Annual Treasury Management Review 2011/12

North Hertfordshire District Council
April 2012

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Annual Treasury Management Review 2011/12

Purpose

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 10/02/2011)
- a mid year (minimum) treasury update report (Cabinet 27/09/2011)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

In addition, Cabinet has received quarterly treasury management update reports on 27/09/2011, 13/11/2011 and 15/02/2012.

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.

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 Finance, Audit and Risk Committee before they were reported to the full Council.

Executive Summary

During 2011/12, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Prudential and treasury indicators	2010/11 Actual £000	2011/12 Original £000	2011/12 Actual £000
Capital expenditure	3,287	6,329	4,784
Capital Financing Requirement:	-36,997	-34,931	-34,931
External debt	5,044	4,892	4,892
Investments			
• Longer than 1 year	14,250	12,250	0
• Under 1 year	33,600	34,957	47,860
• Total	47,850	47,207	47,860

Other prudential and treasury indicators are to be found in the main body of this report. The Director of Finance also confirms that the statutory borrowing limit (the authorised limit) was not breached.

The financial year 2011/12 continued the challenging investment environment of previous years, namely low investment returns and continuing heightened levels of counterparty risk.

Recommendations

The Council is recommended to:

1. Approve the actual 2011/12 prudential and treasury indicators in this report
2. Note the annual treasury management report for 2011/12

Introduction and Background

This report summarises:

- Capital activity 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.

1. The Council's Capital Expenditure and Financing 2011/12

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.

	2010/11 Actual £'000	2011/12 Estimate £'000	2011/12 Actual £'000
Capital expenditure	**3,287**	**6,329**	**4,784**
Financed in year	3,287	6,329	2,730
Un-financed capital expenditure	**0**	**0**	**2,054**

2. 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. It represents the 2011/12 unfinanced capital expenditure (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

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.

Reducing the CFR – the Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council would be required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to reduce a positive CFR. This is effectively a repayment of the borrowing need. 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 2011/12 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report for 2011/12 on 10/02/2011. Because the Council is in the unusual position of having a negative CFR there is no requirement currently to make an annual revenue charge (MRP).

The Council's CFR for the year is shown below, and represents a key prudential indicator. It includes PFI and leasing schemes on the balance sheet, which increase the Council's borrowing need. No borrowing is actually required against these schemes as a borrowing facility is included in the contract (if applicable).

CFR	31 March 2012 £'000
Opening balance	-36,997
Add un-financed capital expenditure (as above)	2,054
Less MRP/VRP*	0
Less PFI & finance lease repayments	12
Closing balance	**-34,931**

Where the CFR is nil or negative on the last day of the financial year, this indicates that the Authority's provision for debt is equal to or greater than the debt incurred. There is accordingly no need to make a Minimum Revenue Provision in the following year.

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

Net borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. This essentially means that the Council is not borrowing to support revenue expenditure. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2011/12 plus the expected changes to the CFR over 2011/12 and 2012/13 from financing the capital programme. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2011/12. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2011 Actual	31 March 2012 Original	31 March 2012 Actual
Net borrowing position	-£42.81m	-£44.32m	-£42.97m
CFR	-£36.00m	-£34.93m	-£34.93m

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 2011/12 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.

	2011/12
Authorised limit	£10.0m
Maximum gross borrowing position	£4.89m
Operational boundary	£6.0m
Average gross borrowing position	£3.04m
Financing costs as a proportion of net revenue stream	-5%

3. Treasury Position as at 31 March 2012

The Council's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for 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 2011/12 the Council's treasury position was as follows:

TABLE 1	31 March 2011 Principal	Rate/ Return	31 March 2012 Principal	Rate/ Return	Average Life yrs
Fixed rate funding:					
-PWLB	£2.04m	8.10%	£1.89m	8.38%	7.39 yrs
-Market	£3.00m	9.63%	£3.00m	9.58%	4.5yrs
Variable rate funding:					
-PWLB	£0.00m		£0.00m		
-Market	£0.00m	0%	£0.00m	0%	
Total debt	**£5.04m**	**8.64%**	**£4.89m**	**8.85%**	**6.39 yrs**
CFR	**-£36.997m**		**-£34.931m**		
Over/ (under) borrowing	**-£31.957m**		**-£30.041m**		
Investments:					
- in house	£1.85m	0.84%	£1.86m	0.88%	
- with managers	£46.0m	2.00%	£46.0m	2.28%	
Total investments	**£47.85m**	**1.81%**	**£47.86m**	**2.08%**	

The maturity structure of the debt portfolio was as follows:

	31 March.2011 actual	2011/12 original limits	31 March.2012 actual
Under 12 months	£2.15m	£0.63m	£2.63m
12 months and within 24 months	£0.63m	£0.60m	£0.60m
24 months and within 5 years	£0.75m	£0.18m	£0.18m
5 years and within 10 years	£1.11m	£1.09m	£1.09m
10 years and above	£0.4m	£0.39m	£0.39m

£2m was borrowed in March 2011 for 10 days to cover a shortfall in cash flow . This was repaid on the 1st April 2011, hence the £2m variance between the original and actual limit repaid during the first 12 months.

The maturity structure of the investment portfolio was as follows:

	2010/11 Actual £000	2011/12 Original £000	2011/12 Actual £000
Investments			
Longer than 1 year	14,250	12.25	0
Under 1 year	33,600	34.957	47,860
Total	47,850	47,207	47,860

The exposure to fixed and variable rates was as follows:

	31 March 2011 Actual	2011/12 Original Limits	31 March 2012 Actual
Fixed rate (principal)	36.1m	29.5m - 42.16m	40.86m
Variable rate (principal)	11.75m	0m - 12.65m	7.00m

4. The Strategy for 2011/12

The strategy in 2011/12, following the collapse of the Icelandic banks, was to only lend to UK banks and building societies. Only UK banks with a credit rating, for longer term deals, greater than “BBB” and F3 or above for short term credit ratings were on the Council’s lending list. (These are Fitch definitions of ratings). Not all building societies are credit rated but this did not preclude them from the lending list as lending to a building society was dependant on their asset size. Where a society did have a rating, this was considered at the time of the deal taking into account the amount of investment and the length of the deal. As well as imposing maximum limits with each counter party, the overall percentage of outstanding investments with each counterparty was assessed to ensure a reasonable spread of investments.

The original budget for capital expenditure in 2011/12 exceeded the level of capital receipts available to fund all projects. Therefore, the initial strategy was to borrow during the year to fund specific capital projects. At the end of the year, there was a shortfall in capital receipts available to fund capital expenditure of £2.054million which was be funded by drawing down the Authority’s cash investments. The impact of not applying useable capital receipts will be to reduce the extent to which the Authority’s Capital Finance Requirement (CFR) is negative and will of course reduce the amount of cash investments available to earn interest (£2million at current rates will achieve about £40,000 per annum in interest). Officers have now received advise from Treasury Advisors who recommend that, given the extent to which the CFR is negative, capital expenditure can be funded by drawing down external investments (set aside receipts). They also advise that it is not likely it would be considered prudent to raise any more external borrowing. In other words such action could be considered to be in breach of the requirements of S.1 of the Local Government Act 2003.

Change in strategy during the year – the strategy adopted in the original Treasury Management Strategy Report for 2011/12 approved by the Council on 10/02/2011 was not subjected to any revision during the year.

5. The Economy and Interest Rates

Sovereign debt crisis. 2011/12 was the year when financial markets were on tenterhooks throughout most of this period, fearful of the potential of another Lehmans type financial disaster occurring, sparked off by a precipitous Greek default. At almost the last hour, the European Central Bank (ECB) calmed market concerns of a liquidity crisis among European Union (EU) banks by making available two huge three year credit lines, totalling close to €1 trillion at 1%. This also provided a major incentive for those same banks to then use this new liquidity to buy EU sovereign debt yielding considerably more than 1%.

A secondary benefit of this initiative was the bringing down of sovereign debt yields, for the likes of Italy and Spain, below panic levels. The final planks in the calming of the EU sovereign debt crisis were two eleventh hour agreements: one by the Greek Government of another major austerity package and the second, by private creditors, of a "haircut" (discount) on the value of Greek debt that they held, resulting in a major reduction in the total outstanding level of Greek debt. These agreements were a prerequisite for a second EU / IMF bailout package for Greece which was signed off in March.

Despite this second bailout, major concerns remain that these measures were merely a postponement of the debt crisis, rather than a solution, as they did not address the problem of low growth and loss of competitiveness in not only Greece, but also in other EU countries with major debt imbalances. These problems will, in turn, also affect the financial strength of many already weakened EU banks during the expected economic downturn in the EU. There are also major questions as to whether the Greek Government will be able to deliver on its promises of cuts in expenditure and increasing tax collection rates, given the hostility of much of the population. In addition, an impending general election in April / May 2012 will deliver a democratic verdict on the way that Greece is being governed under intense austerity pressure from the northern EU states.

The UK coalition Government maintained its aggressive fiscal policy stance against a background of warnings from two credit rating agencies that the UK could lose its AAA rating. Key to retaining this rating will be a return to strong economic growth in order to reduce the national debt burden to a sustainable level, within the austerity plan timeframe. The USA and France lost their AAA ratings from one rating agency during the year.

UK growth proved mixed over the year. In quarter 2, growth was zero, but then quarter 3 surprised with a return to robust growth of 0.6% q/q before moving back into negative territory (-0.2%) in quarter 4. The year finished with prospects for the UK economy being decidedly downbeat due to a return to negative growth in the EU in quarter 4, our largest trading partner, and a sharp increase in world oil prices caused by Middle East concerns. However, there was also a return of some economic optimism for growth outside the EU and dovish comments from the major western central banks: the Fed in America may even be considering a third dose of quantitative easing to boost growth.

UK CPI inflation started the year at 4.5% and peaked at 5.2% in September. The fall out of the January 2011 VAT hike from the annual CPI figure in January 2012 helped to bring inflation down to 3.6%, falling further to 3.4% in February. Inflation is forecast to be on a downward trend to below 2% over the next year.

The Monetary Policy Committee agreed an increase in quantitative easing (QE) of £75bn in October on concerns of a downturn in growth and a forecast for inflation to fall below the 2% target. QE was targeted at further gilt purchases. The MPC then agreed another round of £50bn of QE in February 2012 to counter the negative impact of the EU debt and growth crisis on the UK.

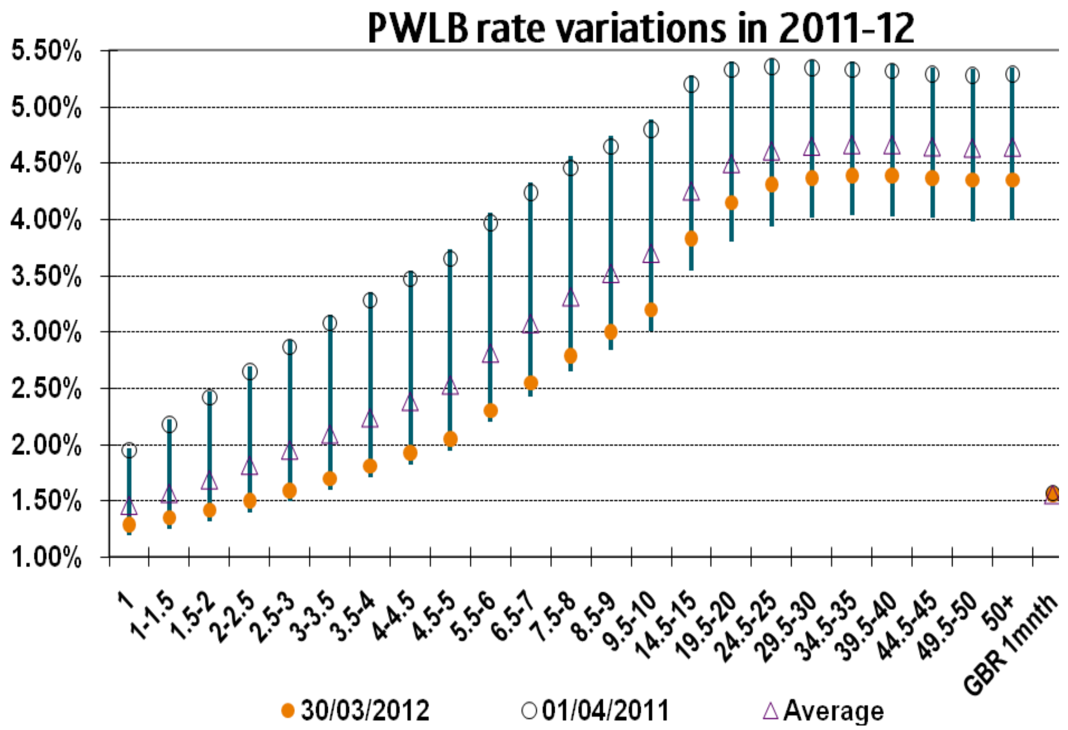
Gilt yields fell for much of the year, until February, as concerns continued building over the EU debt crisis. This resulted in safe haven flows into UK gilts which, together with the two UK packages of QE during the year, combined to depress PWLB rates to historically low levels.

Bank Rate was unchanged at 0.5% throughout the year while expectations of when the first increase would occur were steadily pushed back until the second half of 2013 at the earliest. **Deposit rates** picked up in the second half of the year as competition for cash increased among banks.

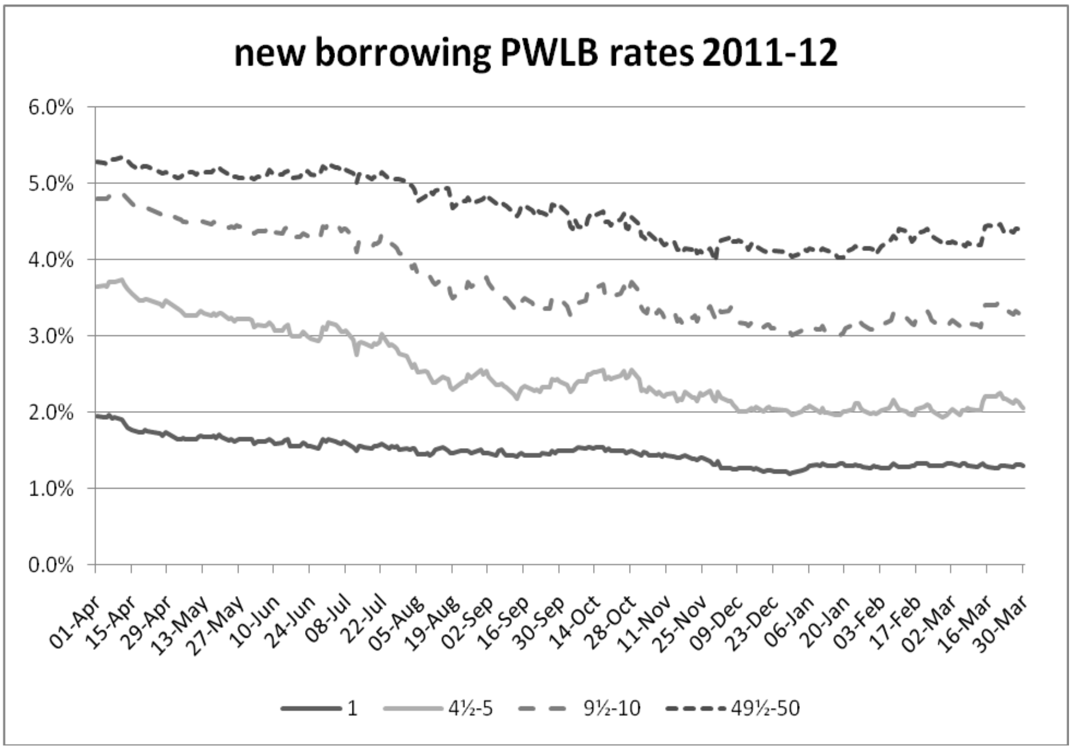
Risk premiums were also a constant factor in raising money market deposit rates for periods longer than 1 month. Widespread and multiple downgrades of the ratings of many banks and sovereigns, continued Euro zone concerns, and the significant funding issues still faced by many financial institutions, meant that investors remained cautious of longer-term commitment.

6. Borrowing Rates in 2011/12

PWLB borrowing rates - the graphs and table for PWLB maturity rates below show, for a selection of maturity periods, the high and low points in rates, the average rates, spreads and individual rates at the start and the end of the financial year.



	PWLB BORROWING RATES 2011/12 for 1 to 50 years								
	1	1.5-2	2.5-3	3.5-4	4.5-5	9.5-10	24.5-25	49.5-50	1 month variable
01/04/2011	1.950%	2.420%	2.870%	3.280%	3.650%	4.800%	5.360%	5.280%	1.570%
31/03/2012	1.290%	1.420%	1.590%	1.810%	2.050%	3.200%	4.310%	4.350%	1.560%
HIGH	1.970%	2.470%	2.930%	3.350%	3.730%	4.890%	5.430%	5.340%	1.590%
LOW	1.190%	1.320%	1.500%	1.710%	1.940%	3.010%	3.940%	3.980%	1.560%
Average	1.466%	1.693%	1.958%	2.243%	2.533%	3.702%	4.610%	4.635%	1.561%
Spread	0.780%	1.150%	1.430%	1.640%	1.790%	1.880%	1.490%	1.360%	0.030%
High date	06/04/2011	06/04/2011	06/04/2011	06/04/2011	11/04/2011	11/04/2011	11/04/2011	11/04/2011	05/04/2011
Low date	29/12/2011	30/12/2011	30/12/2011	27/02/2012	27/02/2012	30/12/2011	18/01/2012	30/11/2011	15/04/2011



7. Borrowing Outturn for 2011/12

Borrowing – One loan was drawn to fund a temporary short fall in cash flow. This loan was taken on the 22nd March and repaid on the 2nd April:

The loans drawn were:

Lender	Principal	Type	Interest Rate	Maturity
Derbyshire County Council	£2.00m	Fixed interest rate	0.5%	11 days

The loans repaid were:

Lender	Principal	Type	Interest Rate	Maturity
Skipton Building Society	£2.00m	Fixed interest rate	0.5%	11 days
PWLB	£0.152M	Fixed interest rate	Various	Various

The average borrowing rate increased from 8.63% to 8.85% due to loans maturing during the year with relatively low interest rates.

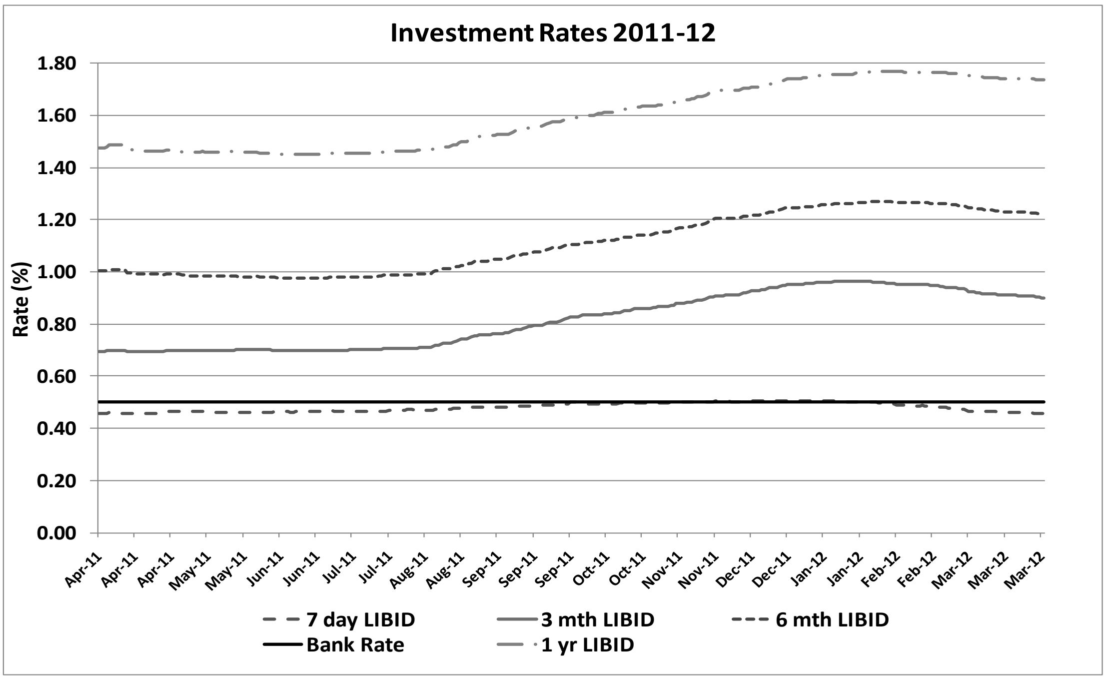
Rescheduling
No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

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. The ECB's actions to provide nearly €1 trn of 1% 3 year finance to EU banks eased liquidity pressures in the EU and investment rates eased back somewhat in the quarter 1 of 2012. This action has also given EU banks time to strengthen their balance sheets and liquidity positions on a more permanent basis. Bank Rate remained at its historic low of 0.5% throughout the year while market expectations of the imminence of the start of monetary tightening was 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, most evident in the Euro zone sovereign debt crisis which resulted in a second rescue package for Greece in quarter 1 2012. Concerns extended to the potential fallout on the European banking industry if the crisis could have ended with Greece leaving the Euro and defaulting.

	Money market investment rates 2011/12					
	Overnight	7 Day	1 Month	3 Month	6 Month	1 Year
01/04/2011	0.43688	0.45625	0.49563	0.69563	1.00313	1.47750
31/03/2012	0.43188	0.45719	0.57100	0.90188	1.22063	1.73806
High	0.54625	0.50531	0.65288	0.96456	1.27063	1.77175
Low	0.43000	0.45625	0.49563	0.69438	0.97625	1.45000
Average	0.44868	0.48009	0.56246	0.81756	1.11025	1.59673
Spread	0.11625	0.04906	0.15725	0.27018	0.29438	0.32175
Date	30/06/2011	30/12/2011	11/01/2012	12/01/2012	25/01/2012	25/01/2012
Date	14/03/2012	01/04/2011	01/04/2011	12/04/2011	11/06/2011	22/06/2011



9. Investment Outturn for 2011/12

Investment Policy – the Council's investment policy is governed by CLG guidance, which was implemented in the annual investment strategy approved by the Council on 10/02/11. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the Fitch credit rating agency for banks and asset size for building society investments. This is supplemented by spreading the investments over a number of counterparties.

The investment activity during the year conformed to the approved strategy.

Resources – the Council's longer term cash balances comprise, primarily, revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources comprised as follows, and met the expectations of the budget:

Balance Sheet Resources (£m)	31 March 2011	31 March 2012
General Fund Balances	1.923	2.674
Earmarked reserves	3.024	2.776
Set Aside Capital Receipts	41.550	41.000
Unapplied Capital Grants	0.264	0.210
Usable capital receipts	1.093	1.197
Total	47.850	47.860

Investments held by cash managers – the Council uses two cash managers (Sterling and Tradition) to invest part of its cash balances. The performance of the managers against the benchmark return was:

Fund Manager	Investments Held	Return	Benchmark*
Sterling	£23m	2.20%	0.97 %
Tradition	£23m	2.37%	0.35 %
Total	£46m	2.28%	0. 66%

*Ave 3 Month LIBID Rate	0.97%
Ave 7 days notice Rate	0.35%

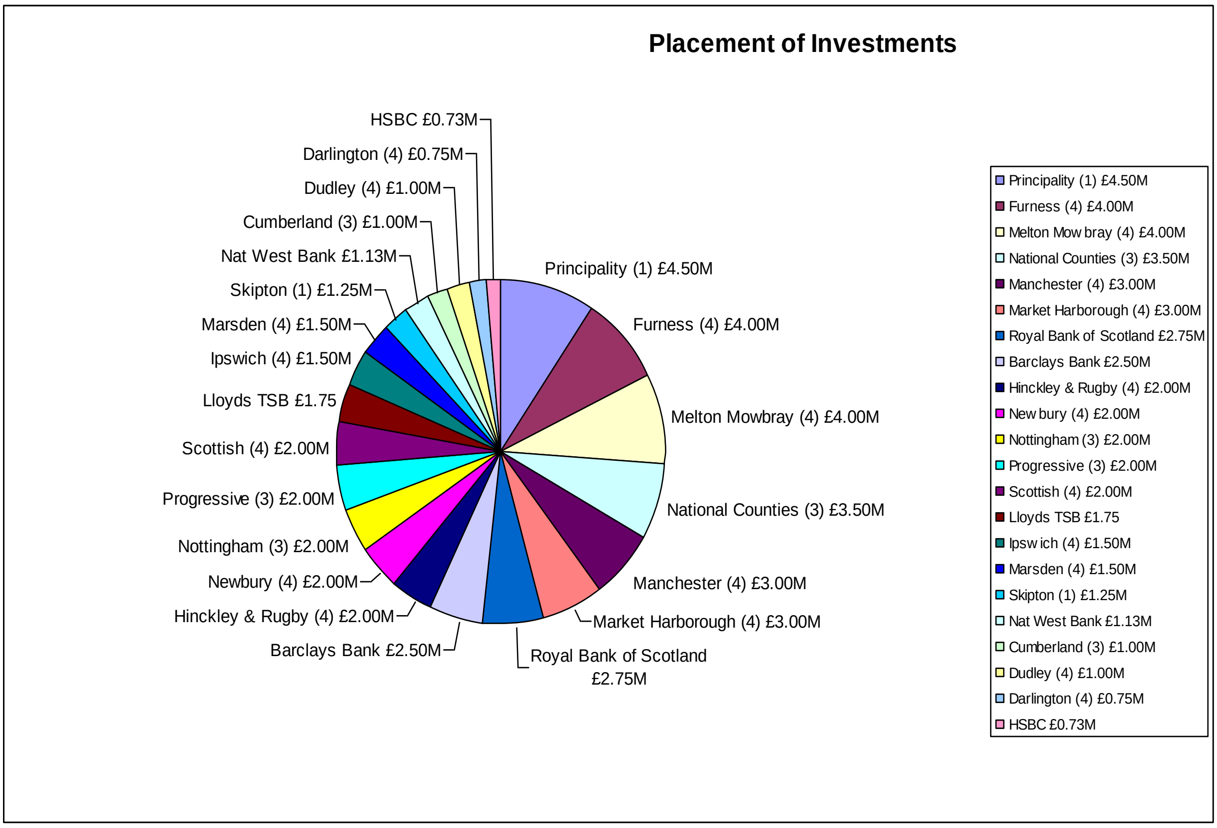
	Ave. Int. Rate Deals made in 1st Qtr %	Ave. Int. Rate Deals made in 2nd Qtr%	Ave. Int. Rate Deals made in 3rd Qtr %	Ave. Int. Rate Deals made in 4th Qtr %	Ave. Int. Rate for Year %
NHDC	1.01	0.86	0.85	0.84	0.88
Sterling	1.87	3.13	2.53	2.21	2.20
Tradition	2.31	1.52	2.25	3.13	2.37

The table below summaries where investments were held at 31 March:

	Investments 31 March 2011	Investments 31 March 2012
Banks	£7.10m	£8.86m
Building Societies	£39.75m	£39.00m
Local Authorities	£1.00m	-
Total	£47.85m	£47.86m

The pie chart below shows the spread of investment balances as at 31 March 2012. The figures shown are in millions whilst the figure in brackets denotes the value of the building societies total assets:

(1) Building Societies with Assets over £4.5bn
(2) Building Societies with Assets between £2.5bn - £4.5bn
(3) Building Societies with Assets between £1.0bn - £2.5bn
(4) Building Societies with Assets between £0.3bn - £1.0bn



The average daily balance of investments was £53.64m with balances varying between £46.01m and £61.89m.

£1.117m of interest was generated from investments during the year. This is slightly more than the estimated interest of £1.108m. The original estimate of £1.002m was increased by £0.085m in the first quarter and again by£0.010mn the second and third quarters to reflect the higher rate of interest achieved on investments made by the cash managers.

	Interest Accrued to 31 March £	Interest Received by 31 March £	Total Interest for the Year £
NHDC	7,554	59,747	67,301
Sterling	249,924	256,135	506,059
Tradition	286,726	257,253	543,979
Total	544,204	573,135	1,117,339

Investments held by the Council - the Council maintained an average balance of £7.64m of internally managed funds. The internally managed funds earned £67,000 of interest with an average rate of return of 0.88%. This compares with a working budget assumption of £0.62m.