Report To:	Date	Classification	Report No.	Agenda Item No.
Audit Committee	**25 September 2012**	**Unrestricted**		

REPORT OF: **Corporate Director, Resources** ORIGINATING OFFICER(S): ***Alan Finch, Service Head, Financial Services, Risk & Accountability*** ***Oladapo Shonola, Chief Financial Strategy Officer***	**2011-12 Treasury Management Outturn Report** WARD(S) AFFECTED: N/A

Lead Member	**Cllr Alibor Choudhury – Resources**
Community Plan Theme	**All**
Strategic Priority	**One Tower Hamlets**

1. SUMMARY

1.1 This report advises the Committee of treasury management activity for the financial year ended 31 March 2012 as required by the Local Government Act 2003.

1.2 The report details the treasury management outturn position based on the credit criteria adopted by the Corporate Director of Resources, the investment strategy for the financial year as approved by Council and the investment returns.

1.3 The Council complied with its legislative and regulatory requirements. The key actual prudential and treasury management indicators detailing the impact of capital expenditure activities during the year, with comparators are also addressed in this report.

1.4 The Corporate Director, Resources confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit (the authorised limit) was not breached.

1.5 The Local Government Act 2003 also requires that a sub-committee scrutinises the investment strategy, mid-year and outturn treasury management reports before they are reported to the full Council. As well as the above reports being reported to either Cabinet or the Audit Committee, updates on treasury management activities were also reported to the Audit Committee on 4 separate occasions.

2. DECISIONS REQUIRED

2.1 Members are recommended to note the contents of this report.

3 REASONS FOR DECISIONS

3.1 This 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 2011/12. 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).

3.2

3.3 During 2011/12 the minimum reporting requirements were that Full Council should receive the following reports:

- an annual treasury strategy in advance of the year (22 February 2011)
- a mid-year (minimum) treasury update report (Council 29 November 2011)
- an annual report following the year describing the activity compared to the strategy (this report)
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3.3 In addition, the Audit Committee received regulatory treasury management activity update reports on 28 June 2011, 20 September 2011, 12 December 2011 and 20 March 2012.

3.4 The regulatory environment places 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.

3.5 The annual report of treasury management should assist in ensuring that Members are able to scrutinise officer decisions and check that investment strategy was implemented as approved by Full Council.

4 ALTERNATIVE OPTIONS

4.1 The Council is bound by legislation to have regard to the Treasury Management (TM) Code. The Code requires that the Council should receive an annual report on treasury management activities.

4.2 If the Council were to deviate from those requirements, there would need to be some good reason for doing so. It is not considered that there is any such reason, having regard to the need to ensure that Members are kept informed about treasury management activities and to ensure that these activities are in line with the investment strategy approved by the Council.

5 BACKGROUND

5.1 The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 require local authorities to have regard to the Treasury Management Code. The Treasury Management code requires that the Council or a sub-committee of the Council should receive an annual report on treasury management activities.

5.2 This report summarises:

- 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;
- Debt activity;
- Summary of interest rate movements in the year;
- Investment activity; and
- Capital expenditure and financing 2011-12

6. CAPITAL EXPENDITURE AND FINANCING 2011-12

6.1 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
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

6.2 The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

£'000	2010/11 Actual	2011/12 Estimate	2011/12 Actual
Non-HRA capital expenditure	111,348	138.300	130,717
HRA capital expenditure	37,227	37,351	31,615
Total Capital Expenditure	148,575	175,651	162,332
Resources			
Capital Grants	97,119	123,951	106,007
Direct Revenue Financing	7,003	2,596	4,861
Major Repairs Allowance	7,641	12,500	11,382
Developers Contributions	5,328	5,180	12,715
Capital Receipts	5,792	11,240	7,462
Capital Expenditure (Financed from borrowing)	**(25,692)**	**(20,184)**	**(19,906)**

6.3 Actual capital expenditure was less than the estimated figure of £175.651m by £13.3m. The slippage was in the main due to the housing element of the capital programme and High Street 2012 programme.

7 OVERALL BORROWING NEED

7.1 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 2011/12 unfinanced capital expenditure as set out in the above table, and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

7.2 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 Public Works Loan Board (PWLB) or the money markets, or utilising temporary cash resources within the Council.

7.3 The Council's non-Housing Revenue Accounts (HRA) underlying borrowing need 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 non-HRA borrowing need (there is no statutory requirement to reduce the HRA CFR).

7.4 The Council's 2011/12 MRP Policy was approved as part of the Treasury Management Strategy Report for 2011/12 on 22 February 2011.

7.5 The Council's CFR for the year is shown below, and represents a key prudential indicator. This includes PFI and leasing schemes on the balance sheet, which increase the Council's borrowing need. No borrowing is actually required against these schemes as a borrowing facility is included in the contract.

CFR £'000	31-Mar-11 Actual	31-Mar-12 Original Indicator	31-Mar-12 Actual
Opening balance	437,731	456,421	456,421
Add unfinanced capital expenditure	25,693	20,184	19,906
Add PFI adjustment	41,205	41,090	41,090
Less MRP	(7,003)	(6,955)	(8,392)
Less HRA Settlement	-	(234,000)	(236,200)
Less PFI Adjustment	(41,205)	(41,090)	(41,090)
Closing balance	**456,421**	**235,650**	**231,735**

7.6 **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 2011/12 plus the expected changes to the CFR over 2012/13 and 2013/14. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2011/12.

7.7 The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator. The implementation of housing finance reform from 1 April 2012 abolished the housing subsidy system financed by central government. As a result of the introduction of the new system of self-financing, the Government paid off £236.2m of HRA debt, leading to an equivalent reduction in HRA CFR. A summary of opening and closing CFR balances are set out in below table.

£'000	31-Mar-11 Actual	31-Mar-12 Original	31-Mar-12 Actual
Non HRA CFR	163,046	163,317	162,060
HRA CFR	293,375	72,333	69,675
CFR (Total)	**456,421**	**235,650**	**231,735**

7.8 **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 2011/12 the Council has maintained gross borrowing within its authorised limit.

7.9 **Maximum gross borrowing** – the maximum outstanding debt owed by the Council at any time during the financial year.

7.10 **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 is acceptable subject to the authorised limit not being breached.

7.11 **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.

£'000	2011/12
Authorised limit	496,079
Maximum gross borrowing position	353,474
Operational boundary	476,079
Financing costs as a proportion of net revenue stream (Non-HRA)	2.12%
Financing costs as a proportion of net revenue stream (HRA)	17.90%

8 <u>TREASURY POSITION as at 31 March 2012</u>

8.1 The Council's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the beginning and the end of 2011/12 the Council's treasury position was as follows:

Debt	31 March 2011 Principal	Rate/ Return	31 March 2012 Principal	Rate/ Return
Fixed Rate Funding:				
-PWLB	275,974	7.71%	13,852	7.63%
-Market	13,000	4.37%	13,000	4.37%
Total Fixed Rate Funding	288,974	7.56%	26,852	6.05%
Variable Rate Funding:				
-PWLB	0	0.00%	0	0
-Market	64,500	1.23%	64,500	1.66%
Total Variable Rate Funding	64,500	1.23%	64,500	1.66%
Total debt	***353,474***	***6.40%***	***91,352***	***2.95%***
CFR	***456,421***		***231,735***	
Over/ (under) borrowing	***(102,943)***		***(140,383)***	

Investments:	31 March 2011 Principal	Rate/ Return	31 March 2012 Principal	Rate/ Return
In house				
External managers	0	0.00%	0	0.00%
Total investments	***201,136***	***1.20%***	***207,600***	***1.52%***

8.2 Overall debt has reduced significantly as a result of the introduction of the HRA self-financing regime which came into effect on 01 April 2012. As part of the implementation of the HRA reform which brought an end to the subsidy system, the Council received £236.2m from the Government towards redeeming a proportion of HRA PWLB debt to ensure that the HRA is able to support itself going forward.

8.3 The under-borrowed amount represents the element of the programme that is currently being funded from internally held resources. Although this reduces the need to borrow from external sources, it does not allow for additional borrowing over and above the CFR. The Council also repaid £25.9m of maturing loans, thereby reducing the overall debt outstanding from £353.4m to £91.4m as at 31 March 2012.

8.4 The maturity structure of the debt portfolio was as follows:

£'000	**31 March 2011 Actual**	**2011/12 Original Limits**	**31 March 2012 Actual**	**31 March 2012 Actual %**
Under 12 months	25,740	10%	932	1.0%
12 months and within 24 months	16,688	30%	13,851	15.2%
24 months and within 5 years	47,102	40%	3,632	4.0%
5 years and within 10 years	113,610	80%	6,064	6.6%
10 years and above	150,334	100%	66,873	73.2%

8.5 The maturity structure for the investment portfolio was as follows:

£'000	31 March 2011 Actual	2011/12 Original Limits	31 March 2012 Actual
Under 1 year	201,136	100%	192,600
More than 1 year	-	25,000	15,000
Total	**201,136**		**207,600**

9 THE STRATEGY

9.1 The expectation for interest rates within the strategy for 2011/12 anticipated low but rising Bank of England base rate, starting in quarter 4 of 2011, with similar gradual rises in medium and longer term fixed borrowing rates over 2011/12. Variable or short-term rates were expected to be the cheaper form of borrowing over the period. The Council has continued with its conservative approach of prioritising security and liquidity over yield, Investments would therefore continue to be dominated by low counterparty risk considerations, though this results in a high cost of carry as investment returns are relatively low compared to borrowing rates.

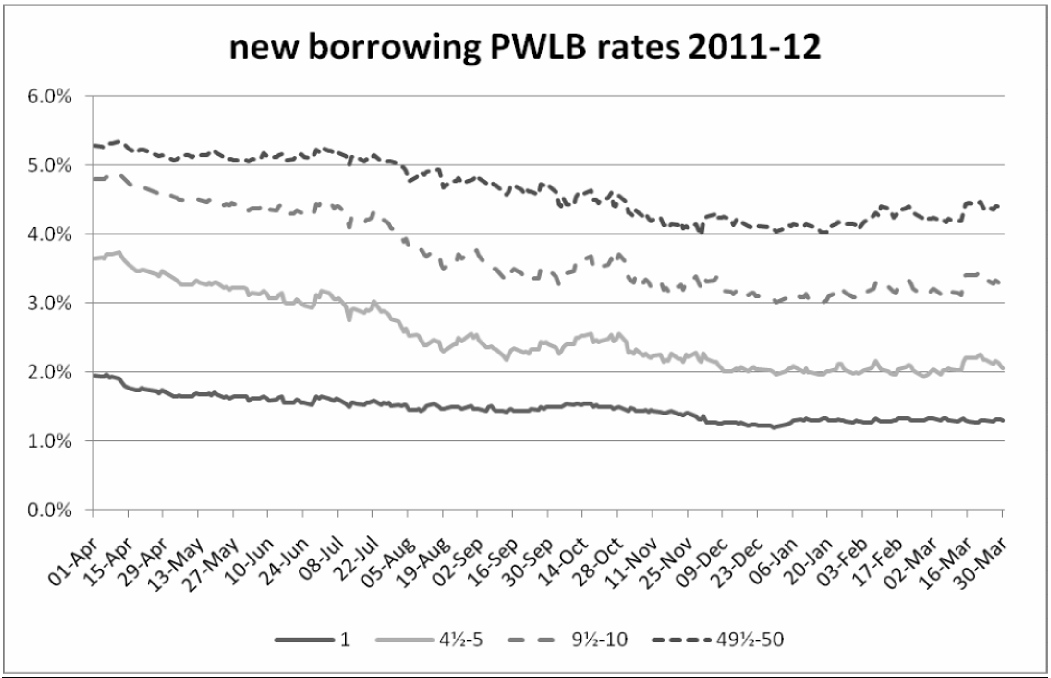
9.2 A revised Treasury Management Strategy was approved by Full Council at its January meeting to incorporate the following changes:

- Allow investment in overseas counterparties from countries that have AAA sovereign rating;
- Increase the individual/group limit for investment in institutions that are wholly or partly owned by the UK government from £30m to £45m;
- Allow up to £25m (previously £12m) of available cash balances to be invested for periods over 364 days up to a maximum of 3 years with a limit of £15m for investments between 2 to 3 years maturity.

9.3 The revised investment strategy for the year end 2011/12 is set out in the table below.

Institution	Minimum High Credit Criteria	Use	Limit
Debt Management Office (DMO) Deposit Facility	Not applicable	In-house	£100m*
Term deposits – Other Local Authorities	Not applicable	In-house	£10m**
Term deposits – banks and building societies	Short-term F1+, Long-term AA-	In-house	£30m
Institutions with Government guarantee on ALL deposits by high credit rated (sovereign rating) countries.	Sovereign rating	In-house	£30m
UK Government Gilts	Long Term AAA	In-house	£20m
Institutions with UK Government support.	Sovereign rating	In-house	£30m
Institutions that are owned/part owned by the UK Government	Sovereign rating	In-house	£45m
Collective Investment Schemes structured as Open Ended Investment Companies (OEICs)			
Money Market Funds	AAA rated	In-house	£10m

9.4 Gilt yields fell for much of the year, until February 2012, as concerns continued building over the EU debt crisis. This resulted in safe haven flows into UK gilts, together with the two UK packages of quantitative easing during the year, combined to depress PWLB rates to historically low levels as illustrated in the chart below.

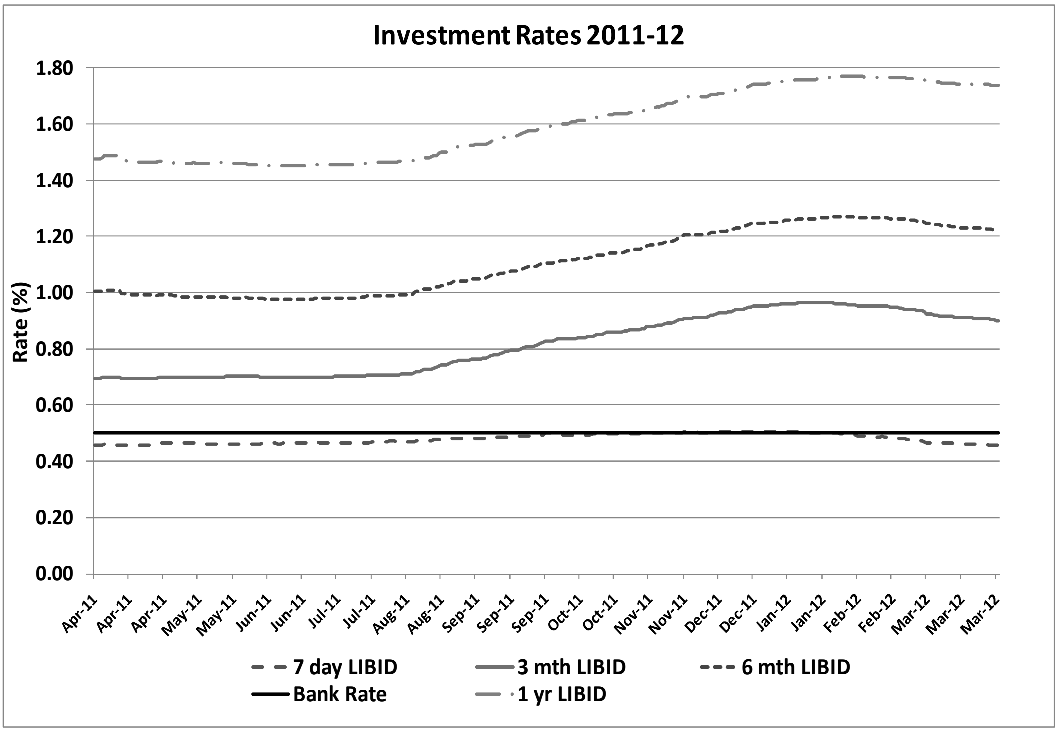


9.5 Risk premiums were also a constant factor in raising money market deposit rates for periods longer than 1 month. Widespread and multiple downgrades of the ratings of many banks and sovereigns, continued Eurozone concerns, and the significant funding issues still faced by many financial institutions, meant that the Council remained cautious of longer-term investments and only invest in institutions with high individual credit quality and in countries with AAA sovereign rating.

10 INVESTMENT RATES

10.1 The tight monetary conditions following the 2008 financial crisis continued through 2011/12 with little material movement in the shorter term deposit rates. However, one month and longer rates rose significantly in the second half of the year as the Eurozone crisis grew. Base rate remained at its historic low of 0.5% throughout the year while market expectations of the start of monetary tightening were gradually pushed further and further back during the year to the second half of 2013 at the earliest.

10.2 The investment rates in 2011/12 are as detailed in the below chart.



11 INVESTMENT OUTTURN

11.1 The Council's investment policy is governed by CLG guidance, which was being implemented in line with the annual investment strategy approved by Full Council on 22 February 2011 and the revised investment strategy approved by Full Council on 25 January 2012. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies supplemented with additional market data (such as rating outlooks, credit default swaps, bank share prices etc.)

11.2 The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

11.3 The Council maintained an average balance of £207.1m of internally managed funds which earned an average rate of return of 1.52%. This compared favourably against the 7-day LIBID of 0.48%.

13. COMMENTS OF THE CHIEF FINANCIAL OFFICER

13.1. The comments of the Corporate Director Resources have been incorporated into the report of which he is the author.

14. CONCURRENT REPORT OF THE ASSISTANT CHIEF EXECUTIVE (LEGAL)

14.1 Treasury management activities cover the management of the Council's investments and cash flows, its banking, money market and capital market transactions, the effective control of risks associated with those activities and the pursuit of optimum performance consistent with those risks. The Local Government Act 2003 provides a framework for the capital finance of local authorities. It provides a power to borrow and imposes a duty on local authorities to determine an affordable borrowing limit. It provides a power to invest. Fundamental to the operation of the scheme is an understanding that authorities will have regard to proper accounting practices recommended by the Chartered Institute of Public Finance and Accountancy (CIPFA) in carrying out capital finance functions.

14.2 The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 require the Council to have regard to the CIPFA publication "Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes" ("the Treasury Management Code") in carrying out capital finance functions under the Local Government Act 2003. If after having regard to the Treasury Management Code the Council wished not to follow it, there would need to be some good reason for such deviation.

14.3 The Treasury Management Code requires as a minimum that there be a practice of regular reporting on treasury management activities and risks to the responsible committee and that these should be scrutinised by that committee. Under the Council's Constitution, the audit committee has the functions of monitoring the Council's risk management arrangements and making arrangements for the proper administration of the Council's affairs.

15. ONE TOWER HAMLETS CONSIDERATIONS

15.1 Interest on the Council's cash flow has historically contributed significantly towards the budget. This Council's ability to deliver its various functions, to meet its Community Plan targets and to do so in accordance with its obligations under the Equality Act 2010 may thus be enhanced by sound treasury management.

16 SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

16.1 There are no Sustainable Actions for A Greener Environment implications.

17. RISK MANAGEMENT IMPLICATIONS

17.1 Any form of investment inevitably involves a degree of risk. To minimise risk the investment strategy has restricted exposure of council cash balances to UK backed banks or institutions with the highest short term rating or strong long term rating.

18. CRIME AND DISORDER REDUCTION IMPLICATION

18.1 There are no crime and disorder reduction implications arising from this report.

21. EFFICIENCY STATEMENT

21.1 Monitoring and reporting of treasury management activities ensures the Council optimises the use of its monetary resources within the constraints placed on the Council by statute, appropriate management of risk and operational requirements.

LOCAL GOVERNMENT ACT 1972 (AS AMENDED) SECTION 100D
LIST OF "BACKGROUND PAPERS" USED IN THE PREPARATION OF THIS REPORT

Brief description of "background papers"	*Name and telephone number of holder And address where open to inspection*