BABERGH DISTRICT COUNCIL

From: Director of Finance	**Report Number: L70**
To: Overview and Scrutiny (Stewardship) Committee	**Date of meeting: 22 September 2011**

ANNUAL TREASURY MANAGEMENT REPORT

1. Purpose of Report

1.1 This report complies with the requirements of the CIPFA Code of Practice on Treasury Management and provides the Committee with a comprehensive assessment of Treasury Management activities for the year

1.2 The report also includes performance on Prudential Indicators which were set in the 2010/11 Treasury Management Strategy.

2. Recommendation

2.1 To note Treasury Management activity for the year and that performance was in line with the Prudential Indicators set for 2010/11.

The Committee is asked to make a recommendation to Full Council on the above matter.

3. Financial Implications

3.1 None directly relating to this report but Members to note the following key outturn matters for the year:

- £2m borrowed from PWLB at a very low rate of 2.01%
- Borrowing maintained at a level below the Capital Financing Requirement (CFR), i.e. utilising internal surplus funds for the capital programme

4. Risk Management

4.1 This report is most closely linked with the Council's Corporate / Significant Business Risk No. 6 – Performance and Cost Management. Key risks are set out below:

Risk Description	Likelihood	Impact	Mitigation Measures
Loss of investment	Low	Critical	Strict lending criteria for high credit rated institutions.

Poor return on investments	High	Marginal	Focus is on security and liquidity, therefore, careful cashflow management and budget monitoring in accordance with the Strategy, is required.
Liquidity problems	Unlikely	Marginal	Careful and regular cashflow monitoring to ensure this does not arise.
Higher than expected borrowing costs	Low	Marginal	Benchmark is to borrow from the Public Works Loan Board whose rates are very low and can be on a fixed or variable basis. Alternative of using internal surplus funds temporarily.

5. Consultations

5.1 None

6. Equality and Diversity Impact

6.1 None

7. Shared Service / Partnership Implications

7.1 None

8. Key Information

8.1 The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which requires local authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code recommends that members are informed of treasury management activities at least twice a year. Scrutiny of treasury policy, strategy and activity is delegated to Overview and Scrutiny (Stewardship) Committee and this Committee receives quarterly reports including the half year and annual treasury reports.

8.2 Treasury management is defined as: “The management of the local authority’s investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks”.

8.3 Overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council’s treasury management objectives.

9. Appendices

Title	Location
(a) Treasury management activity – investment and borrowing activity	Attached
(b) Prudential Indicators	Attached

10. Background Documents

10.1 Cipfa’s code of Practice on Treasury Management (“the Code”)

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Appendix A

Annual Treasury Report 2010/11

Treasury Management Activity

1. Background

The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which requires local authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities at least twice a year. Scrutiny of treasury policy, strategy and activity is delegated to Overview & Scrutiny (Stewardship) Committee and the Council reports quarterly to this Committee.

Treasury management is defined as: "The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

Overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

2. Economic Background

At the time of determining the strategy for 2010/11, interest rates were expected to remain low. The outlook for growth was uncertain due to consumers and corporates trimming their spending and financial institutions exercising restraint in new lending.

The economy's two headline indicators moved in opposite directions with the economy growing by just 1.3% in calendar year 2010. The forecast for 2011 was revised down to 1.7% by the Office of Budget Responsibility in March and higher commodity, energy and food prices and the increase in VAT to 20% pushed the February 2011 annual inflation figure to 4.4%. The Bank Rate was maintained at 0.5%.

The credit crisis migrated from banks to European sovereigns. The ratings of Ireland and Portugal were downgraded to the 'triple-B' category whilst the rating of Greece was downgraded to sub-investment (or 'junk') grade. The sovereign rating of Spain was also downgraded but remained in the 'double-A' category. The results from the EU Bank Stress Tests, co-ordinated by the Committee of European Banking Supervisors, highlighted that only 7 out of the 91 institutions failed the 'adverse scenario' tests. The tests will be repeated in the Spring of 2011.

During the year money market rates increased marginally at the shorter end (overnight to 3 months). 6 - 12 month rates increased between 0.25% to 0.30% over the 12 month period reflecting the expectation that the Bank Rate would be raised later in 2011.

3. The Borrowing Requirement and Debt Management

	Balance 31/3/2010 £m	Debt Maturing £m	Debt Prematurely Repaid £m	New Borrowing £m	Balance 31/3/2011 £m	Avg Rate %	Avg Life (yrs)
CFR	7.160				7.905		
Short Term Borrowing[1]	1.000	(1.75)	0	0.75	0		
Long Term Borrowing	1.100	(0.10)	0	2.00	3.0	2.63%	22
TOTAL BORROWING	2.100	(1.85)	0	2.75	3.0		
Other Long Term Liabilities[2]	0.368	(0.15)	0	0	0.218		
TOTAL EXTERNAL DEBT	2.468	(2.00)	0	2.75	3.218		
Increase/ (Decrease) in Borrowing £m					0.750		

The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31/3/2011 was £7.905m.

Following the CSR on 20th October 2010, on instruction from HM Treasury, the PWLB increased the margin for new borrowing to average 1% above the yield on the corresponding UK Government Gilt. New fixed rate borrowing increased by approximately 0.87% and new variable rate borrowing by 0.90%.

The PWLB remained the Council's preferred source of borrowing and £2m of new PWLB fixed rate EIP loans (Equal Instalments of Principal) were raised during the year at 2.01% which offered the best value in the prevailing interest rate environment. The Council allocated £0.95m of new borrowing to its capital expenditure at the year end. There is no variable rate borrowing.

The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding capital expenditure in the short term. Whilst this position is expected to continue into 2011/12, it will not be sustainable over the medium term and the Council expects it will need to borrow a further £3m over the next two years.

4. Investment Activity

The CLG's revised Investment Guidance came into effect on 1st April 2010 and reiterated the need to focus on security and liquidity, rather than yield. It also recommended that strategies include details of assessing credit risk, reasons for borrowing in advance of need and the use of treasury advisers.

Investments	Balance 31/3/2010 £m	Investments Made £m	Maturities/ Investments Sold £m	Balance 31/03/2011 £m	Avg Rate %	Avg Life (days)
Short Term Investments	2.500	38.500	37.500	3.500	0.72	35
Instant Access Call Accounts (net movement)	0.337	.071		0.408	0.28	1

1 Loans with maturities less than 1 year.
2 Also include here operating leases reclassified as finance leases in 2010/11

Long Term Investments	0	0	0	0		
TOTAL INVESTMENTS	2.837	38.571	37.500	3.908		
Increase/ (Decrease) in Investments £m				1.071		

Security of capital was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2010/11. Investments during the year included:

- Deposits with the Debt Management Office
- Deposits with other Local Authorities
- Call accounts and deposits with Banks and Building Societies systemically important to that 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 (Council's minimum long-term counterparty rating of A+ across all three rating agencies, Fitch, S&P and Moody's); 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. Counterparty credit quality has progressively strengthened/been maintained as demonstrated by the Credit Score Analysis summarised below[3]. The table in Appendix __ 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)
31/03/2010	*5.91*	*A*	*5.82*	*A*	*104*
30/06/2010	*4.97*	*A+*	*4.70*	*A+*	*73*
30/09/2010	*4.65*	*A+*	*4.29*	*AA-*	*68*
31/12/2010	*4.52*	*A+*	*4.17*	*AA-*	*42*
31/03/2011	*2.43*	*AA+*	*2.89*	*AA*	*32*

Liquidity: In keeping with the CLG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use 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. Short term money market rates remained at very low levels which had a significant impact on investment income which achieved £54k against a budget of £47k. The average cash balances representing the Council's reserves and working balances were £8,561k.

[3] *Please refer to Arlingclose's quarterly credit risk benchmarking spreadsheets for your Council's credit scores*

5. Prudential Indicators

The Council can confirm that it has complied with its Prudential Indicators for 2010/11, which were set in February 2011 as part of the Council's Treasury Management Strategy Statement. This document can be accessed through the following link http://www.babergh.gov.uk). Details of Prudential Indicators can be found in Appendix 3. A prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

6. Reform of Council Housing Finance

In its publication ***Implementing self-financing for council housing*** issued in February 2011 the CLG set out the rationale, methodology and financial parameters for the initiative.

Subject to the Localism Bill receiving Royal Assent and a commencement order being passed, the proposed transfer date is Wednesday 28th March 2012 (this fits with PWLB timetables on the payment/receipt of funds to clear by 31st March 2012.)

The treasury management implications of HRA reform and an appropriate strategy to manage the process are being actively reviewed with the Council's Treasury Advisor. This includes a thorough balance sheet analysis to ensure that the General Fund and HRA CFRs are accurate, including an estimate of the 2011/12 position upon which the significant reform settlement will be applied.

Credit Score Analysis

Scoring:

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

The Council aims to achieve a score of 5 or lower, to reflect the Council's overriding priority of security of monies invested and the minimum credit rating of threshold of A+ for investment counterparties.

Appendix B

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Prudential Indicators

Capital Financing Requirement

Estimates of the Council's cumulative maximum external borrowing requirement for 2010/11 to 2012/13 (excluding Housing Reform) are shown in the table below:

	31/3/2011 Estimate £000s	31/3/2011 Actual £000s	31/3/2012 Estimate £000s	31/3/2013 Estimate £000s
Capital Financing Requirement	7,564	7,905	10,571	11,734
Less: Existing Profile of Borrowing	(3,000)	(3,000)	(5,650)	(5,150)
Less: Other Long Term Liabilities	(219)	(218)	(109)	0
Cumulative Maximum External Borrowing Requirement	**4,345**	**4,687**	**4,812**	**6,584**

Balances and Reserves

Estimates of the Council's level of Balances and Reserves for 2010/11 to 2012/13 are as follows:

	31/3/2011 Estimate £000s	31/3/2011 Actual £000s	31/3/2012 Estimate £000s	31/3/2013 Estimate £000s
Balances and Reserves	(3.399)	(5,141)	(3,198)	(3,407)

Prudential Indicator Compliance

(a) Authorised Limit and Operational Boundary for External Debt

- The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of their indebted status. This is a statutory limit which should not be breached.
- The Council's Affordable Borrowing Limit was set at £9.6m for 2010/11.
- 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 2010/11 was set at £5.5m.
- The Director of Finance confirms that there were no breaches to the Authorised Limit and the Operational Boundary during the year; borrowing at its peak was £3.1m.

(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.

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	Limits for 2010/11 %	Maximum during 2010/11 %
Upper Limit for Fixed Rate Exposure	100%	100%
Compliance with Limits:	Yes	Yes
Upper Limit for Variable Rate Exposure	30%	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 31/03/2011	% Fixed Rate Borrowing as at 31/03/2011	Compliance with Set Limits?
under 12 months	50%	0%	£0.2m	6.67%	Yes
12 months and within 24 months	50%	0%	£0.2m	6.67%	Yes
24 months and within 5 years	50%	0%	£0.6m	20.00%	Yes
5 years and within 10 years	100%	0%	£0.9m	30.00%	Yes
10 years and above	100%	0%	£1.1m	36.66%	Yes

(d) 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 Council's policy response since the onset of the credit crunch in 2007 was to keep investment maturities to a maximum of 12 months. No investments were made for a period greater than 364 days during this period.