Annual Report 2010/11
Treasury Management and Actual Prudential Indicators

1. Introduction

1.1 The Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance:

- The Local Government in Scotland Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity;
- The Act permits the Scottish Ministers to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (although no restrictions were made in 2010/11);
- Statutory Instrument (SSI) 29 2004, requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities and, therefore, to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services; and the treasury activity with regard to the CIPFA Code of Practice for Treasury Management in Local Authorities.

1.2 This Council has adopted the CIPFA Code of Practice for Treasury Management in the Public Sector and operates its treasury management service in compliance with this Code and the above requirements. These require that the prime objective of the treasury management activity is the effective management of risk, and that its borrowing activities are undertaken in a prudent, affordable and sustainable basis.

1.3 During 2010/11 the minimum reporting requirements were that the Council receive an annual treasury strategy in advance of the year, a mid year report and an annual report following the year describing the activity compared to the strategy (this report).

1.4 This report sets out:

- A summary of the strategy agreed for 2010/11;
- The Council's treasury position at 31 March 2011;
- The main Prudential Indicators and compliance with limits;
- A summary of the economic factors affecting the strategy over 2010/11;
- The Treasury activity during 2010/11;
- Performance indicators set for 2010/11;
- Risk and Performance.

2. A Summary of the Strategy Agreed for 2010/11

2.1 The treasury strategy expected short term interest rates to remain on hold during 2010/11 while long term interest rates were are at risk of being higher over the medium term. As a result, the Council chose to take a cautious approach to its strategy and take necessary actions on borrowings, investments and debt rescheduling, in conjunction with market conditions at that time.

3. The Council's Treasury Position at 31 March 2011

3.1 During 2010/11, the Executive Director of Corporate Services managed the debt position with the use of internal funds as well as external borrowing, and the treasury position at 31 March 2011 compared with the previous year was:

Table 1

Treasury position	31 March 2011		31 March 2010	
	Principal	Average Rate	Principal	Average Rate
Fixed Interest Rate Debt	£219.339m	5.16%	£214.960m	4.96%
Variable Interest Rate Debt	£0.461m	0.81%	£0.461m	1.01%
Total Debt	**£219.800m**	**5.15%**	**£215.421m**	**4.95%**
Total Investments	**£14.639m**	**0.65%**	**£10.713m**	**0.75%**
Net borrowing position	**£205.161m**		**£204.708m**	

3.2 From the above table, it can be seen that the average interest rate on debt held on 31 March has increased from 4.95% in 2010 to 5.15% in 2011 mainly due to the known replacement of naturally maturing debt. This is a minor increase due to known treasury management action where the replacement type and period of the new loans were undertaken to mitigate the impact of anticipated PWLB interest rate increases. At the same time – in line with market conditions - the average interest rate has reduced on the investments held on 31 March 2010 to 2011 – from 0.75% to 0.65%.

3.3 There are four treasury prudential indicators which contain the activity of the treasury function within certain limits, thereby reducing the risk of an adverse movement in interest rates impacting negatively on the Council's overall position:

- Upper limits on variable rate exposure.
- Upper limits on fixed rate exposure.
- Maturity structures of borrowing.
- Total principal funds invested for greater than 364 days. During 2010/11 the use of investments greater than 364 days was prohibited by the Council, so this indicator is set at nil.

3.4 The indicators within table 2 shows that the upper limits set for debt type and maturity were not breached during the year to 31 March 2011.

Table 2

	2010/11 Actual	2010/11 Revised Indicator	
Upper limits on fixed interest rates *(against maximum position)*	99.79%	100%	
Upper limits on variable interest rates *(against maximum position)*	0.21%	30%	
Maturity structure fixed rate borrowing *(%)*	**Year end Position**	**Max**	**Min**
Under 12 months	0%	15%	0%
12 months to 2 years	12%	15%	0%
2 years to 5 years	15%	30%	0%
5 years to 10 years	14%	50%	0%
10 years to 20 years	5%	50%	0%
20 years to 30 years	1%	50%	0%
30 years to 40 years	13%	50%	0%
40 years to 50 years	10%	100%	0%
50 years to 60 years	16%	100%	0%
60 years to 70 years	14%	100%	0%
Maximum principal funds invested *>364 days*	Nil	Nil	

4. The Main Prudential Indicators and Compliance with Limits

4.1 The Council is required by the Prudential Code to report the actual prudential indicators after the year end.

4.2 **Capital Expenditure and its Financing -** This forms one of the required prudential indicators and shows total capital expenditure for the year and how this was financed. The reduction in total capital expenditure between revised estimate and actual as noted below in Table 3 is due to income and slippage identified to be carried into 2011/12.

Table 3

	2010/11 Actual	2010/11 Revised Estimate
Total capital expenditure	£51.010m	£52.362m
Resourced by:		
Capital receipts and grants	£16.280m	£16.445m
PPP Contractual Liability	£10.526m	£10.526m
Revenue	Nil	Nil
Capital expenditure - additional need to borrow	**£24.204m**	**£25.391m**

4.3 **Net Borrowing and the Capital Financing Requirement (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 used for capital purposes. Net borrowing should not, therefore, except in the short term, exceed the CFR for 2010/11 plus the expected changes to the CFR over 2011/12 and 2012/13.

4.4 The Executive Director of Corporate Services reports that the Council has complied with the requirement to keep adjusted net borrowing below the CFR in 2010/11 as noted below in Table 4.

Table 4

	2010/11 Actual	2010/11 Revised Indicator
Net borrowing position per Table1	£205.161m	£212.191m
PPP long term liability	£94.588m	£94.853m
Adjusted net borrowing position	**£299.749m**	**£307.044m**
Capital Financing Requirement	**£318.910m**	**£322.264m**

4.5 The reduction in the adjusted net borrowing position from the revised 2010/11 indicator to the actual position is due to the Council not borrowing to fund the capital programme during 2010/11 while the reduction in the capital financing requirement is due to slippage in the HRA capital programme.

4.6 **The Authorised Limit -** The Authorised Limit is the “Affordable Borrowing Limit” required by s35 of the Local Government in Scotland 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.

4.7 **The Operational Boundary** – The Operational Boundary is the borrowing position that the Council expects to work around during the year, and periods where the actual position is either below or over the Boundary is acceptable subject to the Authorised Limit not being breached.

4.8 **Incremental Impact of capital investment decisions** - This indicator identifies the trend of the proposed changes in the capital programmes compared to existing commitments and current plans, measured against Band D council tax and weekly housing rents.

4.9 **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.

Table 5

	2010/11	
Revised Indicator - Authorised Limit	**£269.972m**	
Revised Indicator - Operational Boundary	**£247.475m**	
Maximum gross borrowing position during 2010/11	**£235.465m**	
Minimum gross borrowing position during 2010/11	**£215.403m**	
	Estimated	**Actual**
Incremental Impact of capital investment decisions:		
Council Tax (excluding year-end flexibility)	£1.85	£1.91
Rent	£1.48	£1.38
Financing costs as a proportion of net revenue stream:		
Housing	40.57%	40.18%
Non housing	6.48%	5.01%

5. Summary of the Economic Factors affecting the Strategy over 2010/11

5.1 Economic Background for 2010/11

5.1.1 Local authorities were presented with changed circumstances following the unexpected change of policy on Public Works Loan Board (PWLB) lending arrangements in October 2010. This resulted in an increase in new borrowing rates of 0.75 to 0.85%, without an associated increase in early redemption rates. This made new borrowing more expensive and repayment relatively less attractive.

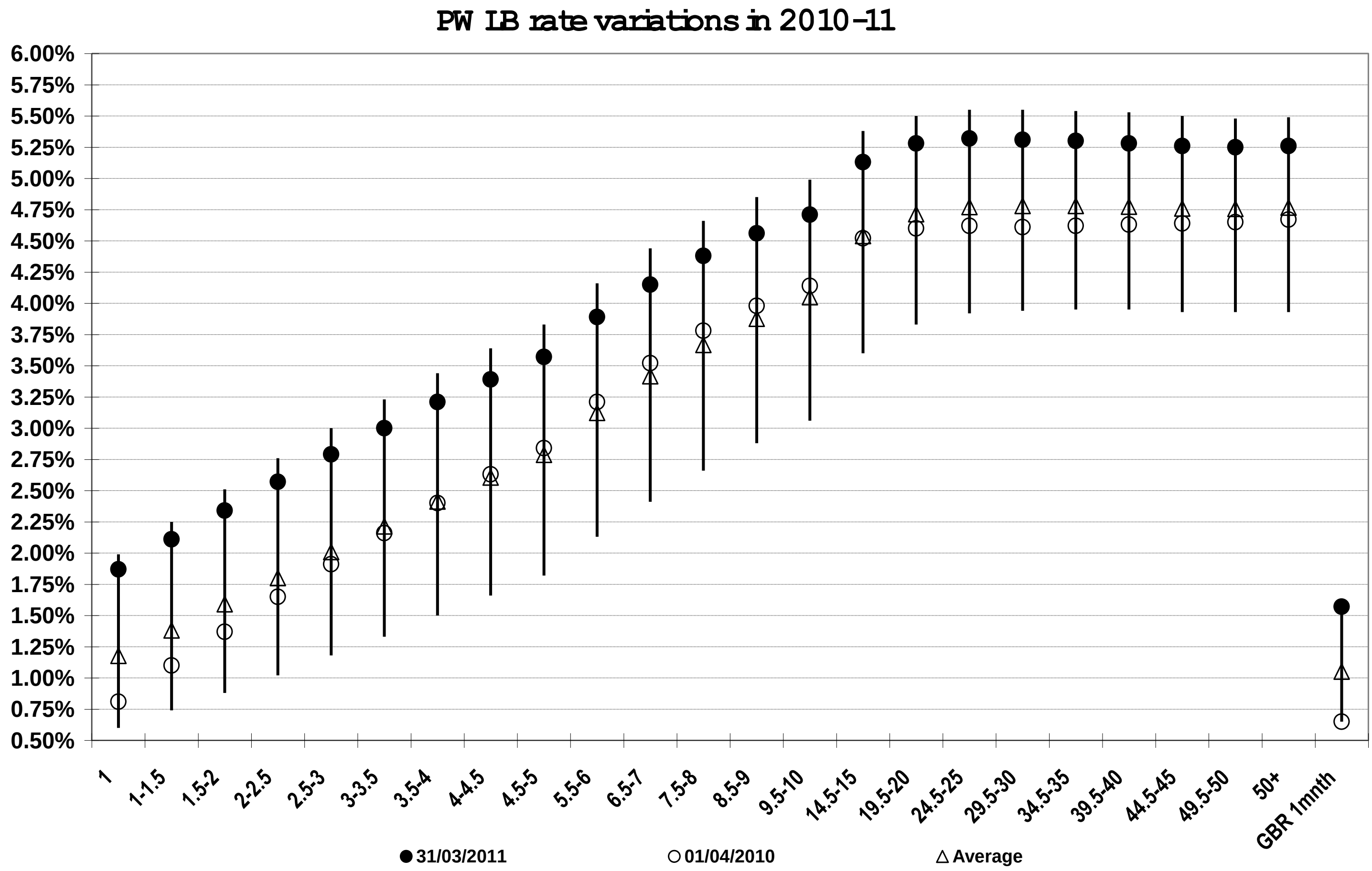
5.1.2 UK growth proved mixed over the year. The first half of the year saw the economy outperform expectations, although the economy slipped into negative territory in the final quarter of 2010 due to inclement weather conditions. The year finished with prospects for the UK economy being decidedly downbeat over the short to medium term.

5.1.3 In March 2011, slowing actual growth, together with weak growth prospects, saw consensus expectations of the first UK rate rise move back from May to August 2011 despite high inflation. However, the disparity of expectations on domestic economic growth and inflation encouraged a wide range of views on the timing of the start of increases in Bank Rate in a band from May 2011 through to early 2013. This sharp disparity was also seen in MPC voting which, by year-end, had three Members voting for a rise while others preferred to continue maintaining rates at ultra low levels.

5.1.4 Risk premiums were also a constant factor in raising money market deposit rates beyond 3 months. Although market sentiment has improved, continued Euro zone concerns, and the significant funding issues still faced by many financial institutions, mean that investors remain cautious of longer-term commitment. The European Commission did try to address market concerns through a stress test of major financial institutions in July 2010. Although only a small minority of banks "failed" the test, investors were highly sceptical as to the robustness of the tests, as they also are over further tests now taking place with results due in mid-2011.

5.1.5 Graph 1 below for PWLB maturity rates below show, for a selection of maturity periods, the range (high and low points) in rates, the average rates and individual rates at the start and the end of the financial year. Variations in most PWLB rates have been distorted by the October 2010 decision by the PWLB to raise its borrowing rates by about 0.75 – 0.85% e.g. if it had not been for this change, the 25 year PWLB at 31 March 2011 (5.32%) would have been only marginally higher than the position at 1 April 2010.

Graph 1



6. Treasury Activity during 2010/11

6.1 **Borrowing** – The Council raised three new long term loans during the year due to the known repayment of a naturally maturing loan of £20.045m and utilisation of the consent to borrow for equal pay granted by the Scottish Government in February 2010 but not approved by Council until 28 April 2010 of £4.413m. Details of the new loans are noted in table 6.

Table 6

Principal Sum	Start Date	End Date	Interest Rate
£10.045m	23 April 2010	28 Oct 2014	2.680%
£10.000m	23 April 2010	28 Oct 2018	3.980%
£4.413m	15 November 2010	15 November 2015	1.600%

6.2 **Rescheduling** – No debt rescheduling was carried out in 2010/11.

6.3 **Repayment** – As noted in 6.1 the Council repaid a naturally maturing loan in early 2010/11 of £20.045m, however, no loans were prematurely repaid during 2010/11.

6.4 **Summary of Debt Transactions** – The overall position of the debt activity, together with the planned movement in some PWLB loans, resulted in an increase in the average interest rate at 31 March year on year by 0.20% from 4.95% to 5.15%.

6.5 **Investment Policy –** The Scottish Government issued The Local Government Investments (Scotland) Regulations 2010 on 1 April 2010.

6.6 The regulations applied from 1 April 2010 and the Council's policy was included in the annual treasury strategy approved by Council on 24 March 2010. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

6.7 The Council's investments increased from £10.713m at the beginning of the year to £14.639m at the end of the year with an average balance of £15.659m and received an average return of 0.65% over the year.

6.8 The Economic Background for 2010/11 (see 5.1 above) set out the fragility and inconsistency of economic conditions during this period. As a result, interest rates remained low impacting adversely on investment returns.

6.9 Security, liquidity and yield benchmarks were introduced for 2010/11. Yield benchmarks are currently widely used to assess investment performance. Discrete security and liquidity benchmarks are new requirements to the Member reporting, although the application of these is more subjective in nature. These were first set in the Treasury Strategy Report which was presented to Council on 24 March 2010.

- **Security -** In the context of benchmarking, assessing security is a very subjective area to assess. Security is currently evidenced by the application of minimum quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody's and Standard and Poors). The Council has benchmarked security risk by assessing the historic level of default against the minimum long term credit rating of AA used in the Council's investment strategy. The Council's maximum security risk benchmark for the current portfolio in relation to investment periods of up to one year (when compared to historic default tables) is set at 0.03% for counterparties with a long term rating of AA. The Executive Director of Corporate Services can report that all investments within the Council's portfolio were repaid on their due dates with no defaults of the principal sums recorded.

- **Liquidity** – As required by the CIPFA Treasury Management Code of Practice The Council has stated that it will "ensure that it has adequate, though not excessive, cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives". In respect to liquidity as defined above the Executive Director of Corporate Services can report that liquidity arrangements during the year were maintained in line with the facilities and benchmarks previously set by the Council as noted below.

  - Bank overdraft - £1.000m
  - Liquid short term deposits of at least £5.000m available on an overnight basis.

- **Yield** – The Executive Director of Corporate Services can report that investment return to date average 0.65% which is a year on year decrease of 0.10% with an average external investment period of 40 days. Table 7 illustrates that the average return of 0.65% was greater than the local measures of yield investment benchmarks approved in March 2010.

Table 7

Benchmark	Benchmark Return	Average Return
Internal returns above the 7 day LIBID rate	0.42%	0.65%
Internal returns above the 1 month LIBID rate	0.44%	0.65%
Internal returns above the Council investment account	0.50%	0.65%

7. Risk and Performance

7.1 The Council has complied with all relevant statutory and regulatory requirements which require the Council to identify and, where possible, quantify the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means both that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

7.2 The Council is aware of the risks of passive management of the treasury portfolio and, with the support of Sector, the Council's advisers, has proactively managed its treasury position within the current economic climate. The Council has complied with its internal and external procedural requirements. There is little risk of volatility of costs in the current debt portfolio as the interest rates are predominantly fixed, utilising long-term loans.

7.3 Shorter-term rates and likely future movements in these rates predominantly determine the Council's investment return. These returns can, therefore, be volatile and, whilst the risk of loss of principal is minimised through the annual investment strategy, accurately forecasting future returns can be difficult.