WIRRAL COUNCIL

CABINET

21 JUNE 2012

SUBJECT	**TREASURY MANAGEMENT ANNUAL REPORT 2011/12**
WARD/S AFFECTED	**ALL**
REPORT OF	**ACTING CHIEF FINANCE OFFICER**
RESPONSIBLE PORTFOLIO HOLDER	**COUNCILLOR PHIL DAVIES**
KEY DECISION	**NO**

1.0 EXECUTIVE SUMMARY

1.1 This report presents a review of Treasury Management activities in 2011/12 and has been prepared in accordance with the CIPFA Treasury Management Code and the Prudential Code for Capital Finance in Local Authorities.

1.2 The year saw these activities realise a net underspend of £3.7 million. Of this sum £2.5 million was anticipated and included in the Estimates 2012/13 as agreed by Cabinet on 21 February 2012. The report also confirms compliance with treasury limits and prudential indicators.

2.0 BACKGROUND AND KEY ISSUES

2.1 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.”

2.2 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.

2.3 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 presently undertaken by the Council Excellence Overview and Scrutiny Committee.

ECONOMIC BACKGROUND

2.4 The 2011/12 Strategy was agreed in February 2011. At that time there were tentative signs that the UK was emerging from recession. Recovery in growth was expected to be slow and uneven as the austerity measures announced in the 2010 Comprehensive Spending Review were implemented in order to reduce the budget deficit, reduce Government borrowing and rebalance the economy. Inflation measured by the Consumer Price Index (CPI) had remained above 3%; Unemployment was at 2.5 million and was expected to rise further as the public and private sector contracted. There was also a high degree of uncertainty surrounding Eurozone sovereign.

2.5 During 2011/12 inflation saw CPI and RPI at 5.2% and 5.6% respectively in September 2011, primarily due to escalating utility prices and the January 2011 increase in VAT to 20%. By February 2012 reductions in transport costs, food prices and the VAT effect falling out CPI was at 3.4% and RPI 3.7%.

2.6 Growth remained elusive. The Bank's Quarterly Inflation Reports saw the outlook downgraded to around 1% in 2011 and 2012. The unresolved problems in the Eurozone weighed negatively on global economic prospects. The UK GDP was positive in only the first and third calendar quarters of 2011; annual GDP to December 2011 registered 0.5%; unemployment rose to 2.7 million and youth unemployment passed 1 million.

2.7 The Bank of England's Monetary Policy Committee maintained the status quo on the Bank Rate which has been 0.5% since March 2009, but increased asset purchases by £75 billion in October 2011 and another £50 billion in February 2012 taking the Quantitative Easing (QE) total to £325 billion.

2.8 In Europe, sovereign debt problems for some countries became critical. Bailout packages were required for Greece and Portugal whilst Spain and Italy came under increased stress in November. Standard & Poor's downgraded nine European sovereigns. The successful Greek sovereign bond swap in March 2012 shortly after its second bailout package allowed it to avoid bankruptcy later that month, but it was not a long-term solution. The ECB's Long-Term Refinancing Operations (LTROs) flooded the financial markets and relieved much of the immediate funding pressure facing European banks but markets ultimately took the view the LTROs simply delayed a resolution of, rather than addressed, the issues.

2.9 Markets sentiment oscillated between 'risk on'/'risk off' modes, this swing becoming the norm for much of 2011/12 as investors shifted between riskier assets and the relative safety of higher quality government bonds. Gilts were a principal beneficiary of the theme which helped push yields lower. There was little market reaction to, or impact on, gilts by the decision by Fitch and Moody's to change the outlook on the UK's triple-A rating from stable to negative. PWLB borrowing rates fell commensurately but the cost associated with borrowing longer-term whilst investing the monies temporarily until required for capital financing remained high.

2.10 Europe’s banking sector was inextricably linked with the sovereign sector. Sharp moves in sovereign Credit Default Swaps and bond yields were fairly correlated with the countries’ banking sector performance. The deterioration in the prospects for real growth had implications for earnings and profit growth and banks’ creditworthiness. The European Banking Authority’s banking stress tests of 70 EU banks undertaken in October 2011 identified a collective €106 billion shortfall to banks’ Core Tier 1 ratio of 9%. The slowdown in debt and equity capital market activity also had implications for banks’ funding and liquidity. These factors, as well as a reassessment by the rating agencies of future sovereign support for banks, resulted in downgrades to the long-term ratings of several UK and non-UK financial institutions in autumn 2011.

INVESTMENT ACTIVITY

2.11 The Department for Communities and Local Government (DCLG) Investment Guidance which came into effect on 1 April 2010 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.

2.12 The opening and closing investment portfolio for 2011/12:-

INVESTMENTS	**Balance at 1 April 2011 £m**	**%**	**Balance at 31 March 2012 £m**	**%**
Current Assets (Cash Equivalents) Loans and Receivables - Specified	12	9	15	15
Available for sale financial assets - Specified	50	37	19	18
Current Assets (Short Term Investments) Loans and Receivables - Specified	60	44	37	36
Available for sale financial assets - Specified	2	1	1	1
Long Term Investments Loans and Receivables - Non Specified	4	- 3	23	22
Available for sale financial assets - Non Specified	8	6	8	8
TOTAL INVESTMENTS	**136**		**103**	

2.13 A breakdown of investments and the movement throughout the year:-

Investments with:	30 Jun 11 £m	30 Sep 11 £m	31 Dec 11 £m	31 Mar 12 £m
UK Banks	61	60	47	35
UK Building Societies	15	15	6	6
Money Market Funds	39	29	40	20
Other Local Authorities	32	36	34	34
Gilts and Bonds	10	8	8	8
TOTAL	**157**	**148**	**135**	**103**

2.14 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 2011/12. 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.
- Bonds issued by Multilateral Development Banks.
- Pooled funds (collective investment schemes) meeting the criteria in SI 2004 No 534 and subsequent amendments.

2.15 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.

2.16 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.

2.17 The Council sought to optimise returns commensurate with the objectives of security and liquidity. The Council considered an appropriate risk management response to uncertain and deteriorating credit conditions in Europe was to shorten maturities for new investments. Short term money market rates also remained at very low levels which had a significant impact on investment income. Income earned on longer-dated investments made in 2010/11 provided some cushion against the low interest rate environment

2.18 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.

2.19 The latest creditor progress report issued by the Administrators Ernst and Young, dated 28 July 2011, outlined that the return to creditors is projected to be 90p in the £ by the end of 2012/13 and the final recovery could be higher. To date, £1.5 million has been received with a further £0.3 million expected before April 2013. 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.

2.20 In summary the budgeted investment income for the year had been estimated at £1.3 million and the actual interest earned was £2.3 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;
- The maturity of long standing GILT, generating a one off £500k surplus.
- Continuing proactive daily cash flow management by the Treasury Management Team.

2.21 The average return on investments for 2011/12 was 0.90%. To place this in context, in 2011/12 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 0.77%. 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

2.22 The underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31 March 2012 was estimated at £378 million. This compares with the total external debt of £326 million.

	Balance on 31-Mar-11 £m	Debt Maturing £m	New Borrowing £m	Balance on 31-Mar-12 £m
CAPITAL FINANCING REQUIREMENT (CFR)	**390**			**378**
PWLB borrowing	100	15	5	90
Market borrowing	174	0	0	174
Total Borrowing	**274**	**15**	**5**	**264**
Other Long Term Liabilities	65	3	0	62
TOTAL EXTERNAL DEBT	**339**	**18**	**5**	**326**

2.23 The average rate of interest paid on Council borrowings as at 31 March 2012 was 5.8% (the same as at 31 March 2011). The average life of Council borrowings is 19 years (compared to 18 years in 2010/11).

2.24 The PWLB remained the preferred source of borrowing given the transparency and control that this continues to provide. In 2011/12 a total of £5 million of new loans were raised which included the replacement of maturing debt.

Loans Borrowed during 2011/12	Principal £m	Fixed/ Variable	Rate %	Final Maturity	Terms
PWLB	5	Fixed	2.30	15 June 2021	Equal Instalments of Principal (E I P)
Total New Borrowing	**5**				

2.25 Given the significant reductions to local government funding the Strategy continued to be 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 has, for the time being, lowered overall treasury risk by reducing both external debt and temporary investments. Whilst this position is expected to continue in 2012/13, it will not be sustainable over the medium term and there will be a need to borrow for capital purposes in the near future.

2.26 During the year four loans matured and have been repaid and four loans, as per the terms of the loans, have been partially repaid.

Loans maturing in 2011/12	Principal £m	Fixed/ Variable	Rate %	Final Maturity	Terms
PWLB	1.50	Fixed	4.50	15-Jun-11	Maturity
PWLB	5.00	Fixed	4.55	07-Nov-11	Maturity
PWLB	5.00	Fixed	5.50	15-Mar-12	Maturity
PWLB	1.50	Fixed	5.25	25-Mar-12	Maturity
PWLB	0.50	Fixed	3.04	19-Dec-19	E I P
PWLB	0.50	Fixed	2.94	19-Dec-19	E I P
PWLB	0.50	Fixed	1.89	15-Jun-20	E I P
PWLB	0.25	Fixed	2.30	15-Jan-00	E I P
Total Maturing Borrowing	**14.75**				

Other Long-Term Liabilities

2.27 Other Long-Term Liabilities include the schools Private finance Initiative (PFI) scheme and finance leases used to purchase vehicles plant and equipment. Under the International Financial Reporting Standards (IFRS) these items are now shown on the Balance Sheet as a Financial Liability and therefore need to be considered within any Treasury Management decision making process.

2.28 During 2011/12, the Council procured two new lease contracts for IT equipment and catering equipment to the value of £167k.

2.29 As at 31 March 2012 the PFI liability was valued at £61 million to be repaid by 2031 and there were twelve finance leases with a total value £1 million, repayable over 1 – 5 years.

Minimum Revenue Provision (MRP)

2.30 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.

2.31 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.

2.32 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).

2.33 The MRP policy for 2011/12 was approved by Cabinet on 21 February 2011 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.

2.34 In 2011/12 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 £5 million in complying with the Regulations.

2.35 The economic situation, both nationally and locally, has an impact upon the financial position of individuals and businesses as well as the Council in respect of the collection of revenues. The Council makes an annual assessment of the potential non-payment of outstanding sums and sets aside an appropriate provision for potential bad debts. In 2011/12 this assessment resulted in the provision for bad debts being increased by £2.3 million. This being funded from the resources made available by the MRP savings.

COMPLIANCE WITH PRUDENTIAL INDICATORS

2.36 The Council can confirm that it has compiled with the Prudential Indicators for 2011/12 that were approved on 21 February 2011 as part of the Treasury Management Strategy Statement. Details of the Indicators are in the Appendix.

2.37 In compliance with the requirements of the CIPFA Code of Practice this report provides a summary report of the treasury management activity during 2011/12. 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.

3.0 RELEVANT RISKS

3.1 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.

4.0 OTHER OPTIONS CONSIDERED

4.1 There are no other options considered in this report.

5.0 CONSULTATION

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

6.0 IMPLICATIONS FOR VOLUNTARY, COMMUNITY AND FAITH GROUPS

6.1 There are no implications arising directly from this report.

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

7.1 In 2011/12 treasury management activities achieved £1 million of additional investment income and a saving of £5 million from capital financing activities. Of this £2.3 million was used to increase the Council provision for bad debts so the net effect is that the sum of £3.7 million has been returned to the General Fund balances. Members are advised that the Estimates 2012/13 agreed by Cabinet on 21 February 2012 included a projected underspend of £2.5 million in 2011/12 from treasury management activities.

7.2 There are no IT, staffing or asset management implications arising directly from this report.

8.0 LEGAL IMPLICATIONS

8.1 The Council's 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 a year.

9.0 EQUALITIES IMPLICATIONS

9.1 There are no implications arising directly out of this report and an Equality Impact Assessment (EIA) is not required.

10.0 CARBON REDUCTION IMPLICATIONS

10.1 There are no implications arising directly out of this report.

11.0 PLANNING AND COMMUNITY SAFETY IMPLICATIONS

11.1 There are no implications arising directly out of this report.

12.0 RECOMMENDATIONS

12.1 That the Treasury Management Annual Report for 2011/12 be agreed.

12.2 That the transfer of the net underspend of £3.7 million to General Fund balances in 2011/12 be agreed.

13.0 REASON FOR RECOMMENDATIONS

13.1 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 2011/12.

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

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APPENDIX

PRUDENTIAL INDICATORS 2011/12

REFERENCE MATERIAL

Code of Practice for Treasury Management in Public Services, CIPFA 2009.
Prudential Code for Capital Finance in Local Authorities CIPFA 2011.

SUBJECT HISTORY

Council Meeting	**Date**
Cabinet - Treasury Management and Investment Strategy 2011 to 2014	21 February 2011
Cabinet - Treasury Management Annual Report 2010/11	23 June 2011
Cabinet - Treasury Management Performance Monitoring	21 July 2011
Cabinet - Treasury Management Performance Monitoring	3 November 2011
Cabinet - Treasury Management Performance Monitoring	2 February 2012

APPENDIX

PRUDENTIAL INDICATORS 2011/12

Capital Financing Requirement
Estimates of the Council's maximum external borrowing requirement for 2011/12 to 2013/14 are shown in the table below:

	31 Mar 12 Estimate £m	31 Mar 12 Estimate £m	31 Mar 13 Estimate £m
Capital Financing Requirement	378	370	369
Less:			
Existing Profile of Borrowing	264	247	217
Other Long Term Liabilities	62	59	56
Cumulative Maximum External Borrowing Requirement	52	64	96

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 £497 million for 2011/12.

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 2011/12 this was set at £482 million.

During the year; external debt at its peak was £339 million.

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	£264m	£0m	**£264m**
Proportion of Borrowings	100%	0%	**100%**
Upper Limit	100%	50%	
Investments	£23m	£80m	**£103m**
Proportion of Investments	22%	78%	**100%**
Upper Limit	100%	100%	
Net Borrowing	**£241m**	**£-80m**	**161**
Proportion of Total Net Borrowing	150%	-50%	**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.

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 12 £m	% of Fixed Rate Borrowing as at 31 Mar 12 %
under 12 months	20	0	17	6
12 months and within 24 months	20	0	30	11
24 months and within 5 years	50	0	29	11
5 years and within 10 years	50	0	34	13
10 years and above	100	20	154	59
			264	**101**

Actual External Debt
This indicator is obtained directly from the Authority's balance sheet. It is the closing balance for actual gross borrowing (short and long term) plus other deferred liabilities. The indicator is measured in a manner consistent for comparison with the Operational Boundary and Authorised Limit.

Actual External Debt	31 Mar 12 £m
Borrowing	264
Other Long Term Liabilities	62
Total	**326**

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 2011/12 the limit was set at £30 million.

As at 31 March 2012 the Council had £23 million of investments for longer than 364 days. This comprised of £17 million with other Local Authorities and £6 million with UK Banks.

Capital Expenditure
This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits and in particular, to consider the impact on Council Tax.

A full breakdown of capital expenditure and capital financing in 2011/12 can be found within the Capital Outturn report elsewhere on this Cabinet agenda.

Ratio of financing costs to net revenue stream
This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs. The ratio is based on costs net of investment income.

Ratio of Finance Costs to net Revenue Stream	2011/12 Estimate %	2012/13 Esimate %	2013/14 Estimate %
Ratio	8.6	9.34	9.57

Incremental Impact of Capital Investment Decisions
This is an indicator of affordability that shows the impact of capital investment decisions on Council tax levels. The incremental impact is calculated by comparing the total revenue budget requirement of the current approved capital programme with the equivalent calculation of the revenue budget requirement arising from the proposed capital programme.

Incremental Impact of Capital Investment Decisions	2011/12 Estimate £	2012/13 Estimate £	2013/14 Estimate £
Increase in Band D Council Tax	13.54	5.30	11.93

Adoption of the CIPFA Treasury Management Code
This indicator demonstrates that the Authority adopted the principles of best practice. The Council approved the adoption of the CIPFA Code at its meeting on 1 March 2012.