WIRRAL COUNCIL

CABINET

23 JUNE 2011

SUBJECT	**TREASURY MANAGEMENT ANNUAL REPORT 2010/11**
WARD/S AFFECTED	**ALL**
REPORT OF	**DIRECTOR OF FINANCE**
RESPONSIBLE PORTFOLIO HOLDER	**COUNCILLOR STEVE FOULKES**
KEY DECISION	**NO**

1.0 EXECUTIVE SUMMARY

1.1 This report presents a review of Treasury Management activities in 2010/11 and confirms compliance with treasury limits and prudential indicators. It has been prepared in accordance with the revised CIPFA Treasury Management Code and the revised Prudential Code.

2.0 RECOMMENDATIONS

2.1 That the Treasury Management Annual Report for 2010/11 be agreed.

2.2 That the transfer of additional investment income of £1 million and the saving of £2 million from capital financing activities in 2010/11 to the General Fund balance be agreed.

3.0 REASON FOR RECOMMENDATIONS

3.1 Wirral has adopted the CIPFA Code of Practice on Treasury Management (“the Code”), which includes quarterly reports to Members of treasury activity. This report is the year end review for 2010/11.

3.2 Under Council financial regulations any surplus resources are returned to balances and so used to support the delivery of other Council services.

4.0 BACKGROUND AND KEY ISSUES

4.1 Treasury management is defined as: “The management of the local authority 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.”

4.2 The Council has adopted the CIPFA Code of Practice on Treasury Management. This requires public sector authorities to determine an annual Treasury Management Strategy and as a minimum, formally report on their treasury activities and arrangements in mid-year and after the year-end. These reports enable those tasked with implementing policies and undertaking transactions to demonstrate that they have properly fulfilled their responsibilities. They also enable those with responsibility/governance of the treasury management function to scrutinise and assess its effectiveness and compliance with policies and objectives.

4.3 Cabinet approves the Treasury Management Strategy at the start of each financial year. This identifies how it is proposed to finance capital expenditure, borrow and invest in the light of capital spending requirements, the interest rate forecasts and the expected economic conditions. During the year Cabinet receives a quarterly monitoring report on treasury management activities and at the end of each financial year this Annual Report. Scrutiny of treasury policy, strategy and activity is delegated to the Council Excellence Overview and Scrutiny Committee.

ECONOMIC BACKGROUND

4.4 At the time of determining the Treasury Management Strategy for 2010/11, interest rates were expected to remain low in response to the state of the UK economy. Spending cuts and tax increases seemed inevitable after the General Election, if the Government had a clear majority. The markets had, at the time, viewed a hung parliament as potentially disruptive, particularly if combined with a failure to articulate a credible plan to reduce Government borrowing. The outlook for growth was uncertain due to consumers and organisations reducing their spending and financial institutions exercising restraint in new lending.

4.5 The two headline indicators moved in opposite directions. The economy grew by 1.3% in 2010 and the forecast for 2011 was revised down to 1.7% by the Office of Budget Responsibility in March 2011.Higher commodity, energy and food prices and the increase in VAT to 20% saw the February 2011 annual inflation figure at 4.4%. The Bank Rate was held at 0.5% as the economy reflected uneven growth and the austerity measures in the Spending Review (SR) in October 2010 reduced public expenditure.

4.6 The US Federal Reserve kept rates on hold at 0.25% and the European Central Bank maintained rates at 1%, with the markets expecting a rate rise in early 2010. The credit crisis migrated from banks to European states. The ratings of Ireland and Portugal were downgraded to the ‘triple-B’ category whilst Greece was downgraded to sub-investment grade. 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 main UK banks’ (Barclays, HSBC, Lloyds and RBS) Tier 1 ratios all remained above 9% under both the ‘benchmark scenario’ and the ‘adverse scenario’ stress tests.

4.7 Gilts benefitted from the Spending Review plans as well as from their relative 'safe haven' status in the face of European sovereign weakness. Five year and ten year gilt yields fell to 1.44% and 2.83% respectively. However, yields rose in the final quarter across all gilt maturities amid concern that higher inflation would become embedded and greatly diminish the real rate of return for fixed income investors.

4.8 During the year money market rates increased marginally at the shorter end (overnight to three months) whilst six to twelve month rates increased between 0.25% to 0.30% over the year reflecting the expectation that the Bank Rate would be raised later in 2011.

INVESTMENT ACTIVITY

4.9 The Department for Communities and Local Government (DCLG) issued revised Investment Guidance which came into effect on 1 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.

4.10 The opening and closing investment portfolio for 2010/11:-

INVESTMENTS	**Balance at 1 April 2010 £m**	**%**	**Balance at 31 March 2011 £m**	**%**
<u>Current Assets (Cash Equivalents)</u> Loans and Receivables - Specified	21	20	12	9
Available for sale financial assets - Specified	6	6	50	37
<u>Current Assets (Short Term Investments)</u> Loans and Receivables - Specified	68	- 63	60	44
Available for sale financial assets - Specified	-	-	2	1
<u>Long Term Investments</u> Loans and Receivables - Non Specified	3	- 3	4	3
Available for sale financial assets - Non Specified	8	8	8	6
TOTAL INVESTMENTS	**106**		**136**	

4.11 Security of capital remained the main investment objective. This was maintained by following the counterparty policy as set out in the Treasury Management Strategy Statement for 2010/11. Investments included:-

- Deposits with other Local Authorities.
- Investments in AAA-rated Stable Net Asset Value Money Market Funds.
- Call accounts and deposits with UK Banks and Building Societies.
- Bonds issued by Multilateral Development Banks.
- Pooled funds (collective investment schemes) meeting the criteria in SI 2004 No 534 and subsequent amendments.

4.12 Counterparty credit quality was assessed and monitored with reference to credit ratings (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 throughout the year.

4.13 In keeping with the DCLG Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds and the use of call accounts.

4.14 The Council sought to optimise returns commensurate with the 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. Income earned on longer-dated investments made in 2009/10 provided some cushion against the low interest rate environment. New longer-term investments were made by purchasing bonds issued by multilateral development banks providing excellent security and an enhanced yield over the equivalent SONIA (Sterling Overnight Index Average) rate.

4.15 In respect of Icelandic investments the Council had £2 million deposited with Heritable Bank, a UK registered Bank, at an interest rate of 6.22% which was due to mature on 28 November 2008. The Company was placed in administration on 7 October 2008. Members have received regular updates regarding the circumstances and the latest situation. In March 2009 an Audit Commission report confirmed that Wirral Council had acted, and continues to act, prudently and properly in all its investment activities.

4.16 The latest creditor progress report issued by the Administrators Ernst and Young, dated 28 January 2010, outlined that the return to creditors is projected to be 85p in the £ by the end of 2012 and the final recovery could be higher. To date, £1.1 million has been received with a further £0.7 million expected before Autumn 2012. However, it should be noted that the amount and timing of future payments are estimates and are not definitive. Favourable changes in market conditions could lead to higher than estimated repayments.

4.17 In summary the budgeted investment income for the year had been estimated at £0.7 million and the actual interest earned was £1.7 million with this additional £1 million principally due to:-

- Average investment balances during the year being higher than originally budgeted which was mainly due to slippage in capital expenditure;
- Continuing proactive daily cash flow management by the Treasury Management Team.

Summary

4.18 The average return on investments for 2010/11 was 1.26%. To place this in context, in 2010/11 the average Bank of England base rate was 0.5% and the average rate of return achieved by the Local Authorities advised by the Treasury Management consultants, Arlingclose, was 0.95%. It should also be noted that Wirral Council's credit risk rating is also lower than the average of these other Local Authorities.

BORROWING ACTIVITY

4.19 The underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31 March 2011 was estimated at £390 million. This compares with the total external debt of £339 million.

	Balance on 31-Mar-10 £m	**Debt Maturing £m**	**New Borrowing £m**	**Balance on 31-Mar-11 £m**
CAPITAL FINANCING REQUIREMENT (CFR)	**385**			**390**
PWLB borrowing	106	16	10	100
Market borrowing	174	0	0	174
Total Borrowing	**280**	**16**	**10**	**274**
Other Long Term Liabilities	68	3	0	65
TOTAL EXTERNAL DEBT	**348**	**19**	**10**	**339**

4.20 Following the Spending Review on 20 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. Premature repayment rates did not benefit from the increase in the margin which potentially makes future rescheduling of PWLB loans more challenging.

4.21 The PWLB remained the preferred source of borrowing given the transparency and control that this continues to provide. In total £10 million of new loans were raised which included the replacement of maturing debt. Both new loans were taken out prior to HM Treasury increasing the borrowing rates. The interest rates payable on these loans represents excellent value for money as rates this low are unlikely to be seen in the near future.

Loans Borrowed during 2010/11	Principal £m	Fixed/ Variable	Rate %	Final Maturity	Terms
PWLB	5	Fixed	3.92	15 March 2060	Maturity
PWLB	5	Fixed	1.89	15 June 2020	E I P
Total New Borrowing	**10**				

4.22 Given the significant cuts to local government funding putting pressure on Council finances, the strategy followed was to minimise debt interest payments without compromising the longer-term stability of the portfolio. The differential between the cost of new longer-term borrowing and the return generated on the temporary investments was significant (between 2% - 3%). The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding capital expenditure. This lowered overall treasury risk by reducing both external debt and temporary investments. Whilst this position is expected to continue in 2011/12, it will not be sustainable over the medium term and there will be a need to borrow for capital purposes in the near future.

4.23 During the year the five loans which matured have been repaid and two loans as per the terms of the loans, have been partially repaid.

Loans maturing in 2010/11	Principal £m	Fixed/ Variable	Rate %	Final Maturity	Terms
PWLB	1.5	Fixed	4.5	15 June 2010	Maturity
PWLB	1.5	Fixed	4.7	25 Sept 2010	Maturity
PWLB	5	Fixed	4.6	7 Nov 2010	Maturity
PWLB	3	Fixed	4.6	7 Nov 2010	Maturity
PWLB	4	Fixed	10.4	15 Dec 2010	Maturity
PWLB	0.5	Fixed	3.0	19 Dec 2019	E I P
PWLB	0.5	Fixed	2.9	19 Dec 2019	E I P
Total Maturing Borrowing	**16**				

4.24 Debt rescheduling is used to reduce the overall exposure to the risk of interest rate movements, to lower the long-term interest charges paid on debt and to smooth the maturity profile without compromising the overall longer-term stability or to alter the volatility profile (i.e. exposure to variable rate debt). This has become more challenging due to the factors discussed in paragraph 4.20 therefore no debt rescheduling took place in 2010/11. The portfolio continues to be reviewed by the Treasury Management Team for debt rescheduling opportunities.

Minimum Revenue Provision (MRP)

4.25 The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 (SI 2008/414) place a duty on local authorities to make a prudent provision for debt redemption. Guidance on Minimum Revenue Provision has been issued by the Secretary of State and local authorities are required to "have regard" to such Guidance under section 21(1A) of the Local Government Act 2003.

4.26 There are four MRP options available namely Option 1: Regulatory Method; Option 2: CFR Method; Option 3: Asset Life Method and Option 4: Depreciation Method.

4.27 Options 1 and 2 may be used only for supported expenditure. Methods of making prudent provision for self financed expenditure include Options 3 and 4 (which may also be used for supported expenditure if the Council chooses).

4.28 The MRP policy for 2010/11 was approved by Cabinet on 22 February 2010 when it was agreed that Option 1 would be adopted for Supported Borrowing and Option 3 for Unsupported Borrowing. When Option 3, the asset life method, is applied to the funding of an asset with a life greater than 25 years a default asset life of 25 years is applied. Estimating assets lives over 25 years is difficult to achieve accurately; therefore, using a default of 25 years is considered the most prudent approach and is in keeping with the Regulations. MRP in respect of PFI and leases brought on Balance Sheet under International Financial Reporting Standards (IFRS) is also calculated using Option 3 and will match the annual principal repayment for the associated deferred liability.

Summary

4.29 In 2010/11 the decision to use internal resources in lieu of borrowing for capital purposes and the beneficial timing of the new borrowing has helped generate savings of £2 million in complying with the Regulations.

4.30 The average interest rate payable on borrowings in 2010/11 was 5.8% and the average life of the loans is 18 years.

COMPLIANCE WITH PRUDENTIAL INDICATORS

4.31 In compliance with the requirements of the CIPFA Code of Practice this report provides Members with a summary report of the treasury management activity during 2010/11. The report also confirms compliance with the Prudential Indicators for 2010/11 that were set on 22 February 2010 as part of the Treasury Management Statement.

4.32 **Capital Financing Requirement**

Estimates of the maximum external borrowing requirement for 2010/11 to 2012/13 are shown in the table below:

	31 Mar 11 Estimate £m	31 Mar 12 Estimate £m	31 Mar 13 Estimate £m
Capital Financing Requirement	390	395	395
Less:			
Existing Profile of Borrowing	274	259	243
Other Long Term Liabilities	65	62	60
Cumulative Maximum External Borrowing Requirement	51	74	92

4.33 **(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 the indebted status. This statutory limit should not be breached and was set at £484 million 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. For 2010/11 this was set at £469 million.
During the year; borrowing at its peak was £355 million.

4.34 **(b) Upper Limits for Fixed and Variable Interest Rate Exposure**

These 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 the portfolio of investments.

Interest Rate Exposure	Fixed Rate of Interest	Variable Rate of Interest	Total
Borrowings	£274m	£0m	**£274m**
Proportion of Borrowings	100%	0%	**100%**
Upper Limit	100%	50%	
Investments	£11m	£125m	**£136m**
Proportion of Investments	8%	92%	**100%**
Upper Limit	100%	100%	
Net Borrowing	**£263m**	**£-125m**	**£138m**
Proportion of Total Net Borrowing	191%	-107%	**100%**

The table shows that borrowing is mainly at fixed rates of interest and investments are mainly at variable rates. This was considered a good position when interest rates were rising as the cost of existing borrowing remained stable whilst investments, at variable rates of interest, generated increasing income. As the position has changed to one of low interest rates, the Treasury Management Team continues to seek to adjust this but is restricted by a number of factors:

- the level of uncertainty in the markets make investing for long periods at fixed rates of interest more risky and, therefore, the Council continues to only invest short term at variable rates of interest;
- many of the loans have expensive penalties for early repayment or rescheduling which makes changing the debt position difficult.

4.35 **(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 Mar 11 £m	% of Fixed Rate Borrowing as at 31 Mar 11 %
under 12 months	100	0	15	5
12 months and within 24 months	100	0	17	6
24 months and within 5 years	100	0	49	18
5 years and within 10 years	100	0	26	10
10 years and above	100	0	167	61
			274	**100**

4.36 **(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 and for 2010/11 the limit was set at £30 million.

The response since the onset of the credit crunch in 2007 has been to keep investment maturities to a maximum of 12 months. No investments were made for a period greater than 364 days during this period.

4.37 **Summary**

During 2010/11 none of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

5.0 RELEVANT RISKS

5.1 The Council is responsible for treasury decisions and activity and none of these decisions are without risk. The successful identification, monitoring and control of risk are important and the main risks are:-

- Liquidity Risk (Inadequate cash resources).
- Market or Interest Rate Risk (Fluctuations in interest rate levels).
- Inflation Risk (Exposure to inflation).
- Credit and Counterparty Risk (Security of investments).
- Refinancing Risk (Impact of debt maturing in future years).
- Legal and Regulatory Risk.

6.0 OTHER OPTIONS CONSIDERED

6.1 There are no other options considered in this report.

7.0 CONSULTATION

7.1 There has been no consultation undertaken or proposed for this report. There are no implications for partner organisations arising out of this report.

8.0 IMPLICATIONS FOR VOLUNTARY, COMMUNITY AND FAITH GROUPS

8.1 There are none arising out of this report.

9.0 RESOURCE IMPLICATIONS: FINANCIAL; IT; STAFFING; AND ASSETS

9.1 In the financial year 2010/11 the treasury management activities resulted in £1 million of additional receipts from investment income and a saving of £2 million from the capital financing activities. These sums can be returned to the General Fund balances.

10.0 LEGAL IMPLICATIONS

10.1 The Council has adopted the CIPFA Code of Practice on Treasury Management. This requires the annual production of Prudential Indicators and a Treasury Management Strategy Statement and the reporting of treasury management activities at least twice per year.

11.0 EQUALITIES IMPLICATIONS

11.1 There are none arising out of this report and an Equality Impact Assessment (EIA) is not required.

12.0 CARBON REDUCTION IMPLICATIONS

12.1 There are none arising out of this report.

13.0 PLANNING AND COMMUNITY SAFETY IMPLICATIONS

13.1 There are none arising out of this report.

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REFERENCE MATERIAL

DCLG Local Authority Investment Guidance,2004
DCLG Changes to the Capital Financing System Consultation, 2009
Code of Practice for Treasury Management in Public Services (Fully Revised Second Edition), CIPFA 2009.
Prudential Code for Capital Finance in Local Authorities (Fully Revised Second Edition), CIPFA 2009.

SUBJECT HISTORY

Council Meeting	**Date**
Cabinet - Treasury Management and Investment Strategy 2010 to 2013	22 February 2010
Cabinet – Treasury Management Annual Report 2009/10	24 June 2010
Cabinet - Treasury Management Performance Monitoring	22 July 2010
Cabinet - Treasury Management Performance Monitoring	14 October 2010
Cabinet – Treasury Management Performance Monitoring	3 February 2011