AGENDA ITEM NO.

ISLE OF ANGLESEY COUNTY COUNCIL	
Report to	**County Council** **Audit Committee**
Date	**13 September 2011** **(27 September 2011 – Audit Committee)**
Subject	**Annual Report on Treasury Management for Financial Year 2010-11**
Portfolio Holder(s)	**Commissioner Byron Davies**
Lead Officer(s)	**Corporate Director (Finance)**
Contact Officer	**David Elis-Williams (Ffôn/Tel:2601)**

Nature and reason for reporting

Comply with regulations issued under the Local Government Act 2003 by presenting an annual report on treasury management after the end of the year.

This report is due to be presented to the Council by 30 September. The Council has resolved that the report is also considered by the Audit Committee.

A – Introduction / Background / Issues

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 actual prudential and treasury indicators for 2010/11. 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).

The report also includes borrowing and investment performance during the year.

Under the Prudential Code it is a requirement that all local authorities set Prudential Indicators for borrowing and investing among other factors each year. The Council confirmed its limits for 2010/11 on 4 March 2010 and outturn information is provided. It also amended the approved counterparty list.

During 2010/11 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year
- a mid year (minimum) treasury update report
- an annual report following the year describing the activity compared to the strategy

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 scrutiny to the treasury management reports. However the requirement for prior scrutiny (by the Audit Committee) before they were reported to the full Council was not achieved and this will need to be implemented in the current year.

Member training on treasury management issues was undertaken during November 2010 in order to support the scrutiny role of members of the Audit Committee. A further session is being arranged.

B - Considerations

The detailed Annual Report on Treasury Management activities for 2010/11 which reviews compliance with the Treasury Management Strategy and reports on borrowing and investment performance during the year is appended.

C – Implications and Impacts

1	**Finance / Section 151**	Author of the Report
2	**Legal / Monitoring Officer**	
3	**Human Resources**	
4	**Property Services** (see notes – separate document)	
5	**Information and Communications Technology (ICT)**	
6	**Equality** (see notes – separate document)	
7	**Anti-poverty and Social** (see notes – separate document)	
8	**Communication** (see notes – separate document)	
9	**Consultation** (see notes – separate document)	
10	**Economic**	
11	**Environmental** (see notes – separate document)	

C – Implications and Impacts		
12	**Crime and Disorder** (see notes – separate document)	
13	**Outcome Agreements**	

CH – Summary

During 2010/11, the Council complied with its legislative and regulatory requirements with the exception that reports to members were not always scrutinised in Audit Committee before being presented to the County Council.

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	2009/10 Actual £000	2010/11 Original £000	2010/11 Actual £000
Actual capital expenditure	24,491	29,000	24,112
Total Capital Financing Requirement:			
• Non-HRA	82,381	81,910	78,585
• HRA	17,201	20,682	19,133
• Total	99,582	102,592	97,718
External debt	97,615	102,600	102,600
Investments*			
• Longer than 1 year	-	-	-
• Under 1 year	22,575	37,000	34,127
• Total	22,575	37,000	34,127

** estimates and actuals, not a prudential indicator*

Other prudential and treasury indicators are to be found in the main body of this report. The Corporate Director (Finance) also confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limits (the authorised limit), was not breached.

The financial year 2010/11 continued the challenging environment of previous years; low investment returns and continuing counterparty risk continued.

D – Recommendation

The Council is recommended to:

1. Note the actual 2010/11 prudential and treasury indicators in this report
2. Note the annual treasury management report for 2010/11

Name of author of report – David Elis-Williams
Job Title – Corporate Director (Finance)
Date – 24 August 2011

Appendices:
Appendix A – Detailed report Appendix 1 – Summary Portfolio Valuation Appendix 2 – Public Works Loans Board Rates during the year Appendix 3 – Economic Conditions Appendix 4 – Borrowing Portfolio Performance Appendix 5 – Interest Analysis compared to Benchmark Appendix 6 – Investment Performance Appendix 7 – Combined Investment Return compared to Benchmark
Background papers
Treasury Strategy 2010/11 Prudential Indicators 2010/11

Annual Treasury Management Report 2010/11

1. INTRODUCTION

This reports content and summarises the following functions / activities in financial year 2010/11:

- 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 2010/11

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

- Financed from borrowing: this may be through planned borrowing or otherwise. 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.

CAPITAL ACTIVITY

£m	2009/10 Actual	2010/11 Estimate	2010/11 Actual
Non-HRA capital expenditure	15	20	15
HRA capital expenditure	9	9	9
Total capital expenditure	**24**	**29**	**24**
Resourced by:			
• Capital receipts	1	2	5
• Capital grants	10	16	12
• Capital reserves	-	-	-
• Revenue	2	3	5
Unfinanced capital expenditure	**11**	**8**	**4**

3. THE COUNCIL'S OVERALL BORROWING NEED

3.1 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 2010/11 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 (non HRA) underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory 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 Minimum Revenue Provision – MRP, 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 statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

The Council's 2010/11 MRP Policy (as required by WAG Guidance) was approved as part of the Treasury Management Strategy Report for 2010/11 on 4 March 2010.

The Council's CFR for the year is shown below, and represents a key prudential indicator. This would include any PFI and leasing schemes on the balance sheet, which would increase the Council's borrowing need, the CFR.

CFR (£m)	31 March 2010 Actual	31 March 2011 Original Indicator	31 March 2011 Actual
Opening balance	92.3	98.4	99.6
Add unfinanced capital expenditure (as above)	10.7	8.3	2.4
Less MRP/VRP*	3.4	4.1	4.3
Closing balance	99.6	102.6	97.7

** Includes voluntary application of capital receipts*

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 2010/11 plus the expected changes to the CFR over 2011/12 and 2012/13. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2010/11. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2010 Actual	31 March 2011 Original	31 March 2011 Actual
Gross borrowing position	£97.6m	£102.6m	£102.6m
Net borrowing position	£75.0m	£65.6m	£68.5m
CFR	£99.6m	£102.6m	£97.7m

3.2 As part of the financing of capital expenditure for last year a decision was taken to use capital receipts and revenue reserves in preference to borrowing in order to reduce the level of debt repayment costs. Because this was a late change, it resulted in external borrowing being £4.9m greater than the capital financing requirement on 31 March. This position is being unwound as £6.5m of external borrowing matures this year.

Generally, we aim to match, over time, the average outstanding debt for the year to the average CFR. This means that revenue and other balances are invested externally on a more tactical basis (rather than repaying external debt). As explained in previous years this approach may appear costly in a low base rate environment. However, we have modelled various options and have concluded that the externalisation option is best. This is because of the sensitivity of the Housing Subsidy calculations to different levels of debt and is the pattern followed by many local authorities with a Housing Revenue Account. This means that loans repaid prematurely are normally replaced by new borrowing.

3.3 The other debt related indicators are:

The authorised limit - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. 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 are 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.

	2010/11
Authorised limit	£115.0m
Maximum gross borrowing position	£102.6m
Operational boundary	£110.0m
Average gross borrowing position	£101.8m
Financing costs as a proportion of net revenue stream	6.6%

On balance sheet leasing would also count against authorised limits. A second set of limits was approved, giving scope for £2m leasing. There was no requirement in the year.

4 TREASURY POSITION AS AT 31 MARCH 2011

4.1 The borrowing and investment figures for the council as at the end of the 2010/11 and 2009/10 financial years are as follows:

	31 MARCH 2010			31 MARCH 2011		
	£000	%	Av Mat	£000	%	Av Mat
Public Works Loans Board – fixed	97,615	5.4	29.5 yrs	102.608	5.31	27.6 yrs
Investments	15,000	2.88		25,000	1.28	
Deposits (no notice)	7.575	0.80		9,127	0.81	
Net position	75,040			68,481		

These are disclosed in the Council's balance sheet at "fair value": see a more detailed analysis in Appendix 1.

4.2 Borrowing is further broken down by maturity as:

£m	31 MARCH 2010		31 MARCH 2011		Limits	
Total long term borrowing	97.6	100%	102.6	100%	upper	lower
< 1 year	0.0	0%	6.5	6%	20%	0%
1 – 2 years	6.5	7%	0.0	9%	20%	0%
2 to 5 years	6.5	7%	6.5	6%	50%	0%
5 – 10 years	10.5	11%	20.0	19%	75%	0%
> 10 years	74.1	75%	69.6	68%	100%	0%

4.3 The trend towards lower fixed term interest rates on the loans portfolio continued this year because new borrowing was taken at rates that are significantly lower than the average rate on the portfolio. These transactions also shortened the average length of the portfolio.

4.4 Part of the Council's deposits is held in no notice deposit accounts which pay interest at rates near the prevailing base rate (£9.127m, £7.575m in 2011). Of the remaining deposits, £25m were being held for periods of up to 364 days at 1.20% to 1.35% (£15m @ 1.00% to 6.55% in 2010).

There were no investments with unexpired periods over 364 days.

5. TREASURY STRATEGY FOR 2010/11

5.1 Our treasury strategy for 2010/11, adopted on the 4 March 2010, was based on the expectation that rates were expected to gradually increase during the year so it would therefore be advantageous to time new long term borrowing for the start of the year when 25 year PWLB rates fall back to or below the central forecast rate of about 4.65%, a suitable trigger point for considering new fixed rate long term borrowing. Variable or shorter term rates were expected to be the cheaper form of borrowing in the period.

5.2 As it turned out, the economic position was as outlined in Appendix 2 and PWLB rates were as shown at Appendix 3. The implementation of the strategy was affected by the unexpected change in policy of the PWLB in October 2010 which resulted in an increase in new borrowing rates of 0.75% to 0.85% without the normal increase in early redemption rates. This made new borrowing more expensive and repayment relatively less attractive.

5.3 The Council borrowed £5m for 9 years at 3.72% in May 2010 before the rate increase. No further borrowing was taken after October and no rescheduling was done. Performance and benchmarking information is shown at Appendix 4 and 5.

6. EFFECT ON 2011/12 AND THE FINANCIAL STRATEGY

6.1 The agreed strategy for 2011/12 was based on an assumption that projected external borrowing (£7.0m) would be used in full. Financing decisions after the year end outlined above reduced CFR. The effect is to reduce the charge to revenue for debt repayment in 2011/12; this has been reported separately to the Board of Commissioners as part of the Q1 Revenue Budget Monitoring report.

6.2 The level of borrowing means that the portfolio should remain safely within the limits approved and there is no reason to propose any changes to Treasury Limits at this time.

7. INVESTMENT

7.1 The tight monetary conditions following the 2008 financial crisis continued through 2010/11 with little material movement in the shorter term deposit rates. Bank Rate remained at its historical low of 0.5% throughout the year, although growing market expectations of the start of monetary tightening saw 6 and 12 month rates picking up.

Overlaying the relatively poor investment returns was the continued counterparty concerns, most evident in the Euro zone sovereign debt crisis which resulted in rescue packages for Greece, Ireland and latterly Portugal. Concerns extended to the European banking industry with an initial stress testing of banks failing to calm counterparty fears, resulting in a second round of testing currently in train. This highlighted the ongoing need for caution in treasury investment activity.

7.2 The expected investment strategy was to keep to shorter term deposits (up to 364 days) although the ability to invest out to longer periods was retained. I expected available cash balances of £37m and ranging between £25m and £45m. The budget was set at 0.90% or £410k after adjusting for the higher rates on existing investments. As it turned out, average balances of £38.9m returned £445k.

7.3 Average rates achieved in 2010/11 compared to other local authorities are shown at Appendix 6 and 7. Our overall performance (1.14%) showed that we outperformed the benchmarking club (0.88%) and compared well nationally with the average performance of (1.19%) but this is against a group including many authorities that have taken an extremely risk averse stance.

7.4 On a month by month analysis, the Council's return was significantly higher (1.19% - 1.78%) in the first quarter until the Barclays (6.55%) two year fixed term deposit matured. The return for the remaining 9 months of the year was between 1.01% and 1.11%.

8. INVESTMENT SECURITY AND CREDIT QUALITY

8.1 No institutions in which we had made investments had any difficulty in repaying investments and interest on time and in full during the year.

8.2 During 2010/11, credit ratings remained poor across the range of our usual counterparties, including most building societies. Since late 2008 it became increasingly difficult to place deposits with appropriate counterparties. In December 2008, I obtained the Council's approval to extend flexibility with counterparties to deal with market changes; this included the ability to invest all our surplus funds with central government if necessary. The list was further widened in April 2010 to include nationalised and partly nationalised institutions. Previous decisions had extended flexibility for investing with local authorities. Our approach of listening to expert advice, taking account of market sentiment and being cautious enabled us to improve credit quality within existing counterparty lists.

8.3 The practical effect of these policies was as follows: During the year we continued to use no notice and short notice accounts with major high street institutions (Santander, Bank of Scotland and Clydesdale Bank) for day to day cash flow.

The three fixed term investments (£15.0m) with high quality British institutions in place at the beginning of the year matured during the year. They were replaced with other investments with British Banks. Two deposits were made with UK local authorities. It was not necessary to resort to depositing funds with central government.

DAVID ELIS-WILLIAMS
CORPORATE DIRECTOR (FINANCE) **7 SEPTEMBER 2011**