APPENDIX 1 -

DRAFT REPORT PRESENTED TO AUDIT COMMITTEE 25TH SEPTEMBER 2012

REPORT OF:	DIRECTOR OF FINANCE
TO:	COUNCIL
ON:	1st November 2012

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DRAFT FOR CONSIDERATION BY AUDIT COMMITTEE
TREASURY MANAGEMENT ANNUAL REPORT 2011-12 AND MID-YEAR REVIEW FOR 2012-13

1. PURPOSE OF THE REPORT

1.1 To advise Members of Treasury Management performance for 2011-12, and update Members with regard to the position to date in 2012-13.

2. RECOMMENDATIONS

2.1 The Council is recommended to note the Outturn position for 2011-12 and confirm that the current Treasury Management Strategy for 2012-13 remain unchanged.

3. BACKGROUND

3.1 In March 2011 the Council agreed a Treasury Management Strategy for 2011-12.

3.2 In March 2012 the Council adopted CIPFA's 2011 Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes, and an updated Treasury Management Policy Statement, and agreed a Treasury Management Strategy for 2012-13.

4. RATIONALE

4.1 The CIPFA Treasury Management Code requires the Council to approve a Treasury Management Strategy (including various Treasury Management indicators) before the start of each financial year, and to consider both the outturn after each year end, and the mid-year position in each current year. The Council has determined to combine the outturn and mid-year review into a single report.

5. KEY ISSUES

5.1 Treasury Priorities

The Council has operated within CIPFA and statutory guidance and requirements in respect of Treasury Management practice. The approved Treasury Management Policy Statement, and more detailed Treasury Management Practices, and each year's Annual Strategy, have all emphasised the importance of Security and Liquidity over Yield.

5.2 2011-12 Outturn

5.2.1 Strategy for the Year

The Treasury Management Strategy for 2011-12 was approved by Council on 7th March 2011.

With short-term interest rates expected to continue to be lower than long-term rates, it was, for a second year, acknowledged that it may continue to be more cost effective to not borrow and reduce the level of investments instead. However it was recognised that long-term interest rates were expected to rise in the future, so the short- term savings would need to be balanced against potential longer term costs.

Long-term borrowing would be taken, therefore, if it became apparent that there was a risk of significantly increased interest rates, or if required to maintain cash flow balances.

Any balances over and above that required to maintain basic liquidity could be invested either in the medium term (out to a year) or in the longer term (over a year). Throughout, priority to be given to security of funds and liquidity (accessibility) over yield (or return).

The limits to investment by reference to amount, duration and credit rating were largely unchanged from those applying in previous years, with the addition of closer controls on foreign and any longer term investments.

5.2.2 Economic Review

The Eurozone debt crisis dominated the year's economic news. The apparent inability of leaders to either agree on remedial policies or implement fiscal consolidation measures prompted frequent bouts of market volatility, as investors positioned themselves for government defaults or even the breakup of the Eurozone itself. Investor confidence in struggling Eurozone nations, such as Greece, Italy and Spain, dived, prompting sharp upward movements in their borrowing costs. Greece finally forced private bondholders into a distressed debt exchange, in return for a more support from the European Union and the IMF.

There was also downward pressure on the creditworthiness of many European banks, prompting a raft of credit rating downgrades and sharp rises in credit default swap spreads. Funding costs went up as interbank lending rates rose sharply above official interest rates. Some European banking groups were bailed out, or forced to consolidate.

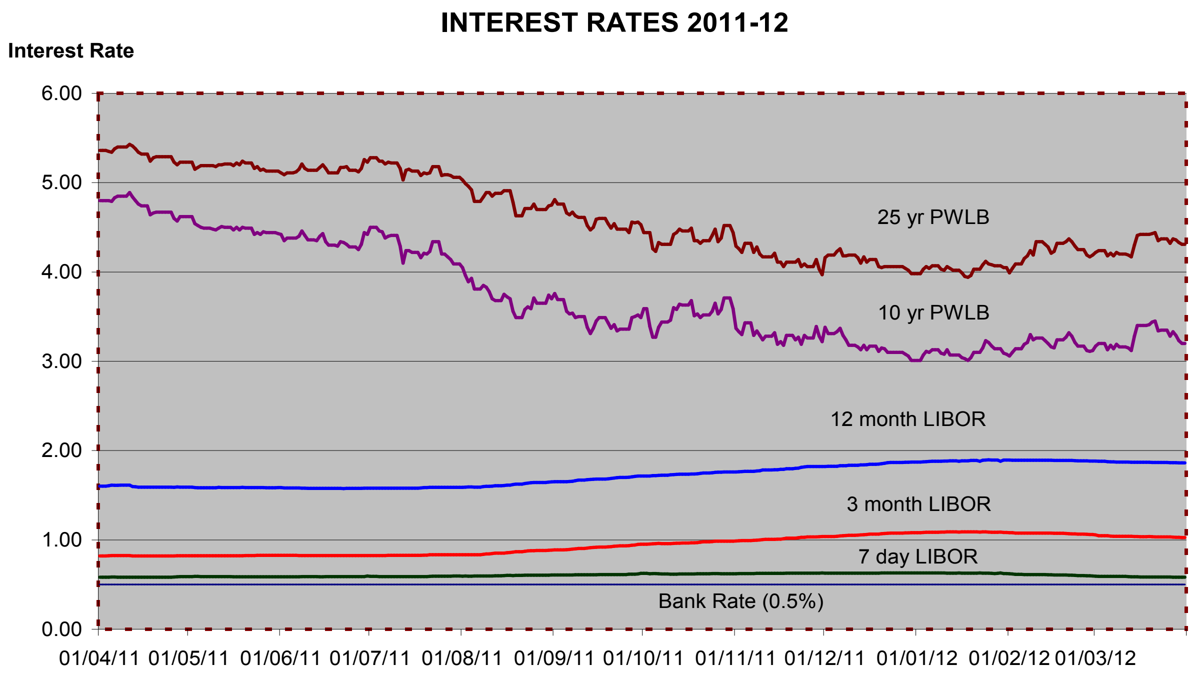
In late 2011, European Central Bank interventions lowered interest rates and reduced the near-term risk of a liquidity crisis. By then, however, the debt crisis had caused a sharp decline in household and business confidence, pushing the Eurozone into recession.

The UK followed the Eurozone into recession over the last six months of the financial year. Other factors responsible for the fall in economic activity included the government's deficit reduction programme, and weak household spending (following higher inflation, subdued wage growth, higher taxes and rising unemployment). Businesses were similarly weakened, with access to credit restricted or too expensive due to a risk-averse banking sector, and limited domestic and foreign demand.

The absence of a quick economic recovery led to rising government budget deficits, especially in the European periphery, further damaging market confidence. Bond yields for many Eurozone governments rose and some countries were unable to raise debt from the market. Greece, Ireland and Portugal were all forced to seek financial assistance from the European Union and the International Monetary Fund.

The UK's worsening financial position was also a concern. However, as financial problems continuing elsewhere in Europe, the UK was perceived to be a relative "safe haven", and strong appetite for UK government debt kept gilt yields low.
While the UK government focused on tightening fiscal policy, The Bank of England loosened monetary policy in October, despite above target inflation. With Bank Rate already at 0.5%, the Monetary Policy Committee approved further quantitative easing, which combined with safe haven buying to push gilt yields to record lows late in 2011.

Interest rates



The Bank of England's Bank Rate remained unchanged, and short term market rates drifted up somewhat as set out in the graph above. The LIBOR (London Interbank Offer Rate), particularly the 3 month LIBOR, has been used as a benchmark for investment returns in the past, but the Council's limited risk appetite in the face of falling credit ratings has meant that such a return was no longer attainable.

Borrowing costs in respect of local authorities' capital financing are largely determined by PWLB rates, in turn set by reference to the cost of Government borrowing through gilts (government debt financing instruments). PWLB rates do vary with the duration of the loan, over recent years tending to increase with loan duration – the 10 and 25 year loan rates are included in the table above as a benchmark Across the year, PWLB rates tended to ease during the first half of the year, reflecting the UK's safe haven status. They then moved up and down in response to market sentiments, with something of an upward shift in March.

5.2.3 Summary of Treasury Management transactions / performance

Debt and investment positions at the start and end of the year were as follows:

	31st Mar 2012 Principal	Rate/ Return	*Av Life yrs*	31st Mar 2011 Principal	Rate/ Return	*Av Life Yrs*
Fixed Rate Funding:						
- PWLB	£99.6m	4.83%	*27.9*	£88.8m	5.04%	*32..3*
- Market	£10.4m	4.50%	*42.7*	£10.4m	4.50%	*43..7*

	£110.0m			£99.2m		
Variable Rate Funding						
- PWLB	£0.0m			£0.0m		
- Market	£13.5m	6.28%	*19.2*	£13.5m	6.28%	*20.2*
	£13.5m			£13.5m		
Funds borrowed by BwDBC	**£123.5m**	**4.96%**	***28.6***	**£112.7m**	**5.14%**	***31.9***
Debt from PFI Arrangements *	£27.1m					
Other Long Term Liabilities – Debt managed by LCC	£19.6m	Actual LCC 11-12 rate 2.1%		£20.4m	Actual LCC 10-11 rate 2.7%	
Total Debt	**£170.2m**			**£133.1m**		
Total Investments	**£22.3m**	0.76%		**£19.3m**	0.95%	

* Note: Interest charges on the PFI debt above did not add to the “bottom line” faced by the Council Taxpayer, as grants covered their cost.

Borrowing Rates are NOT weighted for duration
Average Lives for PWLB/Money Market Loans only (excludes £0.4m irredeemable stock)
Investment Rates show return across the year

Other than the movements on that part of the Council’s debt managed by LCC, the key changes to the Council’s overall debt position across the year were:

(a) the taking on of three new PWLB loans, adding around £11m to the Council’s debt, and

(b) the recognition on the balance sheet of the impact of the new Pleckgate School (finance through Building Schools for the Future), which added around £27m to the Council’s total nominal debt

The accounting adjustments recognising PFI assets and liabilities on the balance sheet are designed to show our effective long term control over the assets concerned, and the parallel “indebtedness” arising from financing the cost of them, but do not add to the “bottom line” met by the Council Tax payer.

No debt restructuring was undertaken in the year, as no opportunities for achieving material benefits from doing so were identified.

The take on of new PWLB loans still left the Council’s debt more than £38 million less than its Capital Financing Requirement (outstanding indebtedness arising from the Capital Programme). Investment balances were, therefore, significantly lower than they would otherwise have been. This, combined with the continuing low interest rates available, and the operation of cautious and short-term approach to investment, reduced the amount of interest earned on balances.

In summary, the outturn position in respect of interest costs and income is as follows:

Outturn 2010-11		Original Budget 2011-12	Outturn 2011-12
£000		£000	£000
6,476	Interest paid on borrowing	8,539	6,346
-	PFI Interest Paid	-	1,681
- 308	Interest receipts	- 196	- 219
5,913	Provision for debt repayment	7,012	6,791

Interest paid on borrowing in 2011-12 was more than £2 million less than the Original Estimate, which had allowed for significant borrowing both late in 2010-11 and across 2011-12. As already noted, there was only limited new long term borrowing, with only part-year effect interest costs.

As with the required balance sheet adjustments, PFI interest charges did not add to the "bottom line" faced by the Council Taxpayer, as grants covered their cost.

The average investment balance across the year was around £31.1 million (£32.6 million in 2010-11). Balances tend to fall to their lowest point at the start and end of each year. The interest earned on balances in 2011-12 was around £0.2 million (£0.3 million in 2010-11) at an average rate of 0.70% (0.95% in 2010-11).

Interest rates have been low for three years, and the rates available from the limited range of institutions the Council can invest with have continued to fall, so overall investment income fell further in 2011-12. Funds have also been invested for shorter periods, and more often with the government's Debt Management Office, to lessen risk, also contributing to lower returns.

The position with regard to performance against Treasury and Prudential Indicators is summarised in the Appendix. There were no breaches of the Borrowing Limits, and the main element to highlight is that the outturn Capital Financing Requirement was, at £208.8 million, higher than the level forecast when setting the Budget for 2011/12 (£199.6 million), as a result of recognising £27 million of PFI debt on the balance sheet.

5.2.4 Treasury Management consultancy

The Council contracts with Sterling Consultancy Services to provide advice and information relating to its investment and borrowing activities. However, responsibility for final decision making remains with the Council and its officers. The previous contract ran to 31 March 2012, with a new contract, agreed after a tendering process, now running to 31st March 2016 .

Sterling have, over the duration of their support to the Council, reviewed the Council's Treasury management procedures and activities. They have provided member training; ongoing officer training; support for and review of treasury decisions, reports and strategies; feedback on accounting for treasury activities; benchmarking with other authorities; guidance on borrowing and investment opportunities; forecasts of interest rates, and regular updates on credit ratings and other information on credit quality. The quality of the support provided has been of a high standard.

5.3 2012-13 Strategy Review

5.3.1 Original Strategy

The Treasury Management Strategy for 2012-13 was approved by Council on 5th March 2012. The Council also adopted the latest (2011) edition of the CIPFA Code of Practice on Treasury Management at that time.

With continuing uncertainty as to future trends in interest rates, and over when it would become necessary to start borrowing, the Original Strategy for 2011/12 was very similar to that for previous years. Short-term interest rates were still expected to continue to be lower than long-term rates, so it was recognised that it may again be beneficial to limit the levels of borrowing taken. However the need to monitor long-term interest rates against the risks of future increases was also recognised.

Cash balances would need to be maintained for managing short-term Council cashflow, with any balances over and above that being invested either in the medium term (out to a year) or in the longer term (over a year). Throughout, priority was to be given to security of funds and liquidity (accessibility) over yield (or return).

The limits to investment by reference to amount, duration and credit rating were, being viewed as already cautious, unchanged.

5.3.2 Mid-year review for 2012-13

Update on the Economy

The ECB's actions prompted an initial calmer period at the start of 2012/13, but the continuing uncertainty over Government finances in Greece and Spain, in particular, pushed the crisis back to the fore, along with further indications of a severe downturn in economic activity. Risk appetite plummeted and Spanish bond yields soared past seven percent, while UK gilt and German bund yields dropped to new record lows. The on-going Eurozone debt crisis was exacerbated by a worldwide slowdown in economic growth

The UK recession continued into quarter 2, with a decline in exports to Europe and weak domestic demand. HM Treasury and the Bank of England interventions were made to try to reduce bank funding costs and improve the availability of cheaper finance for businesses, and the MPC approved a further tranche of quantitative easing

Current Outlook for Interest Rates

Market expectations for significant rises in interest rates have been pushed out until at least 2014, and indeed there is even the possibility of a cut in Bank Rate, all of which will continue to limit the opportunities for earning interest on cash balances.

However the cost of borrowing from the PWLB to finance capital spending is projected to increase, albeit slowly, as the relative attractiveness of UK gilts decreases. The latest central forecast from the Council's treasury management advisers is shown below:

Period	Bank Rate	3 month LIBOR	12 month LIBOR	25-year PWLB rate
Q3 2012	0.50	0.65	1.40	4.10
Q4 2012	0.50	0.65	1.20	4.15
Q1 2013	0.50	0.65	1.30	4.20
Q2 2013	0.50	0.70	1.40	4.25
Q3 2013	0.50	0.80	1.45	4.35
Q4 2013	0.75	0.95	1.50	4.50
H1 2014	1.00	1.20	1.80	4.85
H2 2014	1.50	1.70	2.30	5.10
H1 2015	2.00	2.20	2.80	5.25
H2 2015	2.50	2.75	3.30	5.50

Treasury Performance to Date

Thus far, cash balances have continued to hold up, so only limited new borrowing was undertaken, with a £5 million loan taken from the PWLB on 13th September for 12 years (at a little over 3%)

Investments have continued to be made with a limited range of banks, building societies and Money Market Funds, along with the Government's Debt Management Office, earning interest at low levels (on average below 0.6%).

It is anticipated that some further borrowing will be undertaken later in this year, as revenue cash balances reduce and there is a risk of increases to longer term interest rates. Though other borrowing options are under consideration, it is likely that most of any borrowing will be from the PWLB.

CHANGES IN DEBT OUTSTANDING DURING 2012-13

	End of March 2012		End of August 2012*	
	£000's	£000's	£000's	£000's
TEMPORARY DEBT				
Less than 3 months	0		0	
Greater than 3 months	0		0	
		0		0
LONGER TERM DEBT				
Bonds	23,503		23,503	
Mortgages	17		17	

PWLB	99,632		99189	
Stock & Annuities	404		404	
		123,556		123,113
Lancs County Council transferred debt		19,613		19,417
Recognition of Debt re PFI Arrangements		27,086		27,086
TOTAL DEBT		170,255		169,616
Less: Temporary Lending		22,300		29,200
		147,955		140,416

* before new loan taken of £5 million.

A £0.9 million saving on the £8.5 million Original Estimate for external interest payments has already been reported through Corporate Monitoring, reflecting lower borrowing in 11-12 and early 12-13, as a result of continuing with the policy of deferring borrowing while cash balances permit. Investment returns continue to be low, as initially projected (Original Estimate £0.2 million). Further savings may arise, depending upon market conditions and the resilience of the Council's cash flow.

5.3.3 Updated Investment and Borrowing Strategy

There is no need, at this stage, to reframe the overall strategy set at the start of the year. It is proposed that criteria for investments and Treasury and Prudential Limits and Indicators also remain unchanged.

The Borrowing Strategy will also remain unchanged, with the Council looking to take new borrowing as determined by cash flow requirements and by reference to movements in long term interest rates.

The Public Works Loan Board (PWLB) announced a new PWLB rate, called the certainty rate, which is set 0.2 percentage points below current PWLB rates (currently 1.0% above the UK government bond yield). The certainty rate is available from 1st November this year for local authorities that have met the requisite criteria of providing capital spending and borrowing forecasts to CLG. The Council has complied with the criteria and has access to the certainty rate from the above date. With gilt yields remaining low, it is likely that the Council will seek to take advantage of the lower PWLB rate margin when taking on new long term funding.

5.4 Risk Management

The Council's primary objectives for the management of its investments are to give priority to the security and liquidity of its funds before seeking the best rate of return. The majority of its surplus cash is therefore held as short-term investments with the UK Government, highly rated banks and pooled funds. In addition, the Council holds some investments that entail a slightly higher level of risk, including callable deposits (where there is a risk that changing interest rates may mean that the loan does not run to full term) and unrated building society deposits (where risks have been mitigated by limiting the amount and duration of exposure).

The Council's primary objective for the management of its debt is to ensure its long-term affordability. The majority of its loans (£99 million) have therefore been borrowed from the Public Works Loan Board at long-term fixed rates of interest.

The other significant element of the Council's debt is £23.5 million of "lender's option, borrower's option" (LOBO) loans with initially fixed (and initially low) rates of interest. Under these instruments the Lender can, at certain times, exercise an option to increase the rate payable on the debt, and the Borrower has the choice then to either accept the proposed increase or repay the whole loan (which would mean, effectively, having to live with whatever the market conditions for interest rates were at that point.) This exposes the Council to some risk of rising long-term interest rates, but that is mitigated by the fact that £10 million of this debt (forming a large part of the lowest interest rate elements) can only be "called" once in every five years.

The combination of short duration investments and long duration debt exposes the Council to the risk of falling investment income during periods of low interest rates. Both longer-term investments and any variable rate instruments would hedge against that risk, though the Council currently holds neither of these. However this risk is viewed as of lower priority compared to the requirements of optimising the security and liquidity of investments.

6. POLICY IMPLICATIONS

None

7. FINANCIAL IMPLICATIONS

The financial implications arising from the 2011-12 Treasury Outturn and latest position for 2012-13 have been incorporated into Corporate Budget Monitoring Reports in 2012-13

8. LEGAL IMPLICATIONS

Under the Local Government Act 2003, local authorities determine locally their levels of capital investment and associated borrowing. The Prudential Code has been developed to support local authorities in taking these decisions, and the Council is required by Regulation to have regard to the Code when carrying out its duties under Part 1 of the Local Government Act 2003.

The Department for Communities and Local Government has issued Guidance on Local Government Investments, under the Local Government Act 2003, effective from 1st April 2010. Under this, authorities should manage their investments within an approved strategy, setting out what categories of investment they will use and how they assess and manage the risk of loss of investments.

9. RESOURCE IMPLICATIONS

None as a direct consequence of this report.

10. EQUALITY IMPLICATIONS

None as a direct consequence of this report.

11. CONSULTATIONS

None.

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Date:	11th September 2012
Background Papers:	Treasury Management strategies for 2011-12 and 2012-13 approved at Council 7th March 2011 and 5th March 2012 respectively