CHESHIRE EAST COUNCIL

REPORT TO: CABINET

Date of Meeting:	23rd July 2012
Report of:	Director of Finance & Business Services
Subject/Title:	Treasury Management Annual Report 2011/12
Portfolio Holder:	Councillor Peter Raynes

1.0 Report Summary

1.1 The Treasury Management Policy requires an annual report on the performance of the Council's treasury management operation. This report contains details of the activities in 2011/12 for Cheshire East Borough Council.

2.0 Decision Requested

2.1 To receive the Treasury Management Annual Report for 2011/12 as detailed in Appendix A.

3.0 Reasons for Recommendations

3.1 To meet the requirements of the CIPFA Code of Practice for Treasury Management in the Public Services and the Prudential Code for Capital Finance in Local Authorities.

4.0 Wards Affected

4.1 Not applicable

5.0 Local Ward Members

5.1 Not applicable

6.0 Policy Implications including – Carbon Reduction
- Health

6.1 None

7.0 Financial Implications (Authorised by the Director of Finance & Business Services)

7.1 Contained within the report.

8.0 Legal Implications (Authorised by the Borough Solicitor)

8.1 As noted in paragraph C47 of the Finance and Contract Procedure Rules in the Council's Constitution, the Council has adopted CIPFA's *Code of Practice for Treasury Management in Local Authorities* as this is recognised as the accepted standard for this area. C47 to C52 provide further information relating to treasury management practice, and the Code itself will have been developed and based upon relevant legislation and best practice.

9.0 Risk Management

9.1 The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management function will be measured.

10.0 Background and Options

10.1 This annual treasury report, detailed in Appendix A covers:

- the Councils treasury year end position;
- forecast prospects for interest rates for 2011/12;
- interest rate outturn for 2011/12;
- compliance with treasury limits;
- investment strategy for 2011/12;
- borrowing strategy for 2011/12;
- economic events of 2011/12;
- Prudential indicators 2011/12.

11.0 *Access to Information*

The background papers relating to this report can be inspected by contacting the report writer:

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Appendix A

Treasury Management Annual Report 2011/12

Introduction and Background

The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which requires local authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities at least twice a year. The Cabinet receive an annual report and regular updates through the Quarterly Financial and Performance Reports. The scrutiny of treasury policy, strategy and activity is delegated to the Audit and Governance Committee.

Treasury management is defined as: "The management of the local authority's 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."

Overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

This report:

a) is prepared in accordance with the revised CIPFA Treasury Management Code and the revised Prudential Code;
b) presents details of capital financing, borrowing, debt rescheduling and investment transactions;
c) reports on the risk implications of treasury decisions and transactions;
d) gives details of the outturn position on treasury management transactions in 2011/12;
e) confirms compliance with treasury limits and Prudential Indicators.

1. Treasury Year End Position

The amount of investments outstanding at 31st March 2012 was £50.1m as follows:

	31/03/11	31/03/12
	£m	£m
BANKS (Fixed Deposits)		
Lloyds TSB	8.0	3.1
Barclays Bank	15.0	-
Santander (UK)	5.0	-
BUILDING SOCIETIES		
Nationwide	10.0	-
MONEY MARKET FUNDS		
Prime Rate	8.0	5.0
Ignis	-	4.5
Deutsche	-	4.0
Scottish Widows	6.3	3.5
Standard Life	4.8	-
INSTANT ACCESS ACCOUNTS		
Royal Bank of Scotland	-	5.0
Santander (UK)	7.4	5.0
Co-op Reserve	1.8	-
MANAGED FUNDS		
Investec – Pooled Funds	-	20.0
TOTAL	**66.3**	**50.1**

Despite interest rates remaining at 0.5% during 2011/12, the total investment income was £816,000 which exceeded the budgeted target of £800,000. The overall average rate of interest on all investments in 2011/12 was 1.05% compared to the benchmark 7 day LIBID return of 0.52%. The investment income includes £63,000 relating to deposits made by the former Cheshire County Council with the Icelandic Heritable Bank which were received in 2011/12.

We will continue to monitor performance during 2012/13 through the benchmarking service provided by the Council's Treasury Management Advisors, Arlingclose. The current position for Cheshire East indicates that interest achieved on investments is slightly below average compared to other local authorities but has a lower exposure to credit risk.

2. Icelandic Bank Deposits

On the date Heritable Bank (Heritable) was placed into administration Cheshire County Council had £8.5 million deposited with the bank of which £4.6m is the Cheshire East share. These deposits were immediately frozen. This meant that such monies would not be returned to the Council until such time as the work of the administrator, to ascertain the assets and liabilities of Heritable and to make dividend payments to the bank's creditors (of which the Council is one), has been completed.

Repayment of monies due from Heritable Bank has been continuing and in August 2011 the administrators announced that we are likely to receive around 88% of the original claim, an increase from the original estimate of 85%.

From the total claim of £4.62m we have now received £3.14m (68%).

Further repayments are forecast as follows:

2012/2013 - £1.15m (11% of the original claim)
2013/2014 - £0.46m (9% of the original claim)

3. Interest Rates and Prospects for 2011/12

The Councils' treasury advisors, as part of their service assisted in formulating a view on interest rates. However, there has been no change to the bank base rate since March 2009.

	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2012
Base Rate	**0.50%**	**0.50%**	**0.50%**	**0.50%**	**0.50%**

4. Compliance with Treasury Limits

During the financial year the Councils' operated within the treasury limits and Prudential Indicators set out in the Councils' Treasury Policy Statement and annual Treasury Strategy Statement (see section 8).

5. Investment Strategy for 2011/12

The Council had regard to the DCLG Guidance on Local Government Investments ("the Guidance") issued in March 2004 (revised in 2010) and the revised CIPFA Treasury Management Code and the revised Prudential Code ("the CIPFA TM Code").

Investment instruments identified for use in the financial year are listed under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits were set through the Councils' Treasury Management Strategy Statement and Investment Strategy.

Investment Objectives

All investments were in sterling. The general policy objective of the Council was the prudent investment of its treasury balances. The Councils' investment priorities are the security of capital and liquidity of its investments.

The Council aimed to achieve the optimum return on its investments commensurate with the proper levels of security and liquidity. The DCLG maintains that the borrowing of monies purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity.

Credit Risk

Counterparty credit quality was assessed and monitored with reference to credit ratings; 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. The minimum long-term counterparty credit rating determined for the 2011/12 treasury strategy was A+/A1 across rating agencies Fitch, S&P and Moody's.

Downgrades in the autumn 2011 to the long-term ratings of several counterparties resulted in their ratings falling below the Authority's minimum threshold of A+/A3. The downgrades were driven principally by the agencies' view the extent of future government support (flowing from the recommendations to the government from the Independent Commission on Banking) rather than a deterioration in the institutions' creditworthiness. Further use of these counterparties was suspended until a revised criteria was approved for use from 1st April 2012.

Liquidity

In keeping with the CLG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds / overnight deposits/ the use of call accounts.

Yield

The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate was maintained at 0.5% through the year.

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.

Use of External Fund Managers

In May 2011 the Council placed £20m with Investec in pooled funds, for which the aim is to generate higher returns in a low interest rate environment through investment in a diverse range of instruments. Since joining the fund market conditions have been challenging predominantly caused by problems in the Greek and Spanish economies which affects the whole Eurozone markets. The return on these funds in 2011/12, after allowing for fees, was 0.56%.

Whilst the performance of the fund since we joined is not as good as we originally hoped, these investments should be seen as a longer term investment so true performance can only be judged over a longer period of time.

6. Borrowing strategy

At the end of the year 2011/12 the Council had debt outstanding of £132.3m. Of this £17m represented loans raised from commercial banks whilst £115.3m represented loans from the PWLB. The only borrowing activity which took place in 2011/12 was to refinance £5m maturing PWLB debt with a new 10 year PWLB Equal Instalments of Principal (EIP) loan at a rate of 2.09%. Whilst there is a short term cost of carrying this loan (compared to investment rates) this does offset the interest risk inherent in waiting until liquidity issues force new borrowing.

The maturing debt arose out of a £50m debt restructuring exercise in July 2010 which assumed savings of £4.47m over 10 years based on refinancing the debt at 4.22%. As the refinancing in 2011/12 did not take place until March and was at the lower rate of 2.09% then savings are forecast to be higher. Budgeted savings from debt restructuring up to 31/03/12 were £1.4m, actual savings are £1.6m. .

The Council has been able to internally borrow to fund the capital programme in 2011/12. This has been due to delays in capital expenditure, the current availability of cash resources and the interest rate environment. This strategy has resulted in a saving of interest charges in 2011/12 (interest payable £5.3m compared to budget of £6.1m), but the longer term approach will be to take advantage of short and long term borrowing opportunities with advice from Arlingclose.

7. Economic events of 2011/12

At the time of determining the 2011/12 strategy in February 2011, there were tentative signs that the UK was emerging from recession with the worst of the financial crisis behind it. 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 bring down the budget deficit and government borrowing and rebalance the economy and public sector finances. Inflation measured by the Consumer Price Index (CPI) had remained stubbornly above 3%. Unemployment was at a 16-year high 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 debt sustainability.

Inflation: During 2011-12 inflation remained high with CPI (the official measure) and RPI rising in September to 5.2% and 5.6% respectively primarily due to escalating utility prices and the January 2011 increase in VAT to 20%. Inflation eased slowly as reductions in transport costs, food prices, intensifying competition amongst retailers and supermarkets and the VAT effect falling out in 2012, pushed February 2012's CPI down to 3.4% and RPI to 3.7%. This, however, was not enough to offset low wage growth and, as a result, Britons suffered the biggest drop in disposable income in more than three decades.

Growth, Employment, House Prices: Growth, on the other hand, remained elusive. The Bank's Quarterly Inflation Reports painted a bleak picture as the outlook was downgraded to around 1% in 2011 and 2012 alongside. The unresolved problems in the Eurozone weighed negatively on global economic prospects. UK GDP was positive in only the first and third calendar quarters of 2011; annual GDP to December 2011 registered just 0.5%. Unemployment rose to 2.68 million and, worryingly, youth unemployment broke through the 1 million barrier. House prices struggled to show sustained growth and consumer confidence remained fragile.

Monetary Policy: It was not surprising that the Bank of England's Monetary Policy Committee maintained the status quo on the Bank Rate which has now been held at 0.5% since March 2009, but increased asset purchases by £75bn in October 2011 and another £50bn in February 2012 taking the Quantitative Easing (QE) total to £325bn.

The policy measures announced in the March 2012 Budget statement were judged to be neutral. The government stuck broadly to its austerity plans as the economy was rebalancing slowly. The opinion of independent Office for Budget Responsibility (OBR) was that the government was on track to meet its fiscal targets; the OBR identified oil price shocks and a further deterioration in Europe as the main risks to the outlook for growth and in meeting the fiscal target.

US
The US economy continued to show tentative, positive signs of growth alongside a gradual decline in the unemployment rate. The US Federal Reserve (the Fed) committed to keeping policy rates low until 2014, although a modest shift in the Fed's language in March, alongside an improvement in economic activity, cast doubts about the permanence of the Fed's policy commitment.

Europe
In Europe, sovereign debt problems for some peripheral countries became critical. Several policy initiatives were largely ineffectual; two bailout packages were required for Greece and one for Portugal, and the contagion spread to Spain and Italy whose sovereign bonds came under increased stress in November. Standard & Poor's downgraded nine European sovereigns and the EFSF bailout fund. 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 €1.3 trillion Long-Term refinancing Operations (LTROs) flooded the financial markets with ultra-cheap 3-year liquidity and relieved much of the immediate funding pressure facing European banks in 2012, but markets ultimately took the view the LTROs simply served to delay a resolution of, rather than addressed, the fundamental issues underpinning Euroland's problems.

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, however, were a principal beneficiary of the 'risk-off' 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. Over the 12-month period from April 2011 to March 2012, 5-year gilt yields more than halved from 2.40% to 1.06%; 10-year gilt yields fell from 3.67% to 2.25%; 20-year yields fell from 4.30% to 3.20% and 50-year yields from 4.20% to 3.35%. PWLB borrowing rates fell commensurately, but the cost of carry associated with borrowing longer-term loans whilst investing the monies temporarily until required for capital financing remained high, in excess of 4.1 % for 20-year PWLB Maturity borrowing.

Credit
Europe's banking sector was inextricably linked with the sovereign sector. Sharp moves in sovereign CDS 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 principal 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.

8. Prudential Indicators 2011/12

The Council can confirm that it has complied with its Prudential Indicators for 2011/12, which were approved on 24th February 2011 as part of the Council's Treasury Management Strategy Statement. Details can be found in Annex 1.

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 2011/12. None of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

9. Other Items

Potential for reduced PWLB borrowing rates

A brief paragraph in the 2012 Budget Report (March 2012) contained HM Treasury's intention to offer a 20 basis points discount on loans from the PWLB "for those principal local authorities providing improved information and transparency on their locally-determined long-term borrowing and associated capital spending plans" and the potential of an independent body to facilitate the provision of "a further reduced rate for authorities demonstrating best quality and value for money". More detail is awaited and, given that discussion with relevant bodies will be required, it could be some months before either of these measures is implemented.

Annex 1

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

	31/3/2012 Estimate £m	31/3/2012 Actual £m	31/3/2013 Estimate £m	31/3/2014 Estimate £m
Gross CFR	211	209	234	253
Less: Other Long Term Liabilities	25	25	24	22
Borrowing CFR	**186**	**184**	**210**	**231**
Less: Existing Profile of borrowing	134	134	128	122
Cumulative Maximum External Borrowing Requirement	**52**	**50**	**82**	**109**

Usable Reserves
Estimates of the Council's level of Balances and Reserves for 2011/12 to 2013/14 are as follows:

	31/3/2012 Estimate £m	31/3/2012 Actual £m	31/3/2013 Estimate £m	31/3/2014 Estimate £m
Usable Reserves	59	61	58	55

Prudential Indicator Compliance

(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 their indebted status. This is a statutory limit which should not be breached.
- The Council's Affordable Borrowing Limit was set at £235m 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.
- The Operational Boundary for 2011/12 was set at £225m.
- The Director of Finance & Business Services confirms that there were no breaches to the Authorised Limit and the Operational Boundary during the year; borrowing at its peak was £134m.

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

- These indicators 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 our portfolio of investments.

	Limits for 2011/12 %	Maximum during 2011/12 %
Upper Limit for Fixed Rate Exposure	100%	100%
Compliance with Limits:	Yes	Yes
Upper Limit for Variable Rate Exposure	100%	0%
Compliance with Limits:	Yes	Yes

(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 31/03/2012 £m	% Fixed Rate Borrowing as at 31/03/2012	Compliance with Set Limits?
under 12 months	25%	0%	17.5	13%	Yes
12 months and within 24 months	25%	0%	10.5	8%	Yes
24 months and within 5 years	35%	0%	24.1	19%	Yes
5 years and within 10 years	50%	0%	20.0	15%	Yes
10 years and within 20 years	100%	0%	17.3	13%	Yes
20 years and within 30 years	100%	0%	16.2	12%	Yes
30 years and within 40 years	100%	0%	8.8	7%	Yes
40 years and within 50 years	100%	0%	17.8	13%	Yes
50 years and above	100%	0%	0	0%	Yes

(The 2011 revision to the CIPFA Treasury Management Code now requires the prudential indicator relating to Maturity of Fixed Rate Borrowing to reference the maturity of LOBO loans to the earliest date on which the lender can require payment, i.e. the next call date[1]

(d) **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 as at 31/03/2012	**£m**
Borrowing	134
Other Long-term Liabilities	25
Total	**159**

(e) **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.
- The limit for 2011/12 was set at 40% of total investments.
- One investment of £5m was made in 2011/12 for a period of 365 days which represented a maximum of 11.4% of investments at any one time.

(f) **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 and in the case of the HRA, housing rent levels.

Capital Expenditure	**2011/12 Estimate £m**	**2011/12 Actual £m**	**2012/13 Estimate £m**	**2013/14 Estimate £m**
Total	**77**	**50**	**102**	**53**

- Capital expenditure has been and will be financed or funded as follows:

Capital Financing	2011/12 Estimate £m	2011/12 Actual £m	2012/13 Estimate £m	2013/14 Estimate £m
Capital receipts	16	11	18	7
Government Grants	35	26	46	14
External contributions	1	2	1	0
Revenue contributions	1	0	1	0
Supported borrowing	4	4	3	1
Unsupported borrowing	20	7	33	31
Total Financing and Funding	**77**	**50**	**102**	**53**

(g) **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 Financing Costs to Net Revenue Stream	2011/12 Estimate %	2011/12 Actual %	2012/13 Estimate %	2013/14 Estimate %
Total	5.59	4.98	6.01	7.15

(h) **Incremental Impact of Capital Investment Decisions**

- This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax and Housing Rent levels. The incremental impact is calculated by comparing the total revenue budget requirement of the current approved capital programme with an equivalent calculation of the revenue budget requirement arising from the proposed capital programme.

Incremental Impact of Capital Investment Decisions	2011/12 Approved £	2012/13 Estimate £	2013/14 Estimate £
Increase in Band D Council Tax	2.33	16.35	19.05

(i) **Adoption of the CIPFA Treasury Management Code**
- This indicator demonstrates that the Authority adopted the principles of best practice.

Adoption of the CIPFA Code of Practice in Treasury Management
The Council approved the adoption of the CIPFA Treasury Management Code at its meeting on 24th February 2011

(j) **Gross and Net Debt**

- The purpose of this treasury indicator is to highlight a situation where the Authority is planning to borrow in advance of need.

Upper Limit on Net Debt compared to Gross Debt	**2011/12 Actual £m**	**2012/13 Estimate £m**	**2013/14 Estimate £m**
Outstanding Borrowing (at nominal value)	132	210	231
Other Long-term Liabilities (at nominal value)	25	24	22
Gross Debt	**157**	**234**	**253**
Less: Investments	(50)	(34)	(29)
Net Debt	**107**	**200**	**224**

N.B. CIPFA has acknowledged that the upper limit does not work as was intended and is working on a revised indicator. This indicator will be amended once revised guidance has been received from CIPFA.

(k) **Upper Limit for Total Principal Sums Invested Over 364 Days**

- The purpose of this limit is to contain exposure to the possibility of loss that may arise as a result of the Authority having to seek early repayment of the sums invested.

Upper Limit for total principal sums invested over 364 days	**2011/12 Approved £m**	**2011/12 Revised £m**	**2012/13 Estimate £m**	**2013/14 Estimate £m**	**2014/15 Estimate £m**
	40%	40%	40%	40%	40%