REPORT FOR:	GOVERNANCE, AUDIT AND RISK MANAGEMENT COMMITTEE
Date:	26 June 2012
Subject:	Treasury Management Outturn Report 2011/12
Responsible Officer:	Julie Alderson, Corporate Director Resources
Exempt:	No
Enclosures:	Appendix 1 – Prudential Indicators Appendix 2 – Counterparty Policy

Section 1 – Summary and Recommendations

This report sets out the summary of Treasury Management activities for 2011/12

Recommendations:

The Committee is requested to review and note the outturn position for Treasury Management activities for 2011/12.

Section 2 – Report

Referral to GARM

1. The paper that follows is due to be discussed by Cabinet on 20 June 2012. In line with GARMC's role to scrutinise treasury management activities, Cabinet will refer this report to GARMC. The remainder of the report is identical to that presented to Cabinet.

Introduction

1. Treasury Management is the management of the Council's investments and cash flows, its banking, money market and debt transactions together with the effective control of the risks associated with those activities.

2. The Council is required through regulations issued under the Local Government Act 2003 to produce an annual treasury report reviewing treasury management activities and the 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).

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

- An annual treasury strategy in advance of the year (Council 16 February 2011).
- A mid year treasury update report (Cabinet 15 December 2011).
- An annual report following the year end describing the activity compared to the strategy (this report).

4. The regulatory environment places an onus on members to review and scrutinise the 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. The additional requirements for scrutiny have been delegated to the Governance, Audit and Risk Management Committee (GARMC) and this report will be submitted to GARMC. The Treasury Management Group chaired by the Corporate Director of Resources meets monthly to review treasury activity.

5. This annual treasury report covers

- Overall outturn position on treasury management,
- Council's treasury position as at 31 March 2012,
- The economy in 2011/12,
- Borrowing outturn for 2011/12,
- Investment outturn for 2011/12; and
- Compliance with treasury limits and Prudential Indicators.

Outturn Position

6. There was a favourable variance of £1.5 million on the updated capital financing budget of £22.2 million as detailed below:-

	Latest Budget	Outturn	Variation	
	£000	£000	£000	%
Cost of Borrowing	10,905	11,295	390	3.6%
Investment Income	-498	-1,287	-789	-158%
Minimum Revenue Provision	11,847	10,731	-1,116	-9.4%
Total	**22,254**	**20,739**	**-1,515**	**-6.8%**

7. The favourable outcome arose due to:

(a) Borrowing – gross borrowing costs (excluding allocations) are in line with the budget. The increased costs, relate to (1) allocations to HRA that are £300,000 lower than estimated reflecting the impact of Libid rates (Libid is the rate at which banks will typically expect to receive on lending to other banks) on the specific formula that applies to HRA, and (2) a mid year virement that reduced the budget by £142,000.

(b) Income – the average of interest earned was 1.65%, which compares favourably with the prior year (1.30%) and three month Libid (0.81%). The budget was based on a rate of 0.94%. The average investment balance also exceeded the forecast - £117 million v £86 million.

(c) MRP – The favourable variance results from project underspend and slippage on completion timetables.

Treasury Position as at 31 March 2012

8. The Council's debt and investment position at the beginning and the end of the year was as follows:

	31st March 2012	**Average Rate**	**Average Life yrs**	31st March 2011	Average Rate	Average Life yrs
	£m	**%**	**Yrs**	£m	%	Yrs
Fixed Rate Borrowing						
Public Works Loan Board (PWLB)	218.5	4.09	39.1	130.0	4.50	32.8
Market	131.8	4.65	35.4	131.8	4.65	36.4
Total Debt	**350.3**	**4.30**	**37.8**	**261.8**	**4.57**	34.6
Investments:						
In-House	89.3	1.65	216 days	112.9	1.30	219 days
Total Investments	**89.3**			**112.9**		

The above analysis assumes loans structured as LOBOs (see paragraph 16 below for definition and further details) mature at the end of the contractual period. If the first date at which the lender can reset interest rates was used as the maturity date, the average life for market loans would be 3.1 years and for the whole debt portfolio 25.6 years.

9. Details on borrowing and investment activities follow in the report.

The Economy and Interest Rates

10. 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 Bank Rate would start gently rising from quarter 4 2011. However, GDP growth in the UK was disappointing during the year under the weight 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. The EU sovereign debt crisis grew in intensity during the year, abating temporarily when a second bailout package was eventually agreed for Greece. Inconclusive elections in Greece and growing concerns with Spanish banks combined to reawaken concerns after the year end. 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% but then fell to 3.0% in April 2012, with further falls expected to below 2% over the next two years.

11. Gilt yields fell throughout the year as concerns continued over the EU debt crisis. This resulted in safe haven flows into UK gilts which, together with the two UK packages of quantitative easing during the year, combined to depress PWLB rates to historically low levels. Ten year gilt yields fell to the lowest on record in May 2012.

12. 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 ratings of many banks and sovereigns, continued Eurozone concerns, and the significant funding issues still faced by many financial institutions, meant that many investors remained cautious of longer-term commitment despite the significant pickups available for 1-2 year maturities.

Borrowing Outturn for 2011/12

13. Total long term debt of £350.3 million at the end of March 2012 is made up £131.8 million bank loans and £218.5 million from the PWLB.

14. There was one new loan during the year, with £88.5 million borrowed from the PWLB at an interest rate of 3.48%, with a maturity of 50 years from 28th March 2012. The loan was used to fund the cost of the Housing Revenue Account self-financing requirement to withdraw from the Government Subsidy scheme.

The table below sets out the borrowing maturity profile

	31st March 2012		31st March 2011	
	£m	**%**	£m	%
Under 12 Months	0.0	0.0	0.0	0.0
12 Months and under 24 Months	10.0	2.9	0.0	0.0
24 Months and within 5 years	6.0	1.7	10.0	3.8
5 years and within 10 years	32.0	9.1	38.0	14.5
10 years and above	302.3	86.3	213.8	81.7
Total	**350.3**	**100.0**	261.8	100.0

15. As highlighted in section 8, the average interest rate on debt has moved over the course of the year from 4.57% to 4.30**%.** The approach to funding capital expenditure as discussed in the February 2011 strategy was mainly to use internal funds in recognition of the unfavourable gap between investment returns and borrowing costs and secondly to draw longer term fixed rate debt, to take advantage of low long term rates and to reduce exposure to fluctuations in short term interest rates. The HRA settlement payment was entirely funded from 50 year PWLB debt as the rate achieved of 3.48% was exceptionally low, a function of the impact of the Euro crisis and quantitative easing on gilt rates, together with the reduction of 0.75% in the surcharge over gilts normally levied on PWLB borrowing. With expectations that gilt yields will increase in the next 2-5 years, any additional costs of carrying surplus cash in the short term will be greatly offset with longer term savings in borrowing costs.

16. In aggregate there is £83.8 million of Lender Option Borrower Option (LOBO) structured loans shown in the table above as having maturities of between 38 and 66 years. The lenders are permitted to reset interest rates five years after the loan is drawn and either semi-annually or annually thereafter. Should interest rates on these loans increase, the Council is able to repay at no cost. The table below restates the

maturity profile by including LOBO loans at their first interest reset date. Although gilt rates are at historic lows, there would be a cost to refinance the LOBO loans with traditional borrowing structures.

	31st March 2012	
	£m	%
Under 12 Months	33.8	9.6
12 Months and under 24 Months	10.0	2.9
24 Months and within 5 years	76.0	21.7
5 years and within 10 years	12.0	3.4
10 years and above	218.5	62.4
Total	**350.3**	**100.0**

Investment Outturn for 2011/12

17. The Bank of England base rate has remained at 0.5% since March 2009 while annual average 7 day and 3 month Libid rates of 0.48% and 0.81% respectively have made investing over short horizons unattractive. The investment portfolio achieved an average return of 1.65% in the year, exceeding both the 7 day and 3 month Libid rates.

18. The Council manages its investments in-house and invests with the institutions listed in the Council's approved lending list. The Council will invest for a range of periods from overnight to two years (historically up to five years), dependent on the Council's cash flows, its interest rate view and the interest rates on offer. During the year all investments were made in full compliance with the Council's treasury management policies and practices. Further detail of the credit quality of counterparties is given in appendix 2.

19. At 31st March 2012 the investment portfolio is invested over a spread of maturities up to three years, although the majority is kept short term due to uncertainties over interest rate movements and future cashflow timing. At the year end £18 million matures in more than 12 months taking advantage of the longer tern rates available. These deposits yield between 2.7% and 3.6%, considerably greater than three month deposits which yield less than 1%. Since the revised counterparty policy was approved by Council in February 2012 no new investment has exceeded 24 month duration, although 36 months is permitted for the part nationalised banks.

20. Most deposits are with UK High Street Banks (Barclays, Lloyds, HBOS, RBS, Santander) with Nationwide the only building society and Svenska Handelsbanken the only overseas bank. In addition, three money market funds offering daily liquidity are used. Since the year end all deposits with Santander UK have been repaid. In prior years most of the counterparties met the credit quality required to be "Specified Investments". Following the credit rating downgrades to banks during the autumn of 2011, this is no longer the case.

21. The returns from the investment portfolio are benchmarked by the treasury advisor, Sector, and in the year the weighted average return calculated by Sector of 1.77%

exceeded both their model portfolio (1.76%) and the average of other London Boroughs (1.28%).

22. The table below sets out the investment balances as at 31 March 2012.

	31st March 2012		31st March 2011	
	£m	**%**	£m	%
Specified Investments				
Banks & Building Societies	0.1	0.1	87.2	77.3
Money Market Funds	5.7	6.4	7.7	6.8
Non –Specified Investments				
Banks & Building Soc.	83.5	93.5	18.0	15.9
Total	**89.3**	**100.0**	112.9	100.0

23. Included in the above balances are funds of £10.6 million as at 31 March 2012 invested on behalf of the West London Waste Authority. Since 1st April 2011, the cash balances of the pension fund (£21.1 million as at 31st March 2012) have been held in separate accounts with RBS to comply with new regulations. In aggregate 34% of interest earned is allocated both to the WLWA and to internal funds (schools, housing, insurance etc).

Compliance with Treasury Limits

24. The prudential framework for local authority capital investment was introduced through the Local Government Act 2003. The prudential system provides a flexible framework approach within which capital assets can be procured, managed, maintained and developed. Under this framework, individual authorities are responsible for deciding the level of their affordable borrowing for the Council's capital investment plans that is demonstrated to be affordable, prudent and sustainable.

25. The Act and the supporting regulations require the Council to have regard to the Prudential Code and to set Prudential Indicators for the next three years. The indicators for 2011/12 were approved by the Cabinet in February 2011. During the financial year the Council operated within the treasury limits and Prudential Indicators as shown in Appendix 1.

26. The total capital expenditure for 2011/12 was £35.3 million. Approximately £16.4 million (46% of the total expenditure) was funded from grants, revenue contributions and capital receipts. This resulted in the borrowing requirement of £18.9 million. These values exclude the HRA settlement payment of £88.5 million that was entirely funded by borrowing.

Minimum Revenue Provision (MRP)

27. Under the statutory regulations a Minimum Revenue Provision is made each year to repay the outstanding debt on assets. This is calculated by spreading the capital expenditure over the useful life of the asset.

Financial Implications

28. Financial matters are integral to the report.

Environmental Impact

29. There are no direct environmental impacts.

Performance Issues

30. The Council meets the requirements of the CIPFA Code of Practice for Treasury Management and therefore is able to demonstrate best practices for the Treasury Management function

Risk Management Implications

31. The identification, monitoring and control of risk are central to the achievement of the treasury objectives. Potential risks are identified, mitigated and monitored in accordance with treasury practice notes approved by the Treasury Management Group.

    Risk included on Directorate risk register? Yes
    Separate risk register in place? No

Equalities Implications

32. There is no direct equalities impact.

Corporate Priorities

33. This report deals with the Treasury Management Strategy which is a key to delivering the Council's corporate priorities

Section 3 - Statutory Officer Clearance

Name: Julie Alderson Date: 13 June 2012	√	Chief Financial Officer
Name: Matthew Adams Date: 13 June 2012	√	on behalf of the Monitoring Officer

Section 4 - Contact Details and Background Papers

Contact: George Bruce (Treasury and Pension Fund Manager, Finance & Procurement) Tel: 020-8424-1170 / Email: george.bruce@harrow.gov.uk

Background Papers: N/A

Prudential Indicators

Capital Expenditure and Funding

Table 1	2010/11	2011/12	2011/12
	Actual	Approved	Actual
	£'000	£'000	£'000
Capital Expenditure			
Non - HRA	52,645	45,905	29,226
HRA - settlement funding	0	0	88,461
HRA - routine	5,302	6,360	6,094
TOTAL Expenditure	**57,947**	**52,265**	**123,781**
Funding:-			
Grants	26,101	10,556	10,936
Capital Receipts	5,462	12,789	4,895
Revenue Financing	290	0	528
Major Repairs Allowance	3,932	4,148	0
Total Funding	**35,785**	**27,493**	**16,359**
Internal Borrowing	**2,162**	**24,772**	**18,961**
External Borrowing - HRA settlement	**0**	**0**	**88,461**
External Borrowing – General Fund	**20,000**	**0**	**0**
Total new Borrowing	**22,162**	**24,772**	**107,422**

The above table summarises capital expenditure and sources of funding. General Fund capital expenditure of £29 million in 2011-12 is £17 million lower than that approved in February 2011 and also less than the mid year projection as project completions have been carried forward into the new year. HRA capital expenditure includes the cost of the HRA settlement payment (£88.5 million). Capital receipts are also lower than expected, with the net borrowing needs funded from existing cash balances except for the HRA settlement.

Ratio of Financing Costs to Net Revenue Stream

Table 2	2010/11	2011/12	2011/12
	actual	approved	actual
	£'000	£'000	£'000
Ratio of financing costs to net revenue stream			
Non - HRA	12.95%	11.67%	11.72%
HRA	24.82%	24.76%	8.61%

These ratios consider the affordability of capital expenditure by comparing net interest costs and depreciation with net revenues. A ratio that increases indicates that capital costs take a larger share of resources. The 2011/12 strategy (middle column) omitted finance leasing costs from the ratio, as was the policy at that time. If this had been included, the Non-HRA ratio would have been 12.85% (instead of 11.67%), indicating an improvement in the year.

The ratio of financing costs to revenue for HRA has fallen due to the capitalisation of MRA charges for 2011-12, which will be released in the next two years. The impact is to increase the HRA borrowing cap by the value of the postponed MRA (£4.1 million).

Net Borrowing Requirements

Table 3	2010/11	2011/12	2011/12
	actual	approved	actual
	£'000	£'000	£'000
Net borrowing requirement			
brought forward 1 April	182,054	203,192	195,898
carried forward 31 March	195,898	218,531	294,681
In year borrowing requirement	**13,844**	**-15,339**	**98,783**

The net borrowing requirement looks at the change in debt less investment balances. The increase of £98.8 million is less than the capital expenditure of £107 million (table 1 above) indicating that cash has been generated by revenue transactions.

Capital Financing Requirement

Table 4	2010/11	2011/12	2011/12
	actual	approved	actual
	£'000	£'000	£'000
Capital Financing Requirement as at 31 March			
Non – HRA	251,470	254,866	253,069
HRA	55,197	58,589	149,614
Total	**306,667**	**313,455**	**402,683**
Annual change in CFR			
Non – HRA	13,037	2,117	1,599
HRA	710	1,012	94,717
Total	**13,747**	**3,129**	**96,016**

The Capital Financing Requirement is the historic outstanding capital expenditure that has not been allocated to revenue. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure that is not funded from revenue increases the CFR. The value of finance leases is included. The value is greater than the outstanding borrowing of £375 million, indicating the level of cash generated by revenue balances.

The increase in the year is mainly the HRA settlement payments together with net new capital expenditure less MRP.

Incremental Impact of Capital Investment Decisions

Table 5	2010/11	2011/12	2011/12
	actual	approved	actual
	£'000	£'000	£'000
Incremental impact of capital investment decisions	**£ p**	**£ p**	**£ p**
Increase in council tax (band D) per annum	21.14	53.65	26.74
Increase in average housing rent per week	0.07	1.02	-14.31

The incremental ratios identifies the impact of the cost of debt and depreciation (MRP) linked to new capital borrowing on council taxes and rents. A high or growing ratio would suggest that council taxes or rents will have to increase to fund the capital expenditure programme. The ratio ignores the favourable impact of assets that have become fully depreciated and drop out of the MRP charge.

The incremental impact of General Fund capital investment decisions on council taxes is reduced by the lower capital expenditure, which reduces both financing costs and MRP. For HRA the impact of capitalising one year's MRA is to show a negative cost, which is an ‘accounting anomaly’ that will reverse in 2012-13.

Ratio of Net to Gross Borrowing

Table 6	**2010/11**	**2011/12**	**2011/12**
	actual	**approved**	**actual**
	£'000	**£'000**	**£'000**
Net to Gross Debt Limit			
Gross borrowing	278,908	279,032	375,254
Net borrowing	195,898	218,531	294,681
Net debt percentage	70%	78.3%	78.5%
Minimum ratio		75%	75%

This indicator is designed to highlight borrowing in advance of needs, when large investment cash balances are carried relative to debt. The ratio is expected to increase (which is deemed favourable) as cash balances are reduced to fund the capital programme.

Borrowing and Investment Limits

Table 7	**2010/11**	**2011/12**	**2011/12**
	actual	**approved**	**actual**
	£'m	**£'m**	**£'m**
Authorised Limit for external debt			
Borrowing and finance leases	288	398	375
Operational Boundary for external debt			
Borrowing	262	366	350
Other long term liabilities	26	20	25
Total	288	386	375
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing	262	386	375
Upper limit for variable rate exposure			
Net principal re variable rate borrowing	0	100	0
Upper limit for principal sums invested over 364 days	18	25	18

The approved operational boundary for debt is based on actual debt at the start of the year plus the net projected capital expenditure in the year. The authorised limit is based on CFR balances and includes an allowance for delayed capital receipts. Total borrowing was within both limits during the year. The operational boundary for finance leases was exceeded due to a miscalculation of the actual values when the boundary was set.

Maturity Profile of Debt

Table 8 Maturity structure of borrowing during 2011/12	upper limit	lower limit	Actual March 2012	
	%	%	£m	%
under 12 months	20	0	33.8	9.6
12 months and within 24 months	20	0	10.0	2.9
24 months and within 5 years	30	0	76.0	21.7
5 years and within 10 years	40	10	12.0	3.4
10 years and above	90	30	218.5	62.4
Total			350.3	100.00

The maturity profile of borrowing in the table above is based on the first LOBO loan interest reset dates being taken as the maturity date. No range limits are exceeded, although by 2015 all LOBO loans (currently 24% of borrowing) will fall within the 0-12 month category.

Counterparty Policy

1. The counterparty policy for investments is reviewed annually and approved by both Cabinet and Council, the latest review being in February 2012. The table below identifies the banks in use at the year-end listed against the appropriate counterparty criteria.

Specified Investments

Instrument	Minimum Credit Criteria	Max. maturity period	Year -end Counterparties	Balances £'m
Debt Management Agency Deposit Facility	Government backed	12 months	N/A	0.0
Term deposits – other LAs	Local Authority issue	12 months	N/A	0.0
Term deposits – banks and building societies	AA- Long Term F1+Short-term 2 Support B Individual AAA Sovereign	12 months	Svenska Handelsbanken	0.1
Money Market Funds	AAA	daily	3 funds	5.7
Total Specified Investments				**5.8**

Non Specified Investments

	Minimum Credit Criteria	Max. maturity	Year -end Counterparties	Balances £'m
Term deposits – banks and building societies	A Long Term F1 Short-term 1 Support B Individual UK or AAA Sovereign	3 months	Barclays Nationwide Santander	9.0 20.0 8.0
UK nationalised Banks [RBS & Lloyds / HBOS]	F1 Short-term 1 Support	36 months	Lloyds/BoS RBS	25.0 21.5
Callable Deposits	F1 Short term A Long Term 1 Support	3 months		
Total Non Specified Investments				**83.5**
Total Investments				**89.3**

2. Only one bank meets the credit quality required to be classified as a “Specified Investment”. Other than the two part nationalised banks, all new deposits since December 2011 have a maximum maturity of three months. There are deposits with Nationwide (£5 million) made prior to the change in guidelines that do not mature until November 2013.