APPENDIX A

Annual Treasury Management Review 2011/12

Pendle Borough Council

August 2012

Contents

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).

In respect of 2011/12 the full Council approved a report outlining the annual treasury strategy in advance of the year (Council 24/03/11). In addition, a mid year treasury update report was presented to the Executive in November 2011. Quarterly monitoring reports on treasury management activity have been presented to the Accounts and Audit Committee. This report, following the end of the year describes the activity compared to the approved strategy.

Recent changes in the regulatory environment place a much greater onus on Councillors 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 Councillors.

Training on treasury management issues was provided during the year to Councillors on the Accounts and Audit Committee.

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	12,663	8,494	10,582
Capital Financing Requirement:	8,632	19,432	10,038
Net borrowing	(6,641)	(1,141)	(4,241)
External debt at 31st March	7,859	6,859	6,859
Investments at 31st March • All under 1 year	14,500	8,000	11,100

The value of capital expenditure shown for 2011/12 (original) of £8.494m was estimated before the level of capital programme slippage from 2010/11 was confirmed. The actual slippage was £10.177m as reported in the capital programme outturn report presented to the Executive in June 2012.

The actual Capital Financing Requirement in 2011/12 was lower than the estimate owing primarily to significant slippage on the capital programme and as a result of decisions taken by the Head of Central Services in deciding how to finance the capital programme within the scope of his delegated authority.

Other prudential and treasury indicators are to be found in the main body of this report. The Head of Central Services also confirms that borrowing was only undertaken for a capital purpose and 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.

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.

General Fund	2010/11 Actual £'000	2011/12 Estimate £'000	2011/12 Actual £'000
Capital expenditure	**12,663**	**8,494**	**10,582**
Financed in year	11,424	5,881	8,782
Unfinanced capital expenditure (borrowing need)	**1,239**	**2,613**	**1,800**

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 is required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to reduce the 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 24/03/2011.

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

Capital Financing Requirement	31 March 2011 Actual	31 March 2012 Budget	31 March 2012 Actual
Opening balance	10,500	14,393	8,632
Add unfinanced capital expenditure (as above)	1,239	2,613	1,800
Less MRP/VRP*	(3,107)	(436)	(394)
Closing balance	8,632	16,570	10,038

** Includes voluntary application of HMR capital grant in 2010/11.*

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 2012/13 and 2013/14 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 £'000	31 March 2012 Budget £'000	31 March 2012 Actual £'000
Net borrowing position	(6,641)	(1,141)	(4,241)
CFR	8,632	16,570	10,038

Net borrowing = loan debt less investments

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 £m
Authorised limit	14.00
Maximum gross borrowing position	7.86
Operational boundary	12.00
Average gross borrowing position	6.85
Financing costs as a proportion of net revenue stream	3.13%

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	Average Life yrs	31 March 2012 Principal	Rate/ Return	Average Life yrs
Fixed rate funding:						
-PWLB	£7.86m	3.91%	12.2	£6.86m	3.63%	12.0
Total debt	**£7.86m**	**3.91%**	**12.2**	**£6.86m**	**3.63%**	**12.0**
CFR	**£8.63m**			**£10.04m**		
Over/ (under) borrowing	**(£0.77m)**			**(£3.18m)**		
Investments:						
- in house	£14.5m	0.25% - 1.90%	<1yr	£11.1m	0.70% - 3.10%	<1yr
Total investments	**£14.5m**					

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	£2.000m	£0.000m	£1.000m
12 months and within 24 months	£1.000m	£1.000m	£0.000m
24 months and within 5 years	£0.000m	£0.000m	£1.000m
5 years and within 10 years	£2.000m	£2.000m	£2.000m
10 years and above	£2.859m	£3.859m	£2.859m

With regard to investments, all deposits were made with approved counterparties at durations of less than one year, ranging from overnight money to 364 days.

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 or interest)	100%	Up to 100%	100%
Variable rate (principal or interest)	Nil	Up to 30%	Nil

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

5. The Economy and Interest Rates

The original expectation for 2011/12 was that Bank Rate would start gently rising from quarter 4 2011. However, economic growth (GDP) in the UK was disappointing during the year due to the UK austerity programme, a lack of rebalancing of the UK economy to exporting and weak growth in our biggest export market - the European Union (EU). The EU sovereign debt crisis grew in intensity during the year until February when a refinancing package was eventually agreed for Greece. This 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%, finishing at 3.5% in March, with further falls expected to below 2% over the next two years.

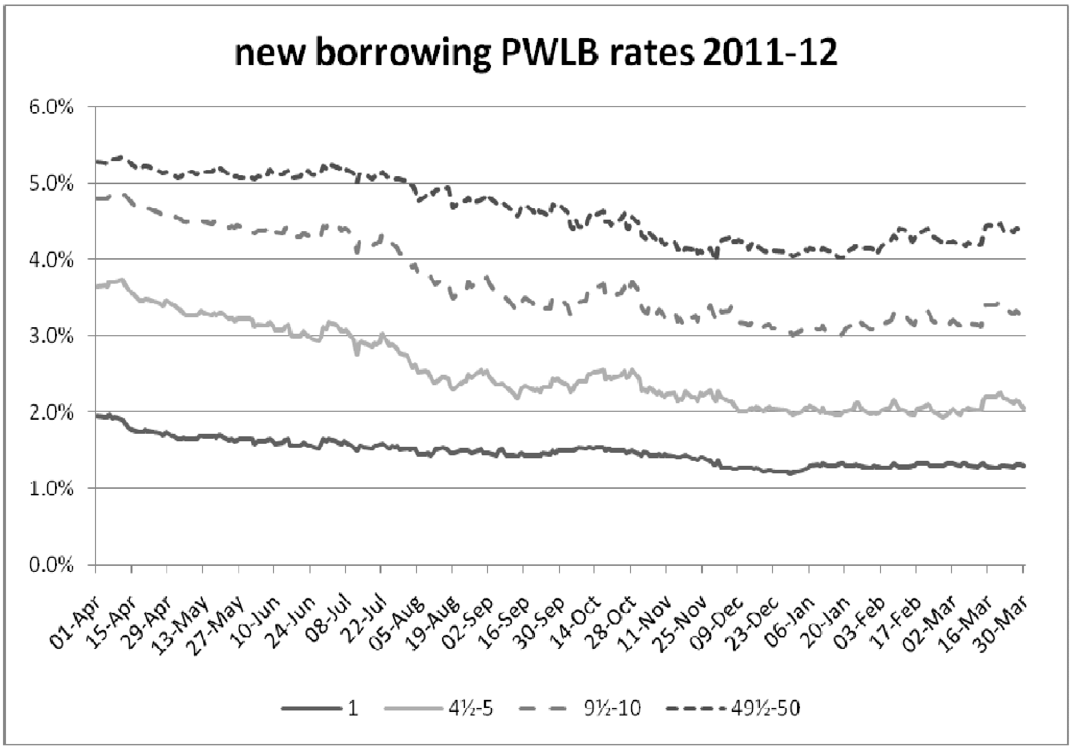
Gilt yields fell for much of the year, until February, as concerns continued building over the EU debt crisis. This resulted in safe haven flows into UK gilts which, together with the two UK packages of QE during the year, combined to depress PWLB rates to historically low levels.

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 credit 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.

The UK coalition Government maintained its tight fiscal policy stance against a background of warnings from two credit rating agencies that the UK could lose its AAA credit 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.

6. Borrowing Rates in 2011/12

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



7. Borrowing Outturn for 2011/12

Treasury Borrowing

Borrowing - loans were drawn to fund the net unfinanced capital expenditure and naturally maturing debt.

The following loan transaction was completed with the PWLB during the year:

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Lender	Principal	Interest Type	Interest Rate	Maturity
PWLB	£1.0m	Fixed rate	2.01%	31.3.16

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.

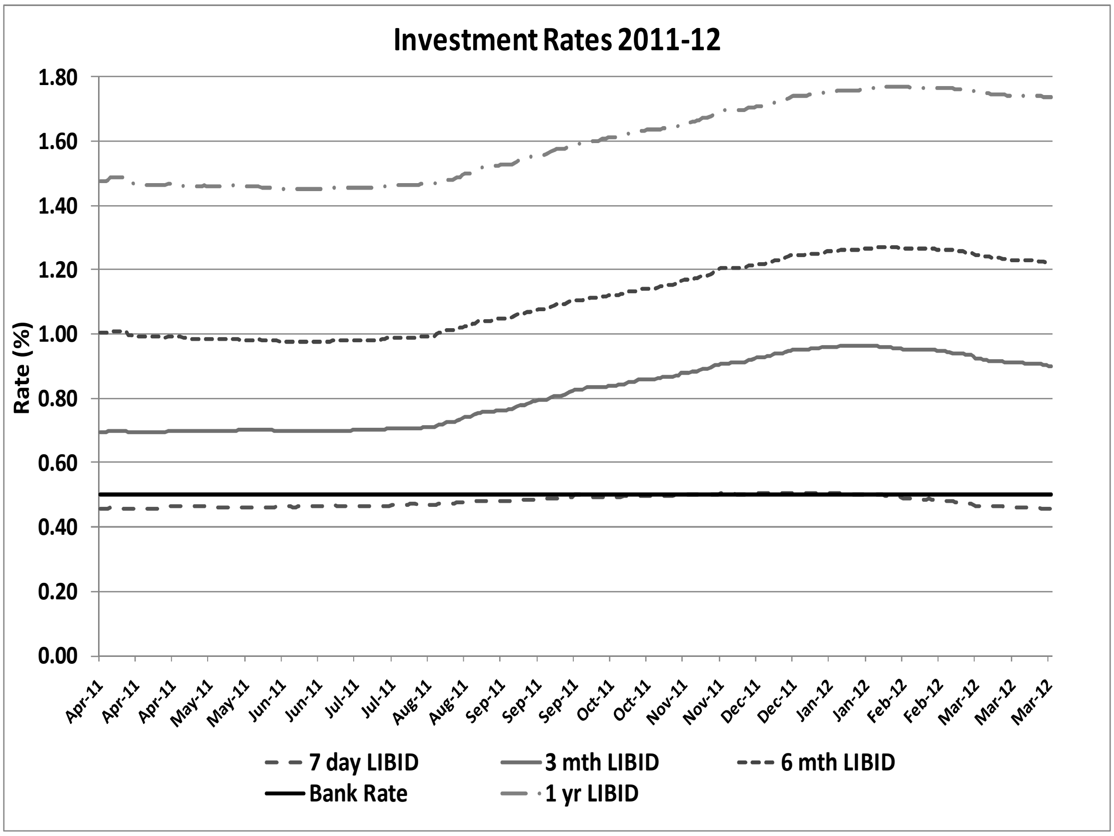
Repayments

1. On 31/7/11 the Council repaid a £2m upon maturity at a rate of 3.94% using investment balances.

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.



9. Investment Outturn for 2011/12

Investment Policy – the Council's investment policy is governed by CLG guidance, which was been implemented in the annual investment strategy approved by the Council in March 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.

Resources – the Council's cash balances comprise revenue and capital resources and cash flow monies. The Council's core cash resources comprised as follows:

Balance Sheet Resources (£m)	31 March 2011	31 March 2012
Balances	**1.250**	**1.250**
Earmarked reserves	**12.132**	**12.082**
Provisions	**0.152**	**0.397**
Usable capital receipts	**2.140**	**1.144**
Total	**15.674**	**14.873**

The Council maintained an average investment balance of £15m of internally managed funds. The funds earned an average rate of return of 1.12%. A comparable performance indicator is the average 3-month LIBID rate, which was 0.82%. This compares with a budget assumption of £8m investment balances earning an average rate of 1%. The variance in the average level of investment is primarily due to slippage on the 2011-12 capital programme of £10.9m.