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AUDIT COMMITTEE – 6 July 2012

ANNUAL REPORT ON THE TREASURY MANAGEMENT SERVICE AND ACTUAL PRUDENTIAL INDICATORS 2011/12

1. INTRODUCTION

1.1 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).

1.2 During 2011/12 the minimum reporting requirements were that the Council should receive the following reports:

- a forecast of the likely activity for the forthcoming year in an annual treasury strategy report (Council 28/02/2011)
- a review of activity in an interim mid-year treasury update report (Information Bulletin November 2011)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

In addition, discussion and consultation was made on a regular basis throughout the year with meetings between the Cabinet member, who is both the Portfolio Holder for Finance and Efficiency and Chairman of the Final Accounts Committee, the Executive Director, the Accountancy Manager and the Treasury Management Accountant. This regular meeting has received regular treasury management update reports and has also reviewed the strategy to be applied, within the approved strategy, as and when changes in circumstances arise.

1.3 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.

1.4 The Portfolio Holder for Finance and Efficiency undertook training on treasury management issues during the year on 24/11/2011 in order to support Members' scrutiny role.

2. BACKGROUND

2.1 This Council has adopted the CIPFA Code of Practice for Treasury Management in the Public Sector and operates its treasury management service in compliance with this Code and the above requirements. These require that the prime objective of the treasury management activity is the effective management of risk, and that its borrowing activities are undertaken in a prudent, affordable and sustainable basis.

2.2 This report sets out the information in the following appendices: -

Appendix 1

- A summary of the treasury strategy agreed for 2011/12;
- A summary of the economic factors affecting the strategy over 2011/12;
- The decisions taken and performance of the treasury service and their revenue effects;
- The Council's treasury position at 31 March 2012;

Appendix 2

- The main Prudential Indicators and compliance with limits;
- Performance indicators set for 2011/12;
- Risk and performance.

3. CRIME AND DISORDER AND ENVIRONMENTAL IMPLICATIONS

3.1 None arising directly from this report.

4. RECOMMENDATIONS

Members are recommended to consider this report.

Further Information	**Background Papers**
Please contact Jan Hawker, Treasury Management Accountant Ext 5722	The Prudential Code, CIPFA Guidance Notes and ODPM Investment Guidance
e-mail: jan.hawker@nfdc.gov.uk	Local Government Act 2003
	SI 2003/3146 - Local Authorities (Capital Finance and Accounting) (England) Regulations 2003
	Cabinet 2 February 2011 -Treasury Management Strategy Report 2011/12
	Published Papers

APPENDIX 1

TREASURY MANAGEMENT PERFORMANCE - 1 APRIL 2011 TO 31 MARCH 2012

1. INTRODUCTION

This appendix sets out the performance for the Council's treasury management activities.

2. TREASURY STRATEGY SUMMARY FOR 2011/12

2.1 Borrowing Strategy

The borrowing strategy for 2011/12 indicated that: -

- Bank base rates would average 0.7% for the year;
- Long-term borrowing to meet capital expenditure would be unlikely to be undertaken as the preference expressed by Members was that the Council should remain debt-free for the time being;
- It was anticipated that the possibility of the commutation of housing subsidy grant may be an issue during the year but that no details were available at that time;
- The Council would borrow temporarily for cash flow purposes;
- Interest payments would be £6,000;
- **Change in strategy during the year** – the strategy adopted in the original Treasury Management Strategy Report for 2011/12 approved by the Council on 28 February 2011 was subject to revision during the year due to finalising of the requirements of the HRA Finance Settlement. The approved borrowing limit was increased to £176m from £26m and the operational boundary to £150m from £0.

2.2 Investment Strategy

The investment strategy for 2011/12 assumed that: -

- investments would be made for medium term periods with fixed rates to lock in good value and security of return if opportunities arose, subject to over riding credit counterparty security;
- total interest earnings were forecast at £350,000. Of this sum earnings from the Council's temporary cash flow investments would be £325,000, statutory interest from the Housing Revenue Account of £18,000 and £7,000 from other sources.

3. SUMMARY OF ECONOMIC FACTORS

3.1 The financial year 2011/12 continued the challenging investment environment of previous years, namely low investment returns and continuing heightened levels of counterparty risk. The original expectation for 2011-12 was that the Bank of England Base Rate would start rising gently from quarter 4 2011. However, GDP growth in the UK was disappointing during the year as a consequence of the UK austerity programme, a lack of rebalancing of the UK economy to exporting and weak growth in our biggest export market - the EU.

3.2 The EU sovereign debt crisis intensified during the year until February when a second bailout package was eventually agreed for Greece. Weak UK growth resulted in the Monetary Policy Committee increasing quantitative easing by £75bn in October and another £50bn in February. The Bank of England Base Rate ended the year unchanged at 0.5% while CPI inflation peaked in September at 5.2% but then fell to 3.4% in February, with further falls expected to below 2% over the next two years.

3.3 Gilt yields fell for much of the year, until February 2012, as concerns continued building over the EU debt crisis. This resulted in increased cash flows into UK gilts which, together with the two UK packages of quantitative easing during the year, combined to reduce borrowing rates to historically low levels.

3.4 **Investment rates.** Risk premiums were also a constant factor in raising money market deposit rates for periods of longer than 1 month. Widespread and multiple downgrades of both sovereign ratings and bank ratings continued the concerns in the Eurozone. Significant funding issues still faced by many financial institutions means that investors remained cautious of longer-term commitment.

3.5 Weak economic figures are estimated in the immediate future and economists are now suggesting that rates will not rise until at least quarter 1 of 2014 and possibly later.

4. LONG-TERM BORROWING

4.1 The Council’s underlying need to borrow to finance capital expenditure is called the Capital Financing Requirement (CFR).

4.2 At 1 April 2011 the Council had no actual external debt but there was historical CFR of £5.068m for the General Fund and £1.897m for the HRA.

4.3 The implementation of housing finance reform at the end of the year abolished the housing subsidy system financed by central government and, consequently, all housing debt has been reallocated nationally between housing authorities. The result of this reallocation is that this Council made a capital payment to the Department of Communities and Local Government of £142.704m.

4.4 This resulted in an increase in both the CFR and in the amount of debt by £143m at the end of the year. This was financed by new external borrowing. There has been no impact on HRA revenue finances in 2011/12 due to compensating adjustments being made in the HRA determination.

	31 March 2011 Actual	31 March 2012 Original	31 March 2012 Actual
	£m	**£m**	**£m**
CFR General Fund	5,068	5,180	4,466
CFR HRA	1,897	1,897	144,601
Total CFR	**6,965**	**7,077**	**149,067**

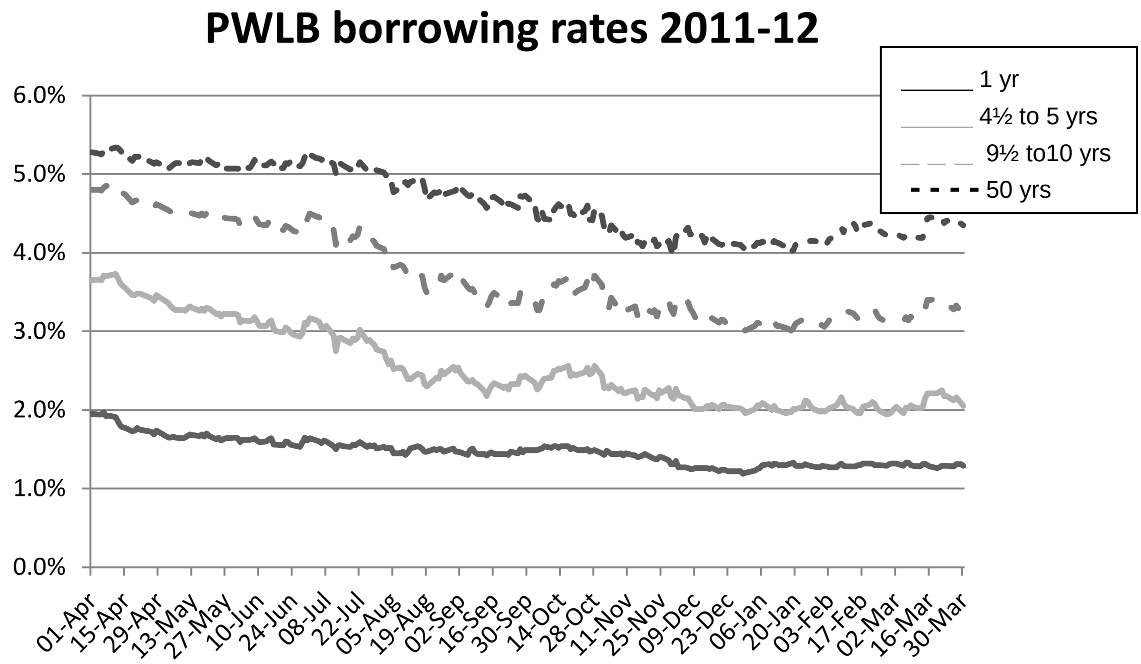
4.5 The new external loans were raised from the Public Works Loan Board (PWLB) on the 28 March 2012. The PWLB is a UK government organisation that makes loans available for public authorities.

4.6 All loans raised have fixed interest rates with interest payable 6 monthly and principal repayable on maturity. PWLB loans raised for the HRA Finance Settlement were issued at a discounted interest rate which was an average of 0.88% lower than the standard rates. The loans were raised as follows:-

Principal £	Interest Rate %	Term of loan Years	Repayment date 28 March
4,100,000	1.50%	6	2018
4,100,000	1.76%	7	2019
4,100,000	1.99%	8	2020
4,100,000	2.21%	9	2021
4,100,000	2.40%	10	2022
4,100,000	2.56%	11	2023
4,100,000	2.70%	12	2024
4,100,000	2.82%	13	2025
4,100,000	2.92%	14	2026
4,100,000	3.01%	15	2027
4,100,000	3.08%	16	2028
4,100,000	3.15%	17	2029
4,100,000	3.21%	18	2030
4,100,000	3.26%	19	2031
4,100,000	3.30%	20	2032
4,100,000	3.34%	21	2033
4,100,000	3.37%	22	2034
4,100,000	3.40%	23	2035
4,100,000	3.42%	24	2036
4,100,000	3.44%	25	2037
4,100,000	3.46%	26	2038
4,100,000	3.47%	27	2039
4,100,000	3.48%	28	2040
4,100,000	3.49%	29	2041
4,100,000	3.50%	30	2042
4,100,000	3.51%	31	2043
4,100,000	3.52%	32	2044
4,100,000	3.52%	33	2045
4,100,000	3.52%	34	2046
4,100,000	3.52%	35	2047
4,100,000	3.53%	36	2048
4,100,000	3.53%	37	2049
4,100,000	3.53%	38	2050
4,100,000	3.53%	39	2051
3,304,000	3.52%	40	2052
142,704,000			

The average interest rate for the first 6 years will be 3.1% assuming that no principal is repaid prematurely.

4.7 The following graph shows how the standard PWLB interest rates moved over the year.



5. TEMPORARY BORROWING

5.1 There were no temporary loans outstanding on 1 April 2011.

5.2 Two temporary loans were raised during the year for cash flow purposes. The loans were for periods up to 6 days and for amounts up to £1m.

5.3 The original estimate for 2011/12 for interest payable was £6,000. Interest payments were £70 for temporary borrowing during the year.

5.4 The average interest rate paid on borrowing during the year was 0.325%

5.5 There were no temporary loans outstanding at 31 March 2012.

6. INVESTMENT

6.1 The original estimate for 2011/12 for interest receivable on temporary investments was £325,000 based on an anticipated earnings benchmark of 1.02% for the year. The actual interest receivable was £453,000 with an average interest rate of 1.27%; a variation of £128,000.

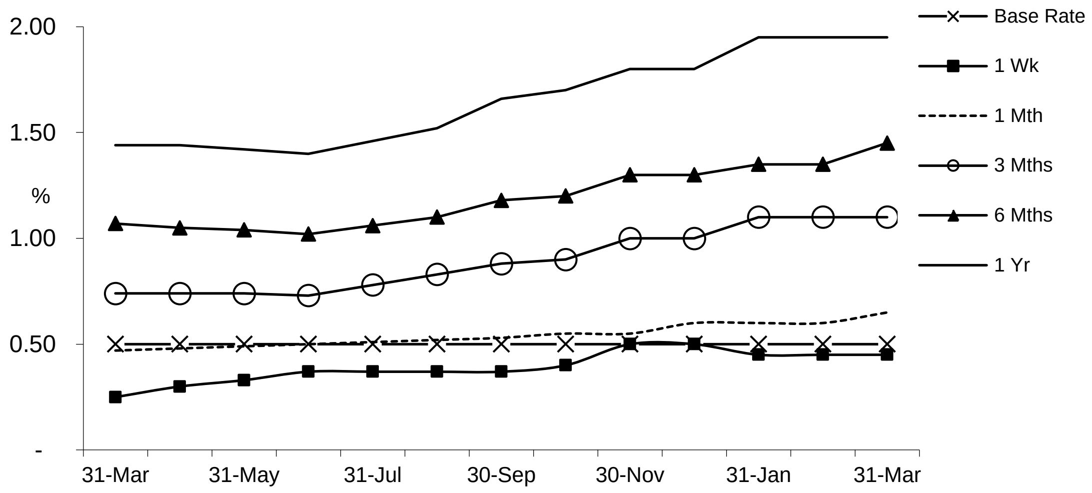
6.2 The cause of this variation was due to two factors:-

		£
	Original estimate for temporary investments earnings	325,000
a.	Higher Interest rate than forecast	80,000
b.	Cash flow effect of rephased expenditure or savings	48,000
		453,000

6.3 Variations were reported to Cabinet during the year as part of the variation on the overall net interest earnings.

6.4 The following chart shows how the interest rates in the money markets generally have increased over the year. However the rates offered by those organisations with which the Council can invest can differ substantially from these averages.

Money Market Interest Rates 1/4/11 to 31/03/12



6.5 There were no movements in the bank base rate during the year:

Date	Bank Base Rate
At 1 April 2011	0.50%
31 March 2012	0.50%

6.6 All temporary investments had been made in accordance with the parameters set within the Council's Treasury Policy Statement and with any other parameters that were imposed at regular reviews during the year.

6.7 At the end of March 2012 most of the temporary investments were kept very short to allow maximum flexibility in the use of funds for the HRA Finance Settlement if required. Consequently the investments at the year end, and shown below, had a lower level of interest rate than they may otherwise have done. The table below shows the list of temporary investments at 31 March 2012.

Borrower	**Amount £**	**Interest Rate %**	**Maturity Date**
Lloyds TSB Bank PLC	3,000,000	2.10	23.07.12
Nationwide BS	2,500,000	0.98	29.06.12
Barclays Bank PLC	3,000,000	0.92	29.06.12
National Westminster PLC	2,000,000	1.00	04.04.12
Money Market Funds	15,400,000	0.83	Instant access
Total	**25,900,000**		

7. BENCHMARKING

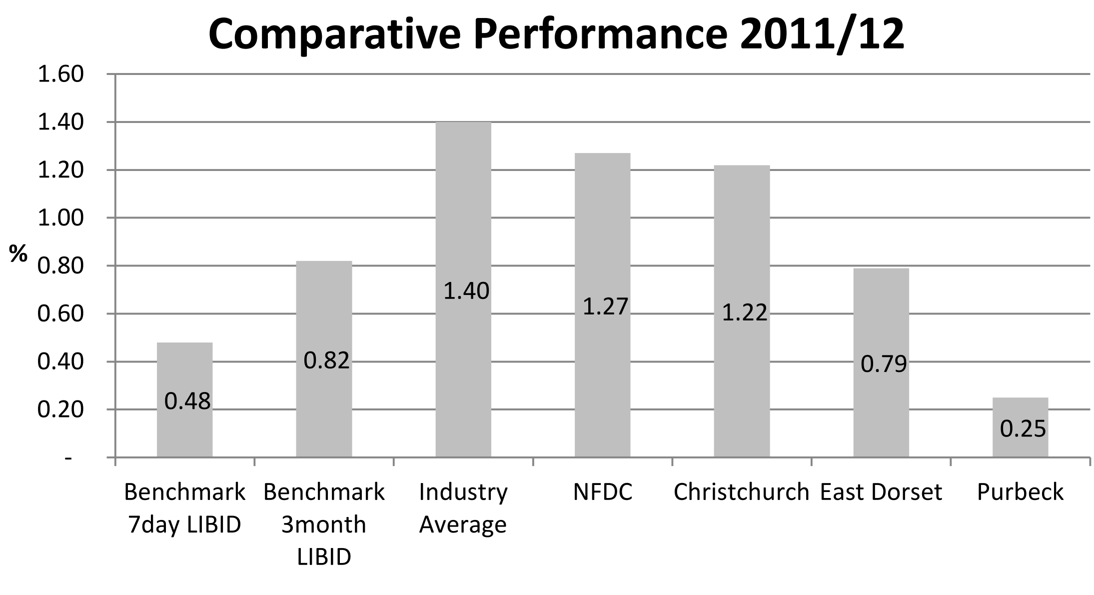
7.1 In order to measure the performance of the Council's investments it is necessary to compare the earnings to a benchmark. The benchmark is established by taking a daily figure published by the money markets and averaging this over the period being measured. In this case the interest rate paid for 7 day money at the London Interbank Bid (LIBID) rate is averaged over one year. The LIBID rate is the rate that major UK banks will pay for money deposits on the London Interbank market.

7.2 The average rate of 7 day LIBID, the interest rate used for benchmarking the Council's interest earnings for 2011/12, was 0.48%. Therefore, the interest earned on temporary investments exceeded the benchmark.

7.3 In addition to benchmarking to the London Money Market interest rates Members have requested a comparison of interest earnings to be made with other councils. All councils develop their own investment criteria and each differs either in the permitted period of investment, the institutions that deposits can be placed with or the limit to which funds can be invested with each organisation. These criteria are also often based on the overall value of funds available for investment within each council. It should be noted that the other councils used in this example have different investment parameters to NFDC and therefore direct comparison is difficult. For example Purbeck District Council relies heavily on investments with the Debt Management Office which pays very low rates of interest but is backed by central government and so deemed a very "safe" investment. East Dorset District Council's investments are generally for a few months while Christchurch Borough Council can invest for longer periods.

7.4 It is interesting to note the widely differing rates of return given the variation in investment parameters.

7.5 The following table shows the average earnings for this council's temporary investments against those of 7 day LIBID, 3 month LIBID, external fund managers' industry average and other councils.



7.6 The performance of this Council's treasury function was better than the benchmarks but lower than the external fund managers' industry average. This industry average includes various investments that the council does not use; i.e. gilts. Although gilts perform well in an environment of falling longer term interest rates, when they pick up capital gains, there is also a risk of capital loss if the interest rate projections reverse.

7.7 Results to 31 March 2012 are summarised as follows: -

	NFDC Temporary interest earnings %	**7-day Bench-mark earnings %**	**Fund Manager industry average %**
Actual Return	1.27	0.48	1.40
Benchmark Return	0.48	0.48	0.48
	£000	**£000**	**£000**
Actual Return	453	171	499
Benchmark Return	171	171	171
Return above/(-)below benchmark	282	0	328

7.8 The value of the interest earned by NFDC on temporary investment as at 31 March 2012 was £282,000 above the benchmark figure as shown at paragraph 6.7. These earnings were £46,000 less than the external fund manager industry average.

8. INVESTMENT PORTFOLIO STRATEGY

8.1 Funds are invested in cash deposits.

8.2 At the start of the year the portfolio was invested in instruments with interest rates averaging 1.57%. This included two investments with original terms of one year that were earning in excess of 2%.

8.3 At the beginning of the year the anticipation was that interest rates would increase in the second part of the year. However base rates stayed at 0.50% for the period and money rates increased slightly as shown at table 6.4 above.

8.4 The main reason for the lower than anticipated interest rates in the money markets was that the economy generally was failing to grow as predicted. That, together with the increasing worry of the sustainability of the Eurozone, contained rates.

8.5 The success of the Money Market Fund, set up in January 2010, led the council to opening two more money market funds. These were used extensively during the year. The funds are AAA rated and the council has instant access to all deposits. The interest rate was not as good as period deposits of 3 months or more with some of the banks in which the council can invest but was much better than both the Government's Debt Management Account Deposit Facility and other local authorities. This fund was used for very short term deposits or where other allowable investment limits had been reached.

8.6 During the year some investments were made for periods of a year with highly rated UK banks and Building Societies. This lengthening of the portfolio profile resulted in increased interest earnings.

8.7 Towards the end of the year some of the higher yielding investments had matured and new investments were targeted for early April 2012. The portfolio of investments actually held in deposits were therefore yielding a lower than expected interest earning average of 1.02% at the year end.

9. TREASURY POSITION AT 31 MARCH 2012

The following table shows the treasury position at the 31 March 2012 compared with the previous year.

	31 March 2011		**31 March 2012**	
	Principal	**Average Rate**	**Principal**	**Average Rate**
	£m	**%**	**£m**	**%**
Total Long-Term Debt	£0.00m	0.0%	£142.70m	3.1%
Total Debt	**£0.00m**	**0.0%**	**£142.70m**	**3.1%**
Variable Interest Rate				
- Money Market Funds	£0.00m	0.8%	£15.40m	0.8%
- Call Account	£0.25m	0.2%	£0.00m	0.2%
	£0.25m	0.2%	£15.40m	0.8%
Fixed Interest Rate				
- Temporary Investments	£21.00m	1.6%	£10.50m	1.3%
- Long Term Investments	£0.00m	0.0%	£0.00m	0.0%
	£21.00m	1.6%	£10.50m	1.3%
Total Investments	**£21.25m**	**1.6%**	**£25.90m**	**1.0%**
Net Debt	**-£21.25m**	**-1.6%**	**£116.80m**	**3.6%**

APPENDIX 2

PRUDENTIAL INDICATORS AND COMPLIANCE ISSUES TO 31 MARCH 2012

1. INTRODUCTION

1.1 The Council is required by the Prudential Code to report the actual prudential indicators after the year-end.

1.2 The following table, at Paragraph 2, provides a schedule of all the mandatory prudential indicators.

1.3 Certain of these indicators must be compared to others and are detailed later in this appendix.

2. ESTIMATED AND ACTUAL TREASURY POSITION AND PRUDENTIAL INDICATORS

2.1 The following table compares the actual figure for 2011/12 with the original indicator for 2011/12 and the actual figure for 2010/11.

2.2 The original indicator for 2011/12 is the same as was included in the Treasury Strategy Report 2011/12.

		2010/11 Actual £000	**2011/12 Original Indicator £000**	**2011/12 Actual £000**
1	**Capital Expenditure**	12,144	16,364	17,023
2	**Capital Financing Requirement (CFR) at 31 March** Housing Non Housing **Total**	 1,897 5,068 **6,965**	 1,897 5,180 **7,077**	 144,601 4,466 **149,067**
3	**Treasury Position at 31 March** Borrowing Other long term liabilities **Total Debt** Investments **Net Borrowing/Investments (-)**	 0 0 **0** 21,250 **-21,250**	 0 0 **0** 13,600 **-13,600**	 142,704 0 **142,704** 25,900 **116,804**
4	**Authorised Limit** (against maximum position)	**Maximum** 2,845	**Maximum** 26,000	
4a	**Revised Authorised Limit** (against max position)		**Maximum** 176,000	**Maximum** 143,193
5	**Operational Boundary** (against average position)	**Average** 56	**Average** 0	

5a	**Revised Operational Boundary** (against average position over 4 days of debt)		**Average** 150,000	**Average** 142,715
6	**Ratio of financing costs to net revenue stream** (non Housing)	1.6%	0.7%	0.1%
7	**Incremental impact of capital investment decisions on the Band D council tax**	£ 5.63	£ 2.07	£ 0.31
8	**Incremental impact of capital investment decisions on the housing rent levels**	£ -0.16	£ -0.28	£ 4.29
9	**Upper limits on fixed interest rate investments** (against maximum position)	**Maximum** 99%	**Maximum** 100%	**Maximum** 100%
10	**Upper limits on variable interest rate investments** (against maximum position)	**Maximum** 24**%**	**Maximum** 50%	**Maximum** 60%
11	**Upper limit on fixed interest rate borrowing** (against maximum position)	**Maximum** 100%	**Maximum** 100%	**Maximum** 100%
12	**Upper limit on variable interest rate borrowing** (against maximum position)	**Maximum** 0%	**Maximum** 50%	**Maximum** 0%
13	**Maturity structure of fixed rate borrowing** (against maximum position)			
	Under 12 months (temporary borrowing only)	100%	**Upper Limit** 100%	1%
	12 months to 2 years	0%	100%	0%
	2 years to 5 years	0%	100%	0%
	5 years to 10 years	0%	100%	14%
	10 years and above	0%	100%	85%
14	**Maturity structure of variable rate investments** (against maximum position)			
	Under 12 months	100%	**Upper Limit** 100%	100%
	12 months to 2 years	0%	75%	0%
	2 years to 5 years	0%	75%	0%
15	**Maximum principal funds invested** (against maximum position)	**Maximum** 48,225	**Maximum** 50,000	**Maximum** 52,365

2.3 Any indicators that were exceeded were guideline limits only. There were no breaches of statutory limits during the year.

2.4 At note 4a and 5a the revised Authorised Limit and Operational Boundary are shown. These were revised to accommodate the borrowing needed for the HRA Finance Settlement on 28 March 2012.

2.5 At note 10 the upper limit on variable interest rate investments was exceeded on two days only which were the 30 and 31 March 2012. As more funds are now invested with the Money Market Funds, which pay a variable rate of interest, it is likely that the proportion of funds invested in these instruments will be higher and that the limit will be revised for the future.

2.6 In addition to the above the Council is required as a Prudential Indicator to:

- Adopt the CIPFA Code of Practice. The compliance for this indicator is shown at paragraph 2.1 in the body of the report.

- Ensure that over the medium term borrowing will only be for a capital purpose (i.e. net external borrowing is less than the CFR). The compliance for this indicator is shown at paragraph 3.1 below.

3. LIMITS TO BORROWING ACTIVITY

3.1 Net external borrowing

	31 March 2011 Actual	31 March 2012 Original Indicator	31 March 2012 Actual
Net borrowing position	**-£21.2m**	**-£14.0m**	**£116.8m**
Capital Financing Requirement	**£7.0m**	**£7.1m**	**£149.1m**

The Capital Financing Requirement (CFR) shows the Council's underlying need to borrow for a capital purpose, and this is an indication of the Council's debt position. In order to ensure that borrowing net of investments will only be for a capital purpose, net borrowing should not exceed the CFR for 2011/12.

The table above shows that the Council has complied with this requirement.

3.2 Borrowing Limits

	2011/12
Authorised Limit (revised)	**£176.0m**
Operational Boundary (revised)	**£150.0m**
Maximum gross borrowing position during the year	**£143.2m**
Average gross borrowing position during the year	**£1.6m**
Minimum gross borrowing position during the year	**£0.0m**

The Authorised Limit must not be breached. The table demonstrates that during 2011/12 the Council has maintained gross borrowing within its Authorised Limit.

The Operational Boundary is the expected average borrowing position of the Council during the year, and periods where the actual position is either below or over the Boundary is acceptable subject to the Authorised Limit not being breached.

4. TREASURY SERVICE PERFORMANCE INDICATORS FOR 2011/12

The treasury service has set the following performance indicators:

- The return on interest earnings should be higher than a benchmark of the 7-day LIBID rate averaged over the year.

5. RISK AND PERFORMANCE

5.1 The Council has complied with all of the relevant statutory and regulatory requirements that limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means that its capital expenditure is prudent, affordable and sustainable, and that its treasury practices demonstrate a low risk approach.

5.2 The Council is aware of the risks of passive management of the treasury portfolio and has proactively managed the investments over the year within the constraints of the investment guidelines.

5.3 Shorter-term market rates and likely future movements of interest rates predominantly determine the Council's investment return. These returns can therefore be volatile and, whilst the risk of loss of principal is minimised through the annual investment strategy, accurately forecasting future returns can be difficult.

5.4 Section 6 and 7 of appendix 1 shows the returns for 2011/12.