ARGYLL AND BUTE COUNCIL | **COUNCIL**
STRATEGIC FINANCE | **28 JUNE 2012**

TREASURY MANAGEMENT ANNUAL REPORT 2011-2012

1. INTRODUCTION

1.1 This report summarises the key points from the treasury management annual report. Preparation of an annual report is a requirement of the Chartered Institute of Public Finance and Accountancy Code of Practice on Treasury Management in Local Authorities.

2. RECOMMENDATIONS

2.1 Members note the annual report on treasury management.

3. DETAILS

3.1 The following highlights key details from the annual report.

3.1.1 Total external debt of £160.408 as at 31 March 2012 with an average rate of interest of 6.139%. This compares to debt of £160.341m with an average rate of 6.139% at March 2011.

3.1.2 No new long term borrowing was taken during the year.

3.1.3 An average return of 0.8% was achieved for cash invested in the various instruments available to the Council during 2011-2012. This compares favourably with a London Interbank Bid rate of 0.480%.

3.1.4 No long term borrowing was repaid during the year.

3.1.5 During the financial year the Council operated within the treasury limits set out in the Council's Treasury Policy Statement and Treasury Strategy Statement.

Bruce West
Head of Strategic Finance
20 June 2012

ANNUAL TREASURY REPORT

2011-2012

Annual Treasury Management Review 2011/12

Purpose

This Council is required by regulations issued under the Local Government in Scotland 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).

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

- an annual treasury strategy in advance of the year (Council 13/03/2011)
- a mid year (minimum) treasury update report (Executive 15/12/2011)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

In addition, this Council has received quarterly treasury management update reports on 11/08/2011 and 8/03/2012 which were received by the Executive.

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.

This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Spokesperson for Resources before they were reported to the full Council.

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:

Actual prudential and treasury indicators	2010/11 Actual £000	2011/12 Original £000	2011/12 Actual £000
Actual Capital Expenditure	21,201	38,094	25,575
Total Capital Financing Requirement	264,977	282,122	256,617
Net Borrowing	125,505	140,000	122,446
External Debt	160,341	150,000	160,408
Investments (Under 1 year)	34,836	10,000	37,962

Other prudential and treasury indicators are to be found in the main body of this report. The Head of Strategic Finance 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 environment of previous years; low investment returns and continuing counterparty risk continued.

Recommendations

The Council is recommended to:

1. Approve the actual 2011/12 prudential and treasury indicators in this report
2. Note the annual treasury management report for 2011/12

1. 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.

2. 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.

	2010/11 Actual £000	2011/12 Original £000	2011/12 Actual £000
Capital Expenditure	**21,201**	**38,094**	**25,575**
Total Capital Financing Requirement			
Resourced by:			
Capital Receipts	0	0	0
Capital Grants	7,095	12,651	11,479
Revenue	915	0	124
Unfinanced Capital Expenditure	**13,191**	**25,443**	**13,972**

3. 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. 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 Scheduled Debt Amortisation or loans repayments, 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 revenue charge each year.

The Council's CFR for the year is shown below, and represents a key prudential indicator. This includes PFI and leasing schemes on the balance sheet, which increase the Council's borrowing need, the CFR. No borrowing is actually required against these schemes as a borrowing facility is included in the contract.

CFR	**31 March 2011 Actual £000**	**31 March 2012 Original £000**	**31 March 2012 Actual £000**
Opening Balance	**274,020**	**279,431**	**264,977**
Add Unfinanced capital	13,191	25,443	13,972
Less Debt Repayments	20,416	21,183	20,584
Less Finance Lease Repayments	1,806	1,569	1,569
Less Other	12	0	179
Closing Balance	**264,977**	**282,122**	**256,617**

The 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. 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.

CFR	**31 March 2011 Actual £000**	**31 March 2012 Original £000**	**31 March 2012 Actual £000**
Net Borrowing Position	125,505	140,000	122,446
CFR	264,977	282,122	256,617

The authorised limit - the authorised limit is the maximum borrowing limit and the Council does not have the power to borrow above this level. The table below demonstrates that during 2010/11 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 £000
Authorised Limit	**330,500**
Maximum Gross Borrowing Position	244,396
Operational Boundary	322,500
Average Gross Borrowing Position	243,690
Financing Costs as a proportion of net revenue stream	11.00%

4. 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:

	Principal 31 March 2012 £m	£m	Rate/ Return %	Average Life years	Principal 31 March 2011 £m	£m	Rate/ Return %	Average Life years
Fixed Rate Funding:								
- PWLB	108.066				108.066			
- Market	12.554				12.554			
		120.620	**6.718%**	**24.24**		**120.620**	**6.718%**	**25.24**
Variable Rate Funding:								
- PWLB								
- Market	39.255				39.255			
		39.255	**4.430%**	**56.58**		**39.255**	**4.430%**	**57.58**
Temporary Loans		**0.533**	**0.187%**			**0.466**	**0.142%**	
Total Debt		**160.408**	**6.139%**	**32.18**		**160.341**	**6.139%**	**33.18**
Investments		**37.962**	**1.668%**			**34.835**	**0.750%**	

PWLB - Public Works Loan Board

The Council's investments were all for under one year at a variable rate of interest.

The maturity structure of the debt portfolio was as follows:

	2010/11 Actual £000	**2011/12 Actual £000**
Under 12 months	496	554
12 months and within 24 months	1	1
24 months and within 5 years	18,930	36,786
5 years and within 10 years	34,304	22,911
10 years and above	106,610	100,156

5. 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 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 in financial markets if the Greek debt crisis were to develop into a precipitous default and exit from the Euro.

6. The Economy and Interest Rates

Sovereign debt crisis. 2011/12 was the year when financial markets were apprehensive, fearful of the potential of another Lehman's type financial crisis, prompted by a precipitous Greek Government debt default. At almost the last hour, the European Central Bank (ECB) calmed market concerns of a liquidity crisis among European Union (EU) banks by making available two huge three year credit lines, totalling close to €1 trillion, at 1%. This also provided a major incentive for those same banks to then use this new liquidity to buy EU sovereign debt yielding considerably more than 1%.

A secondary benefit of this initiative was the bringing down of sovereign debt yields, for the likes of Italy and Spain, below unsustainable levels. The final aspects in the calming of the EU sovereign debt crisis were two eleventh hour agreements: one by the Greek Government of another major austerity package and the second, by private creditors, of a "haircut" (discount) on the value of Greek debt that they held, resulting in a major reduction in the total outstanding level of Greek debt. These agreements were a prerequisite for a second EU / IMF bailout package for Greece which was signed off in March.

Despite this second bailout, major concerns remain that these measures were merely a postponement of the debt crisis, rather than a solution, as they did not address the problem of low growth and loss of competitiveness in not only Greece, but also in other EU countries with major debt imbalances. These problems will, in turn, also affect the financial strength of many already weakened EU banks during the expected economic downturn in the EU. There are also major questions as to whether the Greek Government will be able to deliver on its promises of cuts in expenditure and increasing tax collection rates, given the hostility of much of the population. In addition, an impending general election in May 2012 will deliver a democratic verdict on the way that Greece is being governed under intense austerity pressure from the northern EU states.

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 credit ratings from one rating agency during the year.

UK growth proved mixed over the year. In quarter 2, GDP growth was zero, but then quarter 3 surprised with a return to robust growth of 0.6% q/q before moving back into negative territory (-0.3%) in quarter 4. The year finished with prospects for the UK economy being decidedly downbeat due to a return to negative growth in the EU in quarter 4, our largest trading partner, and a sharp increase in world oil prices caused by Middle East concerns. However, there was also a return of some economic optimism for growth outside the EU and dovish comments from the major western central banks: the Fed in America may even be considering a third dose of quantitative easing to boost growth.

UK CPI inflation started the year at 4.5% and peaked at 5.2% in September. The fall out of the January 2011 VAT increase from the annual CPI figure in January 2012 helped to bring inflation down to 3.6%, finishing at 3.5% in March. Inflation is forecast to be on a downward trend to below 2% over the next year.

The Monetary Policy Committee agreed an increase in quantitative easing (QE) of £75bn in October on concerns of a downturn in growth and a forecast for inflation to fall below the 2% target. QE was targeted at further gilt purchases. The MPC then agreed another round of £50bn of QE in February 2012 to counter the negative impact of the EU debt and growth crisis on the UK.

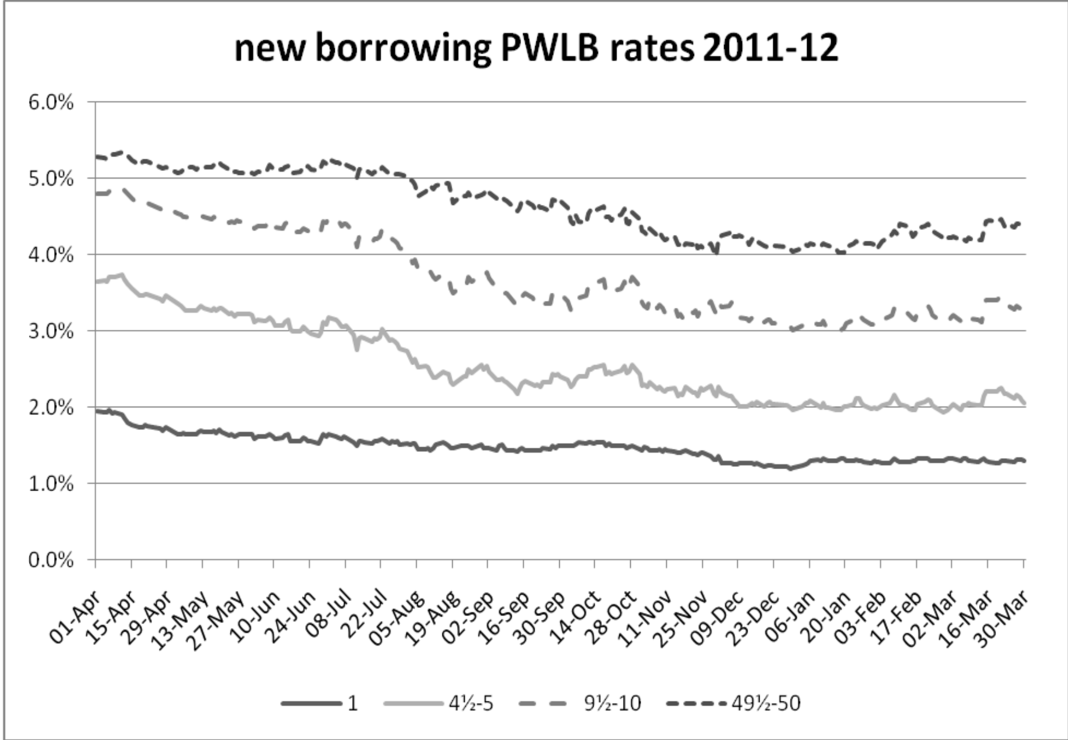
Gilt yields fell for much of the year, until February, as concerns continued building over the EU debt crisis. This resulted in safe haven flows into UK gilts which, together with the two UK packages of QE during the year, combined to depress PWLB rates to historically low levels.

Bank Rate was unchanged at 0.5% throughout the year while expectations of when the first increase would occur were steadily pushed back until the second half of 2013 at the earliest. Deposit rates picked up in the second half of the year as competition for cash increased among banks.

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.

7. Borrowing Rates in 2011/12

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



8. Borrowing Outturn for 2011/12

Treasury Borrowing

There was £203k of new temporary borrowing in 2011/12 at an average rate of 0.292%.

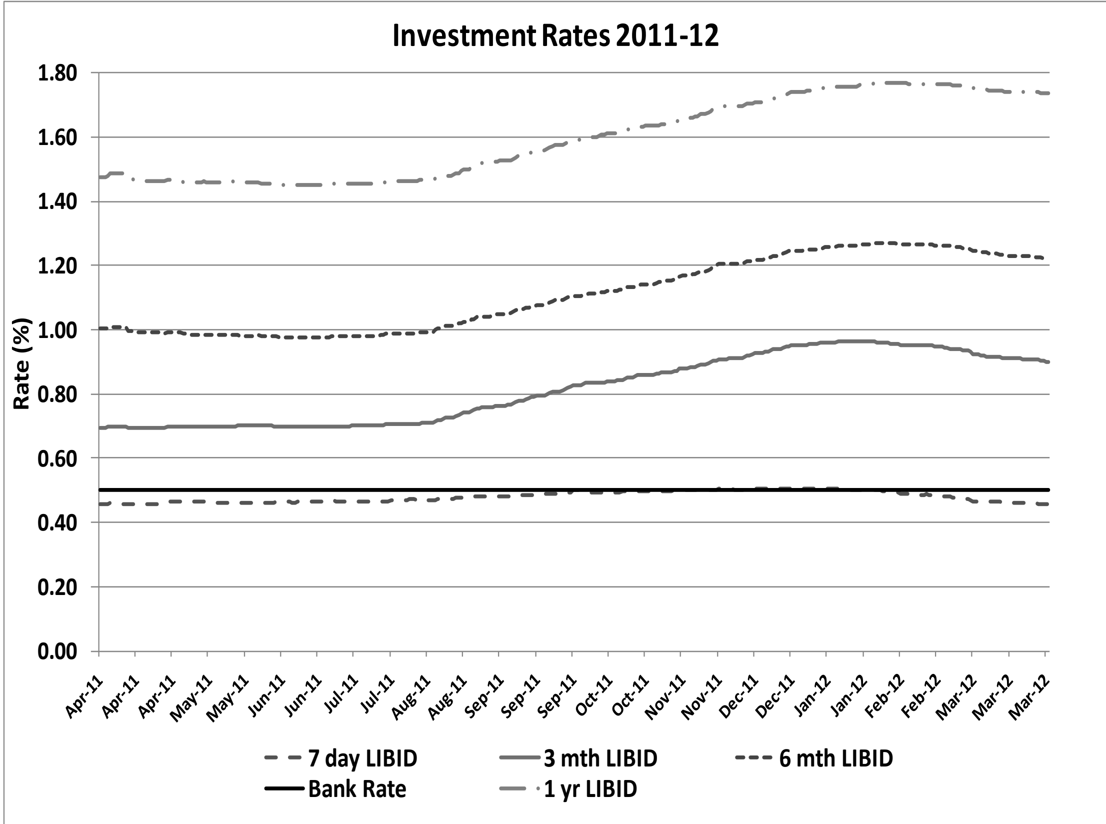
Repayment

There was £162k of temporary borrowing repaid in 2011/12.

9. 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.



10. Investment Outturn for 2011/12

Investment Policy – the Council's investment policy is governed by Scottish Government Investment Regulations, which was been implemented in the annual investment strategy approved by the Council on 26/6/2010. This policy sets out the approach for choosing investment categories and 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 longer term cash balances comprise, primarily, revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources comprised as follows, and met the expectations of the budget:

Balance Sheet Resources	31 March 2011 £m	31 March 2012 £m
General Fund Balance	33,907	34,572
Repairs and Renewals Fund	497	532
Provisions	235	419
Total	**34,639**	**35,523**

Investments held by the Council - the Council maintained an average balance of £47.4m of internally managed funds. The internally managed funds earned an average rate of return of 0.800%. The comparable performance indicator is the average 7-day LIBID rate, which was 0.480%.

Appendix 1

1. PRUDENTIAL INDICATORS	2010/11	2011/12	2011/12
	£ p	£ p	£ p
	estimate	estimate	actual
Capital Expenditure	£'000	£'000	£'000
Non - HRA	21,201	23,264	25,575
TOTAL	21,201	23,264	25,575
Ratio of financing costs to net revenue stream			
Non - HRA	13.09%	11.68%	11.00%
Net borrowing requirment			
brought forward 1 April *	274,020	279,431	264,977
carried forward 31 March *	264,977	282,122	256,617
in year borrowing requirement	(9,043)	2,691	(8,360)
In year Capital Financing Requirement			
Non - HRA	(9,043)	2,691	(8,360)
TOTAL	(9,043)	2,691	(8,360)
Capital Financing Requirement as at 31 March			
Non - HRA	264,977	282,122	256,617
TOTAL	264,977	282,122	256,617
Incremental impact of capital investment decisions	£ p	£ p	£ p
Increase in Council Tax (band D) per annum	38.97	32.40	39.61

2. TREASURY MANAGEMENT PRUDENTIAL INDICATORS	2010/11	2011/12	2011/12
	actual	original	actual
	£'000	£'000	£'000
Authorised limit for external debt -			
borrowing	240,000	239,000	239,000
other long term liabilities	91,500	91,500	91,500
TOTAL	331,500	330,500	330,500
Operational boundary for external debt -			
borrowing	235,000	234,000	234,000
other long term liabilities	88,500	88,500	88,500
TOTAL	323,500	322,500	322,500
Actual external debt	160,341	160,400	160,408
Upper limit for fixed interest rate exposure			
Principal re fixed rate borrowing	100%	100%	100%
Upper limit for variable rate exposure			
Principal re variable rate borrowing	30%	30%	30%
Upper limit for total principal sums invested for over 364 days (per maturity date)	£0.00	£10m	£10m

Maturity structure of new fixed rate borrowing during 2011/12	upper limit	lower limit
under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%