVICE AND ACTUAL PRUDENTIAL INDICATORS 2011/12

EXEMPT INFORMATION

None

PURPOSE

The Annual Treasury report is a requirement of the Council's reporting procedures. It covers the Treasury activity for 2011/12, and the actual Prudential Indicators for 2011/12.

The report meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. The Council is required to comply with both Codes in accordance with Regulations issued under the Local Government Act 2003.

RECOMMENDATIONS

That Council be asked to,

- 1. Approve the actual 2011/12 Prudential Indicators within the report and shown at APPENDIX 1;**
- 2. Accept the Treasury Management stewardship report for 2011/12.**

EXECUTIVE SUMMARY

This report covers Treasury operations for the year ended 31st March 2012 and summarises:

- the Council's Treasury position as at 31st March 2012;
- performance measurement.

The key points raised for 2011/12 are:

- The Economy and Interest Rates
- Treasury Position as at 31 March 2012
- The Strategy for 2011/12
- The Council's Borrowing Requirement and Debt
- Borrowing Rates in 2011/12
- Borrowing Outturn for 2011/12
- Investment Rates in 2011/12
- Investment Outturn for 2011/12
- Performance Measurement
- Icelandic Bank Defaults.

The Treasury Function has achieved the following favourable results:

- The Authority has complied with the professional codes, statutes and guidance;
- There are no issues to report regarding non-compliance with the approved prudential indicators;

- Excluding the Icelandic investments (currently identified 'at risk') the Council maintained an average investment balance externally invested of £17.32m and achieved an average return of 1.25% (budgeted at £22.7m 1.13%);

These results compare favourably with the Council's own Benchmarks of the average 7 day and the 3 month LIBID rates for 2011/12 of 0.48% and 0.82% respectively, and above the CIPFA Treasury Benchmarking Club average rate of 1.19%. This is not considered to be a poor result in light of the current financial climate, our lower levels of deposits/funds and shorter investment timelines due to Banking sector uncertainty, when compared to other Authorities;

- The closing weighted average internal rate on borrowing has reduced from 6.61% to 6.55%;
- The Treasury Management Function has achieved an outturn investment income of £218k compared to a budget of £256k, the shortfall being due to the exceptional circumstances that have continued over the year.

During 2011/12 the Council complied with its legislative and regulatory requirements.

The Executive Director Corporate Services confirms that no borrowing was undertaken within the year and the Authorised Limit was not breached.

At 31st March 2012, the Council's external debt was £65.060m (£20.392 at 31st March 2011) and it's external investments totalled £15.699m (£12.990m at 31st March 2011) this excludes £1.66m Icelandic Banking sector deposits that were 'At Risk' at the year end (£5.16m at the 31st March 2011).

RESOURCE IMPLICATIONS

There are no financial implications or staffing implications arising from the report.

LEGAL/RISK IMPLICATIONS BACKGROUND

The Council is aware of the risks of passive management of the Treasury Portfolio and with the support of Sector, the Council's current Treasury advisers, has proactively managed its debt and investments over this very difficult year.

SUSTAINABILITY IMPLICATIONS

None

CONCLUSIONS

That Members approve the above recommendations, following consideration of the information contained within the report.

BACKGROUND INFORMATION

1. Introduction and Background.

This Council is required by regulations issued under the Local Government Act 2003 to produce an Annual Treasury Management review of 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).

During 2011/12 the minimum reporting requirements were that the full Council should receive the following reports:

- an Annual Treasury Strategy in advance of the year (Council 22nd February 2011);
- a Mid - Year (minimum) Treasury Update Report (Council 13th December 2011);
- an Annual Review following the end of the year describing the activity compared to the strategy (this report).

In addition, the Cabinet has received quarterly treasury management updates as part of the Financial Healthcheck Reports.

Recent changes in the regulatory environment place a much greater onus on members for the review and scrutiny of the 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.

This Council also confirms that it has complied with the requirement under the Code for Scrutiny of Treasury Management Reports by the Audit and Governance Committee. Member training on treasury management issues was undertaken in February and October 2010 in order to support Members' scrutiny role.

2. The Economy and Interest Rates.

The financial year 2011/12 continued the challenging investment environment of previous years, namely low investment returns and continuing heightened levels of counterparty risk. The original expectation for 2011-12 was that Bank Rate would start gently rising from Quarter 4 2011. However, GDP growth in the UK was disappointing during the year under the weight of the UK austerity programme, a lack of rebalancing of the UK economy to exporting and weak growth in our biggest export market - the EU. The EU sovereign debt crisis grew in intensity during the year until February when a second bailout package was eventually agreed for Greece. 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 quantitative easing during the year, combined to depress PWLB rates to historically low levels.

Investment rates:

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 ratings of many banks and sovereigns, continued Eurozone concerns, and the significant funding issues still faced by many financial institutions, meant that investors remained cautious of longer-term commitment.

3. Overall Treasury Position as at 31 March 2012.

At the beginning and the end of 2011/12 the Council's treasury position was as follows*:

GENERAL FUND	31 March 2011 Principal £m	Rate/ Return %	Average Life Years	31 March 2012 Principal £m	Rate/ Return %	Average Life Years
Total debt	0	0	0	0	0	0
CFR	3.833			1.606		
Over / (under) borrowing	(3.833)			(1.606)		
Total investments	10.693	1.33	0.32	12.060	1.25	0.22
Net debt	(10.693)			(12.060)		

HOUSING REVENUE ACCOUNT	31 March 2011 Principal £m	Rate/ Return %	Average Life Years	31 March 2012 Principal £m	Rate/ Return %	Average Life Years
Total debt	20.392	6.61	32.66	65.060	6.55	37.44
CFR	23.395			68.063		
Over / (under) borrowing	(3.003)			(3.003)		
Total investments	4.573	1.33	0.32	5.150	1.25	0.22
Net debt	15.819			59.910		

*As a result of adopting the two pool financing option of the Housing Self Financing Reform, the Authority is required to separate the General Fund (GF) and Housing Revenue Account (HRA) financing.

In terms of its Capital Financing Requirement (CFR) the Authority has maintained the split as determined by the Local Government Act 2003, however, external borrowing (some of which was taken in the early 1990's) and external investments have not been 'earmarked' against one fund or the other, but pooled in line with the previous capital financing code.

Under the new arrangements, it was determined that the Authority's existing external debt of £20.392m would be all classified as HRA debt and would be added to the £44.668m new borrowing undertaken as part of the new financing structure. This means that although General fund has a small CFR of £1.606m, this is financed notionally from internal resources and is not earmarked against any specific external borrowing. With regard to investments, by identifying the value of each funds balances, reserves etc. at the year end, this will provide a basis of a notional split of investments for calculation purposes.

4. The Strategy for 2011/12.

The expectation for interest rates within the strategy for 2011/12 anticipated low but rising Bank Rate (starting in Quarter 4 of 2011) with similar gradual rises in medium and longer term fixed borrowing rates over 2011/12.

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 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 also from shares as investors became very concerned about the potential for a Lehmans type meltdown of financial markets if the Greek debt crisis were to develop into a precipitous default and exit from the Euro.

5. The Borrowing Requirement and Debt.

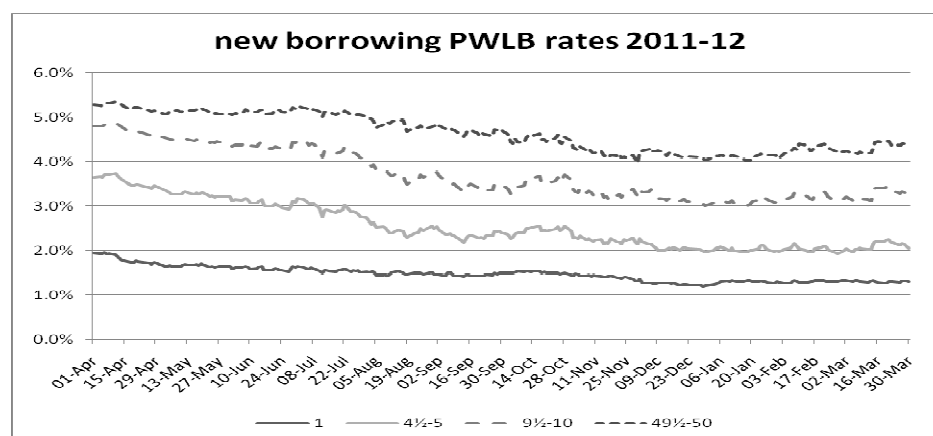
The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR).

The implementation of Housing Finance Reform at the end of the year abolished the Housing Subsidy system financed by central government and, consequently, all housing debt has been reallocated nationally between housing authorities. The result of this reallocation is that this Council made a capital payment to the Department of Communities and Local Government of £44.7m. Towards the end of the year the Authority also received a repayment of £2.1m from the administrators of the Icelandic bank Glitnir HLF. As the Authority obtained a capitalisation approval for this sum and increased the General Fund CFR in 2009/10, it is prudent to reverse this element of the capitalisation. This, together with the revised annual MRP contribution, results in a net increase in the CFR of £42.5m with new borrowing specifically for the HRA of £44.7m at the end of the year which was financed by new external borrowing. There has been no impact on HRA revenue finances in 2011/12 due to compensating adjustments being made in the HRA determination.

	31 March 2011 Actual £m	31 March 2011 Original £m	31 March 2012 Actual £m
CFR General Fund	3.833	3.639	1.606
CFR HRA	23.395	23.395	68.063
Total CFR	27.228	27.034	69.669

6. Borrowing Rates in 2011/12.

PWLB borrowing rates - the graph below shows how PWLB rates fell to historically very low levels during the year.



7. Borrowing Outturn for 2011/12

Borrowing – the Authority borrowed a total of £44.668m for the Housing Revenue Account in 2011/12 from the Public Works Loans Board to finance the Housing Self Financing requirement. The following loans were taken during the year:

Principal	Loan Type	Interest Rate	Years	Maturing
5,000,000	Fixed	3.52%	41	28/03/2053
5,000,000	Fixed	3.51%	42	28/03/2054
5,000,000	Fixed	3.51%	43	28/03/2055
5,000,000	Fixed	3.51%	44	28/03/2056
5,000,000	Fixed	3.50%	45	28/03/2057
3,000,000	Fixed	3.50%	46	28/03/2058
1,000,000	Fixed	3.50%	47	28/03/2059
5,000,000	Fixed	3.49%	48	28/03/2060
5,000,000	Fixed	3.49%	49	28/03/2061
5,668,000	Fixed	3.48%	50	28/03/2062

The above Borrowing requirement in respect of the Housing Self Financing Reform was not included within the budget assumptions for 2011/12 due to the late passage of the legislation through Parliament. Borrowing in year of £7.1m assumed within the base budget to align the Authority's borrowings to its CFR was deferred, as a result of new financing regime and the revised strategy to postpone borrowing to avoid the cost of holding investments and counterparty risk.

No new borrowing was undertaken in year, in respect of the General Fund.

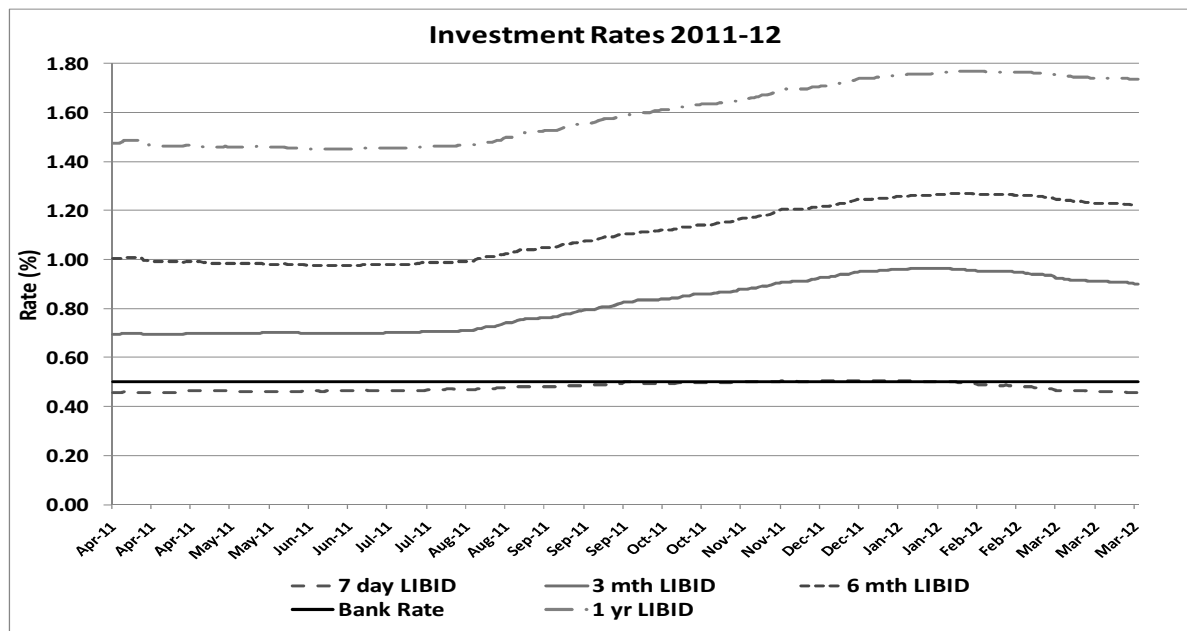
Rescheduling

No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

8. 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. Bank Rate remained at its historic low of 0.5% throughout the year while market expectations of the imminence of monetary tightening were 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 generated by the Eurozone sovereign debt crisis.



9. Investment Outturn for 2011/12.

Investment Policy – the Council’s investment policy is governed by CLG guidance, which has been implemented in the annual investment strategy approved by the Council on 22nd February 2011. 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 maintained an average balance of £17.4m of internally managed funds which earned an average rate of return of 1.25%.

This compares with a budget assumption of interest earned of £256k based on average investment balances of £22.8m at 1.13% investment return

Performance Management;

This service had set the following local performance indicators:

- *To Maximise investment returns by ensuring that the average balance held in the Council’s current accounts (non-interest earning) is maintained below £5,000;*

The actual average balance held in the current accounts for 2011/12 was £2,219 cr (in hand) (£4,459 cr in hand in 2010/11);

The net loss of interest for 2011/12 (loss of investment interest on un-invested balances less any overdraft interest incurred) was £64 compared to £19 for 2010/11 (approximately 18p per day);

- *Average external interest receivable in excess of 3 month LIBID rate;*

Whilst the assumed benchmark for local authorities is the 7 day LIBID rate, a higher target is set for internal performance.

The actual return of 1.25% compared to the 3 month LIBID of 0.817% (0.433% above target).

CIPFA Benchmarking Club;

The Council is a member of the CIPFA Treasury Management Benchmarking Club which is a means to assess our performance for the year against other members. Our average return for the year (as mentioned above) was 1.25% compared to the group average of 1.19% (information from CIPFA Benchmarking Report 2011/12) excluding the impaired investments in Icelandic banks.

This can be analysed further into the following categories:

Category	Average Balance Invested £ m		Average Rates Received %	
	Tamworth Borough Council	CIPFA Benchmarking Club	Tamworth Borough Council	CIPFA Benchmarking Club
Investments < 365 days Managed in-house	9.5	46.1	1.57	1.21
Investments > 365 days Managed in-house	0.5	19.9	1.91	2.53
Notice Accounts	4.9	25.4	0.84	0.83
DMADF	0	6.6	0	0.25
CD's Gilts and Bonds	0	43.4	0.00	3.29
Callable and Structured Deposits	0	19.7	0.00	1.75
Money Market Funds	2.4	21.3	0.70	0.72
All Investments Managed in-house	17.4	105.3	1.25	1.19

The data above displays that despite the Council being a small investor in the markets, performance is marginally better when compared with other members of the benchmarking club.

The graphs reproduced at **APPENDIX 2** highlight Tamworth's investment performance compared to other members of the benchmarking club.

10. Icelandic Bank Defaults

The Authority currently has the following investments 'at risk' in Icelandic banks;

Bank	Original Deposit £m	Accrued Interest £m	Total Claim £m	Reduction due to Exchange rate fluctuations £m	Repayments Received @ 31/03/2012 £m	Balance Outstanding	Anticipated Total Recovery %
Glitnir	3.000	0.232	3.232	0.092	2.554	0.586	100
Kaupthing Singer & Friedlander	3.000	0.175	3.175	0.000	2.000	1.175	83.5
Heritable	1.500	0.005	1.505	0.000	1.022	0.483	88
TOTALS	7.500	0.412	7.912	0.092	5.577	2.243	

At the current time, the process of recovering assets is still ongoing with the administrators. In the cases of Heritable Bank plc and Kaupthing, Singer and Friedlander Ltd, the administrators have made a number of dividend payments to date, with further payments and updates anticipated during 2012/13.

Following the successful outcome of legal test cases in the Icelandic Supreme Court, the Administrators have committed to a full repayment and the authority received a significant sum in late March 2012. However, due to Icelandic currency restrictions, elements of our deposits which are held in Icelandic Krona have been held back pending changes to Icelandic law. This sum has been placed in an interest bearing account and negotiations are continuing for their early release.

Members will be periodically updated on the latest developments of these efforts.

REPORT AUTHOR

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LIST OF BACKGROUND PAPERS

- Local Government Act 2003
- Statutory Instruments: 2003 No 3146 & 2007 No 573
- CIPFA Code of Practice on Treasury Management in Public Services
- Treasury Management Strategy & Prudential Indicators (Council 22nd February 2011)
- Treasury Outturn Report 2010/11 (Council 13/09/2011)
- CIPFA Treasury Benchmarking Club Report 2012

APPENDICES

Appendix 1 : Prudential & Treasury Indicators 2011 / 12

Appendix 2 : Benchmarking Data

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