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PERTH AND KINROSS COUNCIL

3 October 2012

ANNUAL TREASURY REPORT 2011/12

Report by Head of Finance

ABSTRACT
This report summarises the Council's treasury activities for the 2011/12 financial year and compares actual performance with the approved Treasury and Investment Strategy for 2011/12.

1. RECOMMENDATION

1.1 It is recommended that the Council notes the content of this report, which is submitted in accordance with the Council's approved Treasury Management Practices (TMPs).

2. BACKGROUND

2.1 A requirement of the Council's approved TMPs (TMP6 Reporting Requirements & Management Information Arrangements) is the reporting to the Council of the expected treasury activity for the forthcoming year (i.e. the Treasury and Investment Strategy), and the subsequent reporting of the actual results and activities (i.e. this Annual Treasury Report). The Council meeting on 23 February 2011 approved the strategy for the 4 financial years 2011/12 to 2014/15 (Report No. 11/71 refers). This is the first opportunity to submit this year's Annual Report, which covers:

- The Council's treasury position
- The forecast economic outlook and borrowing strategy for 2011/12
- The actual economic situation for 2011/12
- Actual long term borrowing and debt restructuring in 2011/12
- The investment strategy and outurn for 2011/12
- Compliance with treasury policies and limits during 2011/12

3. THE TREASURY POSITION

3.1 In order to place this report in context, the Council's Treasury position at the beginning and at the end of the year is shown below:

	Principal Outstanding 31 Mar 2011 £M	Average Rate %	Principal Outstanding 31 Mar 2012 £M	Average Rate %
Fixed Rate Funding				
• Public Works Loan Board (PWLB)	150.2	4.08	160.0	4.06
• Market Bonds	43.2	4.59	43.2	4.59
• Local Loans & Bonds	0.3	0.75	0.3	0.75
	193.7	4.19	203.5	4.16
Variable Rate Funding				
• Temporary Loans	0.0	0.00	0.0	0.00
• Local Loans	2.3	0.10	2.3	0.10
	2.3	0.10	2.3	0.10
TOTAL DEBT	**196.0**	**4.14**	**205.8**	**4.12**
SHORT TERM INVESTMENTS	**22.3**	**1.51**	**40.0**	**1.93**

4. THE FORECAST ECONOMIC OUTLOOK AND BORROWING STRATEGY 2011/12

4.1 The strategy for the year was based on the view that the global economy had been going through a period of extreme volatility which made it difficult to forecast interest rates with any degree of certainty. It was, however, anticipated that interest rates might start increasing in the second half of the year. At the start of the year the Bank Rate was 0.5%, and was forecast to start increasing towards the end of the year, and then rise steadily through 2012/13 and 2013/14. It was expected that the longer-term Public Works Loan Board (PWLB) rates would follow a similar trend over this same period. Shorter and medium term PWLB rates were expected to follow the same pattern, although remaining at a lower level than longer term rates.

4.2 The effect on interest rates for the UK was therefore expected to be as follows:

- Short-Term Interest rates – it was anticipated that the Bank Rate would begin to increase at the end of 2011/12 to around 1%, and this would continue, with steady increases over the next few years.

- Long-Term Interest Rates – The view on longer-term fixed rates was that long term (over 25 years) Public Works Loan Board (PWLB) rates would also increase during 2011/12, reaching 5.30% by year end. The 10 year rate was expected to reach around 4.70% by the end of 2011/12.

4.3 The estimated capital borrowing requirement for 2011/12 at the start of the year was £25.1M, and included deferment of new borrowing from 2010/11. The new Borrowing requirement over the whole four year period totalled £97.8M, and included some refinancing of maturing debt over the 4 year period. This was particularly significant as 2011/12 co-incided with the period of lowest forecast interest rates. Effective Treasury Management considers the longer-term position in order to minimise costs and risks in the Council's portfolio. It was anticipated that this might include borrowing for future year requirements earlier within the 4 year period, whilst rates were at their forecast low point even if this resulted in short term carrying costs (due to low investment returns). This approach is consistent with the Prudential Code, however it must be considered in conjunction with the assessment of the associated additional risks; particularly from the resultant increase in the level of investments in the short term.

4.4 These factors gave rise to the anticipated strategy that Best Value would be achieved by taking advantage of short dated borrowings throughout the period. This applied particularly to borrowing periods up to 10 years where the rate was forecast to remain lower than the longer term rates. However, consideration would also be given to the use of longer term borrowing to make longer term savings and reduce the refinancing risk in later years. LOBO's (Lender Option Borrowers Option) or other appropriate market instruments were also to be considered and used where they offered favourable rates in comparison to PWLB. However, these would be considered in conjunction with the associated risks with LOBO's due to their variable rate nature after their initial period elapses, and their less flexible terms.

4.5 The Council has traditionally adopted a policy of minimising exposure to risk, thus favouring fixed longer term borrowing, and the above strategy was viewed as low risk. However, it was acknowledged that there were several factors which could impact on interest rates in the year ahead. Therefore the Council continued to apply its well developed approach to managing risk and monitoring interest rates with a view to reviewing this strategy should circumstances change.

5. ACTUAL ECONOMIC SITUATION 2011/12

5.1 2011/12 proved to be another unsettled year for the financial markets. Economic growth in the UK slowed throughout the year, whilst sovereign debt issues in some Eurozone countries intensified. Weak growth in the UK led the Bank of England to increase its programme of "quantitative easing", whilst the Bank Rate remained unchanged at 0.5% throughout the year. During this period, inflation fell significantly in the latter half of the year, after peaking at 5.2% in September 2011, down to 3.5% in March 2012.

5.2 The UK coalition government, in order to reduce the national debt and preserve the UK's AAA credit-rating, took a tough fiscal policy stance. Subsequently, the economy has experienced a period of slowing growth, turning to recession by the first quarter of 2012. However, it is anticipated this will reverse by the end of 2012.

5.3 Gilt yields reduced for much of the year as the financial markets responded positively to the government's debt reduction plans. The yields fell further as a result of Eurozone sovereign debt concerns, with the UK seen as a “safe haven” for investment. Further quantitative easing during the year also reduced yields. All of these factors contributed to yields falling to historic lows over the year.

5.4 The Eurozone sovereign debt crisis caused considerable concerns in the financial markets. Bailouts for Greece (twice), Ireland and Portugal and a debt write-down imposed on some creditors of Greece caused international investors to invest in non-Eurozone government bonds, including UK Gilts.

5.5 Investment deposit rates increased slightly in the second half of the year due to liquidity and Eurozone concerns. However, in early 2012, following the European Central Bank’s (ECB) action to increase liquidity in the banking system, investment rates reduced again. However, with the exceptionally low Bank Rate, investment income returns remained at low levels throughout the year

5.6 PWLB fixed rates all fell over the year. For example, the 9-10 year PWLB rate at 1 April 2011 was 4.71%, and fell as low as 2.99% in January 2012, before finishing the year at 3.24%. Similarly, the 25 year PWLB rate fell from 5.34% to 3.96%, and ended the year at 4.38%. The same pattern emerged for all PWLB rates and various PWLB rates for the year are shown graphically at Appendix I.

6. ACTUAL LONG TERM BORROWING AND DEBT RESTRUCTURING

6.1 The actual treasury activities during 2011/12 are comprehensively detailed in the 4 quarterly reports previously submitted to the Council (Report No’s 11/495, 11/645, 12/77 and 12/187 refer).

6.2 As noted in Section 4.3, before the start of the year the Council’s estimated new Capital borrowing for 2011/12 was £25.1M. The actual Borrowing requirement by the end of the year reduced to £22.4M due to rephasing and slippage within the Capital programme partly offset by new borrowing from the previous year being deferred into 2011/12.

6.3 In summary, a total of £15M was borrowed from the PWLB, at an average rate of 3.79% and for an average time period of 10.3 years, all of which was borrowed in August 2011. This is the same as the average actual PWLB rate during 2011/12 for 10 years. In contrast, the average long term rate available from the PWLB for 25 years was 4.62% and for 50 years was 4.64%. There was only £5.2M of maturing debt with the PWLB during the year and no premature repayments were made due to the low interest rates.

6.4 The average PWLB debt portfolio rate for the Council reduced very slightly from 4.08% at the start of the year, to 4.06% at the end of the year for the total of £160.0M PWLB debt held by the Council. The total PWLB borrowing only increased by £9.8M over the year, as a result of the activities discussed above compared to the actual borrowing requirement of £22.4M. Therefore, some of the Borrowing Requirement has been carried-forward into 2012/13.

The LOBO's (Lender Option Borrower Options) average rate remained at 4.59% over the year as all of the loans had already moved into their "step-up" period and no rate changes were instigated. There were no new LOBOs entered into during the year.

6.5 As a result of the above strategy and actual treasury activities in the year, the Council's average Consolidated Loans Fund (CLF) interest rate remained broadly unchanged at 3.70% in 2011/12 (3.67% in 2010/11). A comparison of the Council's CLF rate over recent years with the average for other Scottish Local authorities is shown graphically at Appendix II. Whilst figures for the Scottish average have not yet been published for 2011/12, this graph shows that over time, this Council's average borrowing costs have reduced year-on-year at a faster rate than the Scottish average. This equates to savings in Loan Charges of approximately £2M per annum on average compared to the Scottish average.

7. INVESTMENT STRATEGY AND OUTURN 2011/12

7.1 The tight monetary conditions and economic uncertainty continued through 2011/12 with little material movement in shorter term deposit rates. Throughout the financial year the Bank (Base) Rate remained at 0.5%, however some deposit rates increased as problems in the Eurozone grew. There were continued counterparty concerns, mostly as a result of the Eurozone sovereign debt crisis, with these concerns extending to the European banking industry. However, in January 2012, the ECB stepped-in to provide short term liquidity to banks. This highlighted the ongoing need for caution in treasury investment activity.

7.2 As a result, advantage was taken where possible (within counterparty limits) of the higher interest rates available for longer time periods (up to 12 months). For shorter lending periods, the notice bank deposit investment accounts and money market funds held by the Council provided a higher return on investments than rates available on the money markets, whilst helping meet daily cashflow requirements and keeping within counterparty limits. During the year, no investment was made for more than 12 months. All these investment activities were in line with the approved strategy for 2011/12. As a result of this strategy, the average rate achieved on investments outstanding at 31st March 2012 was 1.93%, compared to the previous year's rate of 1.51%. For further comparison, the average temporary borrowing rate for the year was 0.156%. Total interest received in 2011/12 amounted to £685,165 (£535,4654 in 2010/11).

7.3 The original Strategy also anticipated that investments would not exceed £50M during the year unless, for example, new borrowing was undertaken. As described in Section 6 there was new borrowing undertaken totalling £15M in the year, and in addition the level of expenditure by the Council was below cashflow forecasts. Consequently, the level of investments exceeded this forecast in the first half of the year and peaked at £67.75M on 21 September 2011. The level of investments slowly reduced over the remainder of the year and at the end of the financial year stood at £40M.

7.4 The Council's strategy of reducing its level of investments could only partly be continued by the deferment of some of the new borrowing requirement. However due to the low level of interest rates, the premature repayment of debt was not considered desirable. Additionally, lower levels of expenditure, particularly in the Capital Programme, acted to increase the Council's cash balances and as a result the level of investments fell more slowly than originally anticipated.

7.5 The Council continued its efforts to recover its deposit with Icelandic Bank, Glitnir. The Icelandic District Court and Supreme Court both ruled that local authority deposits had priority over other creditors claims, and therefore that 100% of the amount outstanding was payable. Subsequently, the Council received 80% of the funds in March 2012. The remaining 20% was paid out by Glitnir in Icelandic Krona. However due to currency restrictions, these funds still remain in Iceland until the Icelandic Central Bank lift the restrictions. Any further developments will continue to be reported to the Council as part of the Quarterly Treasury Activity and Compliance reports.

7.6 All financial investments by the Council's Common Good Funds were made through the Council's Loans Fund, in accordance with their policies for Permitted Investments. There were no further investments made by the Council of this nature. Any other investments held with external fund managers are outwith the scope of the investment regulations, as they all relate to funds held by Council operated Charities or Trusts.

7.7 The Annual Property Investment Strategy for 2011/12 was also approved by the Council at its meeting on the 23 February 2011 (Report 11/71 refers) and was complied with in full, with no breaches in compliance with permitted investment limits.

7.8 The anticipated income from the Council's property portfolio for 2011/12 was projected to be £2,060,000, but as noted in the quarterly report to the Council on 14 December 2011 (report 11/645 refers) this was anticipated to reduce to £1,982,000 to reflect a loss of rental income. The actual Income for the Council's property portfolio for 2011/12 was £1,987,000.

7.9 There were neither additional risks indentified nor new property investments entered into over the year. The strategy action plan remained on programme.

8. COMPLIANCE WITH TREASURY POLICIES AND LIMITS

8.1 There were no breaches of compliance with the Council's approved lending policy in 2011/12. All aspects of the Prudential Code, including Prudential Indicators and limits, were fully adhered to throughout the year.

9. CONSULTATION

9.1 The Chief Executive, and the Council's Treasury advisers, Sector Treasury Services Ltd, have been consulted in the preparation of this report.

10. RESOURCE IMPLICATIONS

10.1 There are no resource implications arising directly from this report.

11. COUNCIL CORPORATE PLAN OBJECTIVES 2009-12

11.1 The Council's Corporate Plan 2009-2012 lays out five Objectives which provide clear strategic direction, inform decisions at a corporate and service level and shape the resources allocation. They are as follows:

(i) A Safe, Secure and Welcoming Environment
(ii) Healthy, Caring Communities
(iii) A Prosperous, Sustainable and Inclusive Economy
(iv) Educated, Responsible and Informed Citizens
(v) Confident, Active and Inclusive Communities

11.2 The Chief Executive's Service provides a range of functions for internal and front-line customers alike. Those functions support the work of the whole Council by assisting them in the delivery of the Council's Corporate Objectives. As a consequence, this report does not specifically relate to one of the objectives, but assists with the delivery of all five.

12. EQUALITIES ASSESSMENT

12.1 The Council's Corporate Equalities Assessment Framework requires an assessment of functions, policies, procedures or strategies in relation to race, gender and disability and other relevant equality categories. This supports the Council's legal requirement to comply with the duty to assess and consult on relevant new policies to ensure there is no adverse impact on any community group or employees.

12.2 The function, policy, procedure or strategy presented in this report was considered under the Corporate Equalities Assessment Framework and the determination was made that the items summarised in this report do not require further assessment as they do not have an impact on people's wellbeing.

13. STRATEGIC ENVIRONMENTAL ASSESSMENT

13.1 Strategic Environmental Assessment (SEA) is a legal requirement under the Environmental Assessment (Scotland) Act 2005 that applies to all qualifying plans, programmes and strategies, including policies (PPS). The matters presented in this report were considered under the Environmental Assessment (Scotland) Act 2005 and no further action is required as it does not qualify as a PPS as defined by the Act and is therefore exempt.

14. CONCLUSION

14.1 The approved borrowing strategy for the year was to minimise exposure to risk, and was designed to take advantage of shorter and longer term rates as opportunities arose throughout the year. Economic uncertainties and debt issues in Europe acted to keep UK interest rates low. Some new PWLB borrowing was undertaken when the rates were favourable over a range of medium term repayment periods, to smooth the maturity profile and to ensure an optimum position for the Council. All borrowing undertaken was on fixed rate terms. There was no premature repayment of debt undertaken in the year, due to the low level of interest rates which meant that rescheduling of debt was not cost-effective.

14.2 There was some investment of cashflow surpluses undertaken for longer periods (up to 12 months) to take advantage of more attractive rates. For shorter term cashflow surpluses the investment deposit accounts and Money Market Funds (MMF) were generally used in order to manage cashflow and liquidity while giving competitive interest rates as money market rates stayed low.

14.3 There were no breaches of compliance within the lending policy during the year, and all Prudential Indicators were complied with during the year. As a result of the activities undertaken throughout 2011/12 the Council's plans remain affordable, prudent and sustainable.

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Background Papers: No background papers, as defined by Section 50D of the Local Government (Scotland) Act 1973 (other than any containing confidential or exempt information) were relied on to any material extent in preparing the above report.

Chief Executive,
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Date - 25 September 2012.

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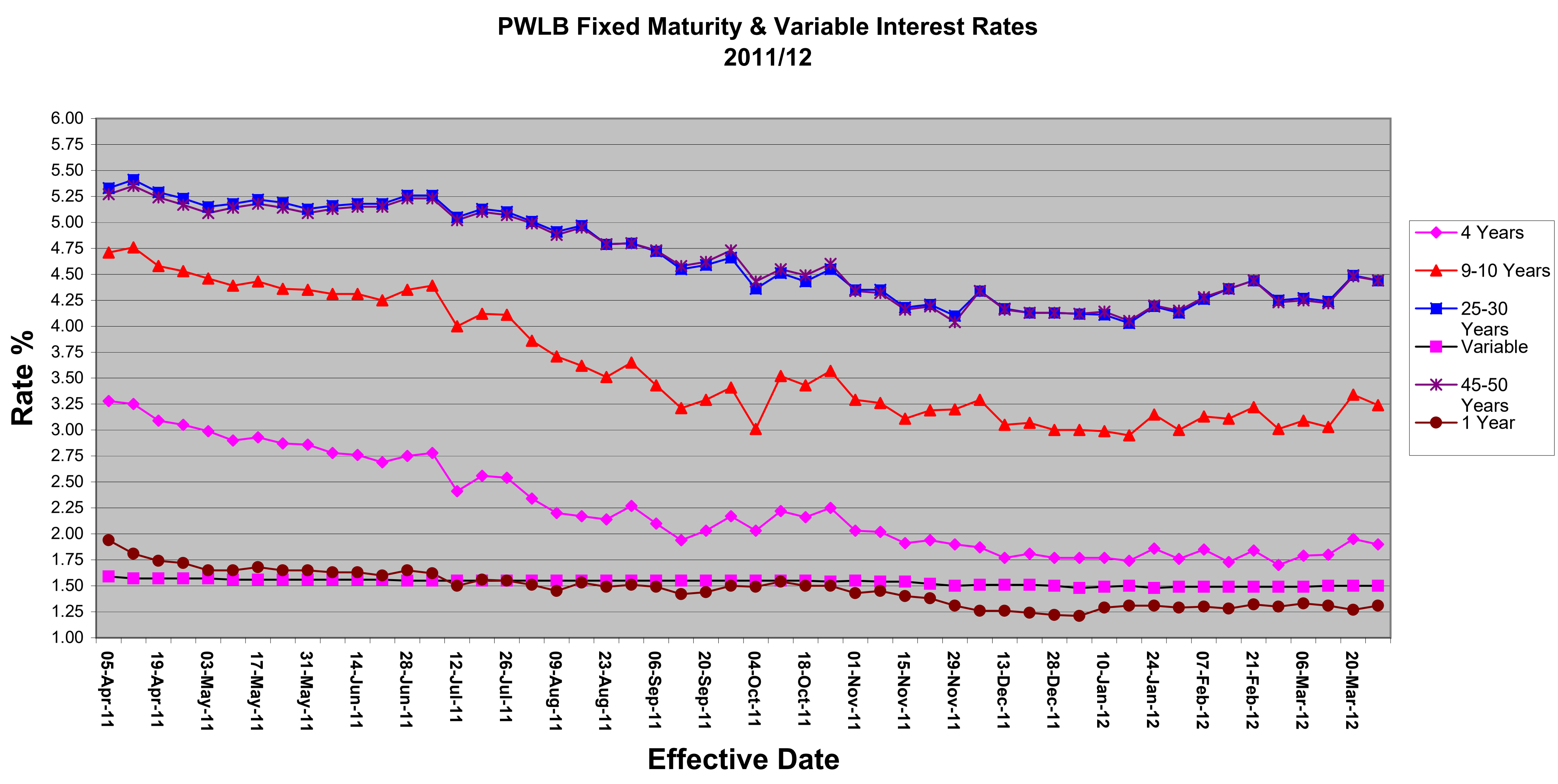
PWLB Fixed Maturity & Variable Interest Rates
2011/12
Rate %
Effective Date
4 Years
9-10 Years
25-30 Years
Variable
45-50 Years
1 Year
6.00
5.75
5.50
5.25
5.00
4.75
4.50
4.25
4.00
3.75
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05-Apr-11
19-Apr-11
03-May-11
17-May-11
31-May-11
14-Jun-11
28-Jun-11
12-Jul-11
26-Jul-11
09-Aug-11
23-Aug-11
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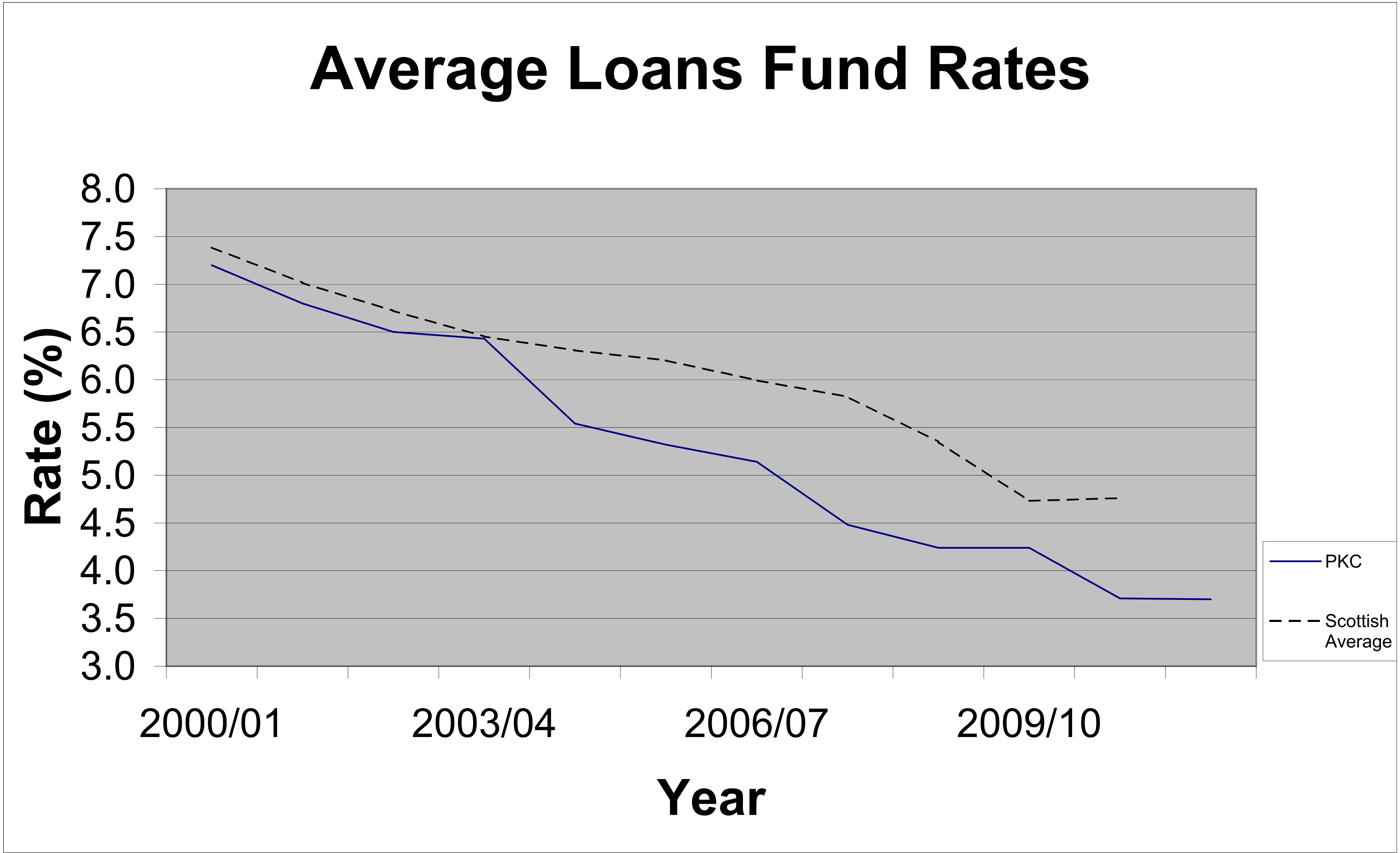
Average Loans Fund Rates
8.0
7.5
7.0
6.5
6.0
5.5
5.0
4.5
4.0
3.5
3.0
Rate (%)
2000/01
2003/04
2006/07
2009/10
Year
PKC
Scottish Average