

Annual Treasury Outturn Report 2011/12

1 Purpose

- 1.1 The County Council adopts the key recommendations of the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice, which includes an annual report on the treasury management strategy after the end of each financial year.

2 Summary

- 2.1 Treasury management in the context of this report is defined as:

“The management of the organisation’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.”

- 2.2 This annual report sets out the performance of the treasury management function during 2011/12, to include the effects of the decisions taken and the transactions executed in the past year.
- 2.3 Overall responsibility for treasury management remains with the County Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the County Council’s treasury management objectives.
- 2.4 All treasury activity has complied with the County Council’s Treasury Management Strategy Statement and Investment Strategy for 2011/12, and all relevant statute, guidance and accounting standards.
- 2.5 The prudential and treasury management indicators which are all covered in this report are:
- actual capital financing requirement
 - actual external debt
 - authorised limit and operational boundary for external debt
 - upper limits for fixed interest rate exposure and variable interest rate exposure
 - maturity structure of fixed rate borrowing
 - total principal sums invested for periods longer than 364 days
 - ratio of financing costs to net revenue stream.

- 2.6 The County Council's treasury advisers, Arlingclose, provide support in undertaking treasury management activities.

3 Economic background

- 3.1 At the time of determining the 2011/12 strategy in December 2010, 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.
- 3.2 In terms of monetary policy, 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 has increased asset purchases by £75bn in October 2011 and another £50bn in February 2012 taking the Quantitative Easing (QE) total to £325bn.
- 3.3 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.
- 3.4 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.

- 3.5 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 European Financial Stability Facility (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 European Central Bank (ECB) €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.
- 3.6 Market 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%.
- 3.7 In terms of credit, Europe's banking sector was inextricably linked with the sovereign sector. Sharp moves in sovereign Credit Default Swaps (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.

4 The borrowing requirement and debt management

	Balance on 31/03/2011 £m	Net new borrowing £m	Balance on 31/03/2012 £m
Capital Financing Requirement	747.6		720.0
Long Term Borrowing	365.9	18.8	384.7
Temporary borrowing	38.8	9.3	48.1
Total Borrowing	404.7	28.1	432.8
Other Long Term Liabilities	94.5	8.7	103.2
Total External Debt	499.2	36.8	536.0

- 4.1 Capital expenditure for the year was £161.7m, £4.9m less than estimated at £166.6m. £6.3m of that capital expenditure was financed by borrowing and from other long term liabilities and repayments of £33.9m were made, resulting in a decrease in the capital financing requirement of £27.6m, as reflected in the table above.
- 4.2 The County Council funded £20m of its historical capital expenditure through new borrowing from the PWLB. The PWLB remained the County Council's preferred source of borrowing, given the transparency and control that its facilities continue to provide.

Loans borrowed during 2011/12	Principal £m	Average rate %	Average Maturity (years)
PWLB Fixed Rate Equal Instalment of Principal (EIP) Loans	20.0	2.42	8.5

- 4.3 Whilst the County Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31 March 2012 is £720.0m, a cautious approach has been applied in terms of take-up of new borrowing to minimise debt interest payments without compromising the long-term stability of the portfolio. Internal resources in lieu of external borrowing have been used to a significant extent in order to lower overall treasury risk by reducing both external debt and temporary investments.

Actual External Debt

- 4.4 This indicator is obtained directly from the Authority's balance sheet. It is the closing balance for actual gross borrowing plus other long-term liabilities. This Indicator is measured in a manner consistent for comparison with the Operational Boundary and Authorised Limit.

Actual External Debt as at 31 March 2012	£m
Borrowing	432.8
Other Long-term Liabilities	103.2
Total	536.0

5 Investment activity

- 5.1 The County Council has invested according to a low risk, high quality lending list as outlined in the Investment Strategy for 2011/12.

	Balance on 31/03/2011 £m	Balance on 31/03/2012 £m	Average Rate % / Average Life (yrs)
Instant access monies	33.6	62.5	0.96% / 0.0 yrs
Short term investments	171.2	192.5	1.35% / 0.2 yrs
Long term investments	10.0	65.0	1.81% / 2.8 yrs
Total investments	214.8	320.0	1.37% / 0.7 yrs

- 5.2 Security of capital remained the County Council's main investment objective. This was maintained by following the County Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2011/12. Investments during the year included:

- deposits in AAA-rated Money Market Funds
- deposits with UK local authorities
- call accounts and deposits with banks and building societies systemically important to the UK's banking system.

- 5.3 Counterparty credit quality was assessed and monitored with reference to:
- credit ratings
 - credit default swaps
 - any potential support mechanisms
 - share prices.
- 5.4 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.
- 5.5 This particular criterion was amended by the County Council on 24 February 2012 to A-/A3 in response to downgrades in credit ratings below A+ of many institutions considered to be systemically important to the financial system. The downgrades were driven principally by the agencies' view of 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.
- 5.6 The County Council maintained a sufficient level of liquidity through the use of Money Market Funds and the use of call accounts.
- 5.7 The County Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK base rate was maintained at 0.5% through the year.

- 5.8 The County 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 remained at very low levels which had a significant impact on cash investment income – see table below.

Date	Bank Rate	O/N LIBID	7-day LIBID	1-month LIBID	3-month LIBID	6-month LIBID	12-month LIBID	2-yr SWAP Bid	3-yr SWAP Bid	5-yr SWAP Bid
01/04/2011	0.50	0.40	0.54	0.54	0.69	1.12	1.59	1.89	2.36	3.00
30/04/2011	0.50	0.50	0.40	0.49	0.69	1.05	1.52	1.62	2.07	2.74
31/05/2011	0.50	0.40	0.40	0.52	0.69	1.08	1.56	1.53	1.89	2.54
30/06/2011	0.50	0.50	0.40	0.50	0.77	1.06	1.54	1.44	1.82	1.50
31/07/2011	0.50	0.40	0.40	0.50	0.78	1.07	1.55	1.29	1.53	2.09
31/08/2011	0.50	0.40	0.40	0.56	0.86	1.15	1.63	1.27	1.43	1.92
30/09/2011	0.50	0.60	0.60	0.54	0.92	1.21	1.69	1.25	1.38	1.75
31/10/2011	0.50	0.63	0.55	0.56	0.96	1.25	1.74	1.30	1.42	1.81
30/11/2011	0.50	0.65	0.58	0.64	1.01	1.31	1.80	1.41	1.49	1.76
31/12/2011	0.50	0.50	0.65	0.67	1.05	1.35	1.84	1.31	1.34	1.54
31/01/2012	0.50	0.50	0.70	0.68	1.06	1.38	1.87	1.20	1.23	1.46
29/02/2012	0.50	0.50	0.75	0.67	1.05	1.37	1.87	1.22	1.29	1.54
31/03/2012	0.50	0.55	0.55	0.61	1.00	1.33	1.84	1.22	1.30	1.59
Minimum	0.50	0.10	0.35	0.49	0.68	1.01	1.40	1.08	1.23	1.46
Average	0.50	0.47	0.52	0.58	0.89	1.21	1.69	1.36	1.55	1.98
Maximum	0.50	0.65	0.95	0.68	1.06	1.38	1.87	1.95	2.42	3.07
Spread	--	0.55	0.60	0.19	0.38	0.37	0.47	0.87	1.19	1.60

- 5.9 The County Council's average cash investment balance was £344m during 2011/12, and interest earned was £4,923,000, leading to an average yield of 1.4%.
- 5.10 A small number of longer term cash investments for periods of up to two years were made in order to access higher investment returns in the current low interest rate environment.
- 5.11 Cash investments with longer than 364 days to maturity were restricted to a maximum of £120m, with a maximum investment being placed with one institution of £20m.

Compliance with Prudential Indicators

- 5.12 The County Council can confirm that it has complied with its Prudential Indicators for 2011/12, which were set in February 2011 as part of the County Council's Treasury Management Strategy Statement.

- 5.13 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 taken in relation to investment activity with priority being given to security and liquidity over yield.

Capital Financing Requirement

- 5.14 The underlying need to borrow for capital purposes, as measured by the Capital Financing Requirement (CFR) is a core driver of treasury management activity. The estimates and actual position as at 31 March 2012 are:

	31/03/2012 Estimate £m	31/03/2012 Actual £m
Total Capital Financing Requirement	715.9	720.0
Less:		
Existing profile of long term borrowing	-387.7	-384.7
Other long term liabilities	-114.7	-103.2
Temporary borrowing	-	-48.1
Cumulative additional maximum external borrowing requirement	213.5	184.0

Authorised Limit and Operational Boundary for external debt

- 5.15 CIPFA's Code of Practice requires authorities to set an Authorised Limit for external debt, defined as the sum of external borrowing and other long-term liabilities. This is a statutory limit which should not be breached. The County Council's Authorised Limit was set at £860m for 2011/12.
- 5.16 This limit is based on the estimated Capital Financing Requirement (CFR) in order to enable it to be financed entirely from external borrowing should the County Council's internal reserves become depleted. The limit also includes an allowance for temporary borrowing to cover normal revenue cash flow requirements and unexpected outflows or delays in receiving cash.
- 5.17 During 2011/12, the gross borrowing reached a maximum of £536m which is within the Authorised Limit of £860m.

- 5.18 The County Council also needs to set an Operational Boundary for external debt. This should reflect the most likely scenario and be consistent with the County Council's capital plans and Treasury Management Strategy. Temporary breaches of the 2011/12 Operational Boundary can take place for cash flow reasons, but any sustained breach will lead to further investigation. The County Council approved an Operational Boundary for 2010/11 of £780m.
- 5.19 During 2011/12, the gross borrowing reached a maximum of £536m which is within the Operational Boundary of £780m.

Upper limits for fixed interest rate exposure and variable interest rate exposure

- 5.20 These indicators allow the County Council to manage the extent to which it is exposed to changes in interest rates.
- 5.21 The County Council has to set an upper limit on its fixed interest rate exposure, which is expressed in terms of the maximum long-term fixed-rate principal sums which can be outstanding on any day in each year. The County Council approved an upper limit on fixed interest rate exposure for 2011/12 of £780m.
- 5.22 During 2011/12, the long-term fixed-rate principal sums outstanding reached a maximum of £418m which is within the upper limit on fixed interest rate exposure of £780m.
- 5.23 The County Council also has to set an upper limit on its variable interest rate exposure. The County Council approved an upper limit on variable interest rate exposure for 2011/12 of £780m, which is based on the Operational Boundary and has been set to give the County Council maximum policy flexibility. The limit enables the potential for a refinancing from, e.g., fixed to variable rate borrowing.
- 5.24 During 2011/12, the variable interest rate exposure reached a maximum of £118m which is within the upper limit on variable interest rate exposure of £780m.

Maturity structure of fixed rate borrowing

- 5.25 The Code also requires the County Council to set upper and lower percentage limits on the maturity structure of its long-term fixed rate borrowing during 2011/12. The following table shows the limits approved by the County Council. These have been set in order to allow maximum flexibility in managing the debt portfolio and are consistent with the existing portfolio.

	Upper limit (%)	Lower limit (%)	Actual (%)
Under 12 months	50	0	3
12 to 24 months	50	0	3
24 months to 5 years	50	0	12
5 years to 10 years	75	0	16
10 years to 20 years	75	0	29
20 years to 30 years	75	0	35
30 years to 40 years	100	0	2
40 years to 50 years	100	0	0
50 years and above	100	0	0

- 5.26 The County Council's long-term fixed rate borrowing during 2011/12 has not breached these set limits.

Total principal sums invested for periods longer than 364 days

- 5.27 For 2011/12, the County Council originally set an upper limit of £60m on investments for periods longer than one year in February 2011. On setting the Treasury Management Strategy Statement for 2012/13 in February 2012, the opportunity was taken to revise the upper limit for 2011/12 to £120m.
- 5.28 This indicator allows the County Council to manage the risk inherent with longer term investments, and lending for longer than 364 days and up to a maximum of two years is currently restricted to UK local authorities only (including police and fire authorities).
- 5.29 An exception to this was the lending of £5m to Lancashire County Council for a 20-year term specifically in relation to forecasted cash flow surpluses on the Council's 25-year Street Lighting PFI project, which has secured an investment income stream for the project at an interest rate of 3.8% on a £5m element of its cash flow surpluses.

- 5.30 The County Council's long-term investments during 2011/12 have not breached this set limit.

Ratio of financing costs to net revenue stream

- 5.31 The ratio of financing costs to the net revenue stream shows the estimated annual revenue costs of borrowing (interest payable on debt plus the minimum revenue provision for repaying the principal less interest on balances) as a percentage of the amount in the draft revenue budget to be met from central government grant and by local taxpayers. Actual figures for 2010/11 and 2011/12 together with the actual for 2011/12 are set out in the table below.

	2010/11 Actual £m	2011/12 Estimate £m	2011/12 Actual £m
Financing costs	50.0	64.0	59.4
Net revenue stream	672.1	715.6	715.6
Ratio	7.44%	8.94%	8.30%

- 5.32 Lower financing costs in 2011/12 than estimated reflect the underspending reported in the 2011/12 outturn report.