Stevenage BOROUGH COUNCIL

Part I – Release to Press

Meeting: **Audit Committee/Council** **Agenda Item:** **11**

Portfolio Area: Resources

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ANNUAL TREASURY MANAGEMENT REVIEW 2010/11

NON-KEY DECISION

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REASON FOR URGENCY

The requirement of the Treasury Management code is that Audit Committee has been delegated the responsibility of scrutiny of Treasury Management reports by the Audit Committee before they were reported to the full Council. The Annual Treasury Management review will be presented to Council in October for approval.

1. PURPOSE

1.1 The Council is required under the Local Government Act 2003 to produce an Annual Treasury Report reviewing treasury management activities including the 2010/11 prudential and treasury indicators. 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 This report is one of three reports required under the code of practice, the other reports being:

- Annual Treasury Strategy in advance of the year (last reported 23/02/2011)
- Mid year Treasury Update report (last reported Council 23/2/2011)

2. RECOMMENDATIONS

2.1 That the Audit Committee recommends Council to approve the 2010/11 prudential and treasury indicators in this report.

3. BACKGROUND

3.1 Summary

3.1.1 It is a requirement of the Treasury Management Code of Practice (revised 2009) that Council receive an annual report on the performance of the treasury management function.

3.1.2 This report summarises:

- Capital expenditure for 2010/11;
- Impact of the expenditure 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.

4. REASONS FOR RECOMMENDED COURSE OF ACTION AND OTHER OPTIONS

4.1 The Council's Capital Expenditure and Financing 2010/11

4.1.2 Capital expenditure is monies expended on assets with a life of more than one year, within the guidelines laid out in Accounting Practises. These costs can be financed either by capital resources the Council has on its Balance Sheet e.g. capital receipts, capital grants, revenue contributions etc. or by making a revenue contribution to capital.

4.1.3 If sufficient resources are not available this would give rise to a borrowing need. The actual expenditure for the year forms part of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

Table One- 2010/11 Capital Expenditure and Financing

	2009/10 Actual £'000	2010/11 Estimate £'000	2010/11 Actual £'000
Non-HRA Capital Expenditure	5,724	7,311	6,069
HRA Capital Expenditure	19,745	17,639	17,300
Total Capital Expenditure	**25,469**	**24,950**	**23,369**
Resourced by:			
• Capital Receipts	11,542	2,586	2,464
• Capital Grants	1,669	4,433	3,932
• Capital Reserves	6,207	6,544	6,020
Expenditure Requiring Borrowing	**6,051**	**11,387**	**10,953**

4.2 The Council's overall borrowing need

4.2.1 The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure calculates the Council's debt position. The CFR can be calculated by totalling the capital activity of the Council less the resources which have been used to pay for the capital spend. The CFR represents the 2010/11 unfinanced capital expenditure (see above table), and prior years' unfinanced capital expenditure which has not yet been paid for by borrowing or other resources.

4.2.2 Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Based on the Capital Strategy, the treasury service manages the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be 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.

4.3 The 2010/11 Capital Financing Requirement and Minimum Revenue Requirement

4.3.1 In 2010/11 the Council did not borrow to fund the General Fund capital programme, this was despite an amount of £800,000 included in the Capital Strategy. The main reason for this was slippage on the capital programme.

4.3.2 The Council has HRA borrowing as at 31 March 2011 of £17.04Million, this borrowing is called 'supported borrowing' and the interest cost is refunded by the Government via the HRA subsidy system.

4.3.3 The Council must borrow in line with the Prudential Code which requires the Council to demonstrate a need to borrow and to show the cost of that borrowing on either the General Fund or HRA, (see Appendix A Prudential Indicators). Statutory controls are in place to ensure that borrowing for capital assets is repaid over the life of the asset. This is done through the Minimum Revenue Requirement (MRP), which effectively equates to repaying the principal or monies borrowed, in line with how long the asset will last. The Council is required to make an annual revenue charge, or MRP, which reduces the CFR and so the underlying need to borrow. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments.

4.3.4 The statutory requirement to repay debt does not necessarily have to coincide with the physical borrowing. When borrowing interest rates are relatively high compared to investment interest earned, the Council may decide to use investment balances to finance expenditure, until rates converge and borrow at a later date.

4.3.5 The Council could reduce its CFR further 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).

4.3.6 The Council's 2010/11 MRP Policy, as required by CLG Guidance, was approved as part of the 2010/11 Treasury Management Strategy Report on 24 February 2010. However because of the slippage on the 2010/11 capital programme, the Council did not have an underlying need to borrow in 2010/11. There is an estimated £2.8Million of borrowing required in 2011/12.

4.3.7 The Council's CFR for the year is shown below, and represents a key prudential indicator.

Table Two CFR calculation 2009/10 and 2010/11		
CFR Calculation	**31 March 2010 (£'000)**	**31 March 2011 (£'000)**
Opening Balance	**(6,122)**	**6,051**
Closing Capital Financing Requirement (General Fund)	26,743	26,743
Closing Capital Financing Requirement (Housing Revenue Account)	(20,692)	(9,739)
Closing Balance	**6,051**	**17,004**

4.3.8 The CFR as at 31 March 2011 has increased by £10.9Million, this relates to expenditure on Decent Homes, which is funded through supported borrowing.

4.4 Other indicators

4.4.1 The **net borrowing position** of the Council as at 31 March 2011 was £1.01Million. This was total borrowings or loans of £17.004 Million less total investments held of £15.99Million. This compared to the 2010/11 estimate of £1.55Million, the variation to estimate was due to slightly higher investment balances than estimated.

4.4.2 The **authorised limit and operational boundary** is the limit at which the Council can borrow up to, a breach of the authorised limit would require a report to Council. The limits for 2010/11 included an additional £15Million for authorised and £10Million for operational limits, above the anticipated long term borrowing needs of the Council. This was to allow for any short term cash flow needs that might arise during the course of the year or the ability to borrow (up to the limit) to cover any additional capital needs that might arise and be approved as part of the Capital Strategy.

4.4.3 The headroom on the borrowing limits was also to allow for any changes as a result of the introduction of International Financial Reporting Standards. Technical accounting changes could have meant leases being reclassified as a finance lease rather than an operating lease, would require it to be brought on balance sheet, and recorded as debt. It was therefore prudent not to amend this in 2010/11. This indicator will be reviewed as part of the 2011/12 mid year Treasury Management report. However, the indicator remains unchanged for 2011/12 and will updated at the Mid Year Review, this will also include any changes required as a result of the introduction of Self Financing for the HRA in 2012/13.

4.4.4 The **ratio of financing costs to net revenue stream,** this is the interest costs divided by the General Fund net requirement. The 2010/11 indicator is lower than estimated 0.55% compared to 0.67%. This is because the Council did not need to borrow for the 2010/11 General Fund capital programme. The remaining interest payable related to the cost to the General Fund of the interest due to the HRA.

4.4.5 An updated list of all Treasury Prudential Indicators is shown at Appendix A and include an update on the 2011/12 indicators as a result of the 2010/11 actuals. All Prudential Indicators will be further reviewed and updated at a later date, taking into account the latest position on HRA Self Financing and a further update on the anticipated capital expenditure and borrowing requirements.

4.5 Treasury Position 31 March 2011

4.5.1 The Council's debt and investment position is organised by the Treasury Management section, in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risk.

4.6 Borrowing and Investment Position

4.6.1 The opening and closing position of the Council's treasury position is shown in Table Three:

Table Three Treasury Position as at 31 March 2011

	31 March 2011 Principal £'000s	Rate / Return %	Average Life (Yrs)	31 March 2010 Principal £'000s	Rate / Return %	Average Life (Yrs)
Fixed rate funding - PWLB*	17,004	3.99	14.10	5,000	4.72	24.28
CFR	17,004			6,051		
Over/(under) borrowing	0	0		(1,051)	(17.4)	
Investments – In house	15,990	0.93		15,975	1.99	

**All borrowings taken out were fixed rate.*

4.6.2 The maturity structure of debt portfolio is detailed in Table Four:

Table Four Maturity of Debt Portfolio for 2009/10 and 2010/11		
Time to maturity	**31 March 2011 Actual**	**31 March 2010 Actual**
24 months or more and less than 5 years	5,500	0
5 years or more and less than 10 years	3,741	0
10 years or more	7,763	5,000
Total	**17,004**	**5,000**

4.6.3 All the Council's investments at both 31 March 2011 and 2010, were due or mature within one year. A summary of the Council's exposure to fixed and variable rate principal is shown below in table five:

Table Five Fixed and Variable Rate Investment Totals for 2009/10 and 2010/11		
	31 March 2011 Actual	**31 March 2010 Actual**
Fixed rate principal	14,004	3,000
Variable rate principal	(12,990)	(13,975)

4.7 The Strategy for 2010/11:

4.7.1 The outturn against the original 2010/11 Strategy remained largely in line with expectations. Although the original Strategy was amended to reflect a change in profile (delay) in receiving capital receipts, there was also slippage against the capital programme. The amendment made to the Strategy at the 2010/11 mid-year review for £800,000 of for the General Fund, was not required.

4.7.2 As part of the 2010/11 mid year review counterparty limits or the amount the Council would invest with anyone banking group reduced from £7.5Million to £5.0Million. The reduction in the limit was reduced to reflect lower overall investment balances and the need to reduce the level of exposure of the Council to any one counterparty.

4.8 Compliance with Prudential Limits 2010/11

4.8.1 The 2010/11 mid-year review reported the two breaches which had occurred in the first six months of the year, which related entirely to the Council not having any fixed investments. At the time there were no fixed rate deals which offered better rates than the unprecedented low rates achieved on variable investments. The limit has been subsequently removed and kept under review, as it is not relevant in the current economic climate.

4.8.2 There was an additional breach in January 2011, when a counterparty failed, (in error) to repay a maturing principal balance of £3Million to the Council. This resulted in exceeding the counterparty limit by £1.56Million for one night. The money was refunded the following day and the Council was fully refunded for associated costs of breach.

4.8.3 The full list of approved Treasury Prudential Indicators and their corresponding actual expenditure for 2010/11 are shown at Appendix A.

4.9 2010/11 Economic & Interest Rate Review

4.9.1 2010/11 proved to be another watershed year for financial markets. Rather than a focus on individual institutions, 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.

4.9.2 UK growth proved mixed over the year. The first half of the year saw the economy outperform expectations, although the economy slipped into negative territory in the final quarter of 2010 due to inclement weather conditions. The year finished with prospects for the UK economy being decidedly downbeat over the short to medium term while the Japanese disasters in March, and the Arab Spring, especially the crisis in Libya, caused an increase in world oil prices, which all combined to dampen international economic growth prospects.

4.9.3 The change in the UK political background was a major factor behind weaker domestic growth expectations. The new coalition Government struck an aggressive fiscal policy stance, evidenced through heavy spending cuts announced in the October Comprehensive Spending Review, and the lack of any “giveaway” in the March 2011 Budget. Although the main aim was to reduce the national debt burden to a sustainable level, the measures are also expected to act as a significant drag on growth.

4.9.4 Gilt yields fell for much of the first half of the year as financial markets drew considerable reassurance from the Government’s debt reduction plans, especially in the light of Euro zone sovereign debt concerns. Expectations of further quantitative easing also helped to push yields to historic lows. However, this positive performance was mostly reversed in the closing months of 2010 as sentiment changed due to sharply rising inflation pressures. These were also expected (during February / March 2011) to cause the Monetary Policy Committee to start raising Bank Rate earlier than previously expected.

4.9.5 The developing Euro zone peripheral sovereign debt crisis caused considerable concerns in financial markets. First Greece (May), then Ireland (December), were forced to accept assistance from a combined EU / IMF rescue package. Subsequently, fears steadily grew about Portugal, although it managed to put off accepting assistance till after the year end. These worries caused international investors to seek safe havens in investing in non-Euro zone government bonds.

4.9.6 Deposit rates picked up modestly in the second half of the year as rising inflationary concerns, and strong first half growth, fed through to prospects of an earlier start to increases in Bank Rate. However, in March 2011, slowing actual growth, together with weak growth prospects, saw consensus expectations of the first UK rate rise move back from May to August 2011 despite high inflation. However, the disparity of expectations on domestic economic growth and 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. This sharp disparity was also seen in MPC voting which, by year-end, had three members voting for a rise while others preferred to continue maintaining rates at ultra low levels.

4.9.7 Risk premiums were also a constant factor in raising money market deposit rates beyond 3 months. Although market sentiment has improved, continued Euro zone concerns, and the significant funding issues still faced by many financial institutions, mean that investors remain cautious of longer-term commitment. The European Commission did try to address market concerns through a stress test of major financial institutions in July 2010. Although only a small minority of banks "failed" the test, investors were highly sceptical as to the robustness of the tests, as they also are over further tests now taking place with results due in mid-2011.

5. IMPLICATIONS

5.1 Financial Implications

5.1.1 This report is of a financial nature and reviews the treasury management function for the 2010/11 financial year any consequential financial impacts of the strategy have been reflected in the July Capital Strategy update and the 4th Quarter report.

5.2 Legal Implications

5.2.1 Approval of the Prudential Code Indicators and the Treasury Management are intended to ensure that the Council complies with relevant legislation and best practice.

5.3 Risk Implications

5.3.1 The table below identifies the risks if the recommendations are agreed. The risks have been assessed in accordance with the Council's risk management strategy.

	Description of risk	**Mitigation**	**Residual Risk Level**
1.	Investment balances increase and monies placed with banking groups exceed approved Counter Party Limits	The Treasury Team would actively seek to find alternative Counter Parties to lend to, or seek Council approval to increase the Counter Party Limits	M
2.	There is a reduction in available resources to fund the capital programme.	If the CFR increased in 2011/12 because the Council needed to borrow additional funds this would have	L

		to be in excess of the current headroom of £10Million in the operational boundary limit	
3	The Council invests funds with a bank which is unable to meet the repayment.	The Counter Party ratings are reviewed on a weekly basis and should prevent placing funds with banks at risk. The Council has a very strict lending criteria.	L

5.4 Equalities and Diversity Implications

5.4.1 All the services identified in the report have their own Equalities Impact Assessments, which are reviewed where appropriate.

BACKGROUND DOCUMENTS

- Treasury Management Reports
- Sector Reports

APPENDICES

- Appendix A – Prudential Indicators