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<b>REPORT TO:</b>	<b>FINANCE AND MANAGEMENT COMMITTEE (SPECIAL – FINAL ACCOUNTS)</b>	<b>AGENDA ITEM: 7</b>
<b>DATE OF MEETING:</b>	<b>30th JUNE 2011</b>	<b>CATEGORY: DELEGATED</b>
<b>REPORT FROM:</b>	<b>CHIEF EXECUTIVE OFFICER</b>	<b>OPEN</b>
<b>MEMBERS' CONTACT POINT:</b>	<b>KEVIN STACKHOUSE (01283 595811) CHIEF FINANCE OFFICER <a href="mailto:Kevin.stackhouse@south-derbys.gov.uk">Kevin.stackhouse@south-derbys.gov.uk</a></b>	<b>DOC: u/ks/treasury management/annual reports/201011</b>
<b>SUBJECT:</b>	<b>TREASURY MANAGEMENT ANNUAL REPORT 2010/11</b>	<b>REF:</b>
<b>WARD (S) AFFECTED:</b>	<b>ALL</b>	<b>TERMS OF REFERENCE: FM 08</b>

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## **1.0 Recommendations**

- 1.1 That the Treasury Management Annual Report for 2010/11 is considered and approved.
- 1.2 To note the Treasury Management Stewardship Report and Prudential Indicators for 2010/11 (as detailed in Appendix1) and that the Council complied fully with all requirements.
- 1.3 That the Statement on the Minimum Revenue Provision for 2010/11 is recommended to Council for approval.

## **2.0 Purpose of Report**

- 2.1 To detail the Council's actual borrowing and lending for 2010/11 compared to the approved strategy, including performance against its Prudential Indicators. This is in accordance with the Local Government Act 2003 and associated regulations.

## **3.0 Executive Summary**

- 3.1 The Council's borrowing and investment strategy for the year required that its cash flow requirements were managed through short-term borrowings and bank deposits. Overall, the Council's cash flow remained positive throughout the year as forecast
- 3.2 However, some short-term borrowing was undertaken towards the end of the financial year. This is normal and is mainly due to the fact that council tax is collected over the first 10 months of the year but payments continue for 12 months.

- 3.3 As financial monitoring reports throughout the year highlighted, the main Bank of England Base Rate remained at 0.5% throughout the year. This continued to limit the amount of interest earned on short term investments and bank deposits.
- 3.4 In undertaking its treasury management functions during the year, the Council managed its activities within its prudential indicators and approved lending policy.

#### **4.0 Detail**

##### **Borrowing During 2010/11**

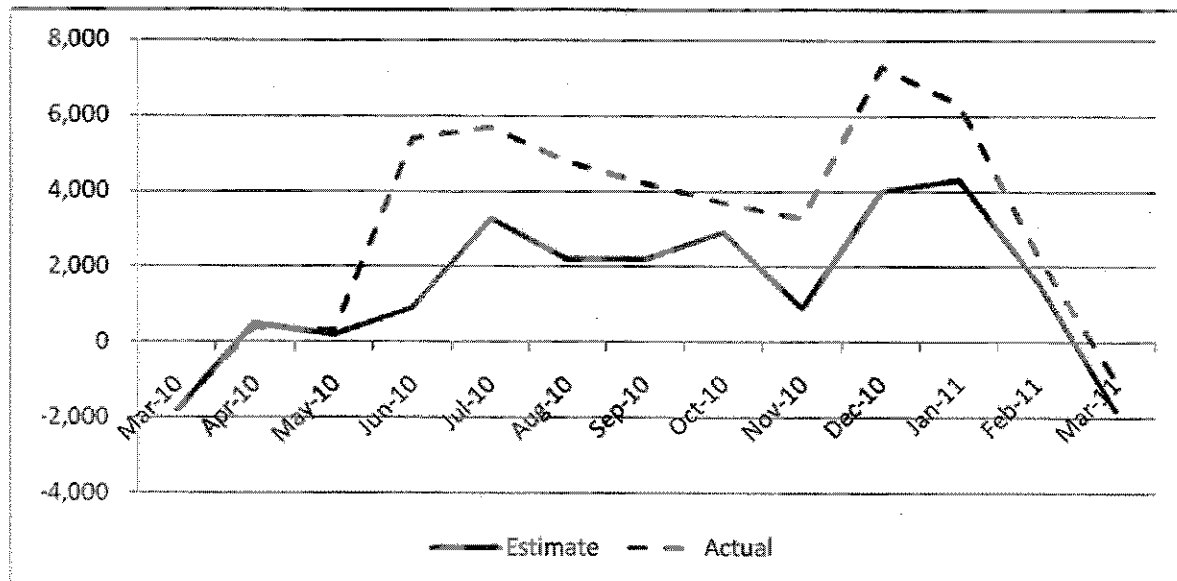
- 4.1 The Council's approved borrowing strategy for 2010/11 was:
- To manage its cash flow requirements through short-term borrowings and bank deposits
  - That in accordance with capital investment requirements, no longer-term borrowing is undertaken in the year
  - That the one remaining Money Market loan of £1m be repaid should the Lender invoke their option to increase the interest rate

##### **The Council's Cash Flow During 2010/11**

- 4.2 The Council's cash flow can fluctuate on a daily basis depending on the timing of income and expenditure.
- 4.3 At certain times of the year, the Council may need to borrow to cover shortfalls on a temporary basis, whilst when cash flow is positive any surplus funds are invested on a temporary basis. However, the Council still has a long-term underlying need to borrow.
- 4.4 For several years the Council has not undertaken any form of new long-term borrowing having financed its capital expenditure from other sources such as government grants and external funding.
- 4.5 In addition, the Council has, over recent years, generated substantial receipts for which expenditure is then spread over a number of years, e.g. Section 106 contributions. In the meantime, the Council benefits from having the cash in the bank.
- 4.6 Except for one money market loan, the Council is effectively debt free having repaid its remaining Government debt back in March 2004.
- 4.7 The Council effectively invests its balances and reserves over the year and this generates interest for the General Fund and Housing Revenue Accounts. In addition, the Council is generally able to collect its main income in the form of council tax and business rates before it is spent or re-distributed. This is invested on a short-term basis and generates a return for the Council.

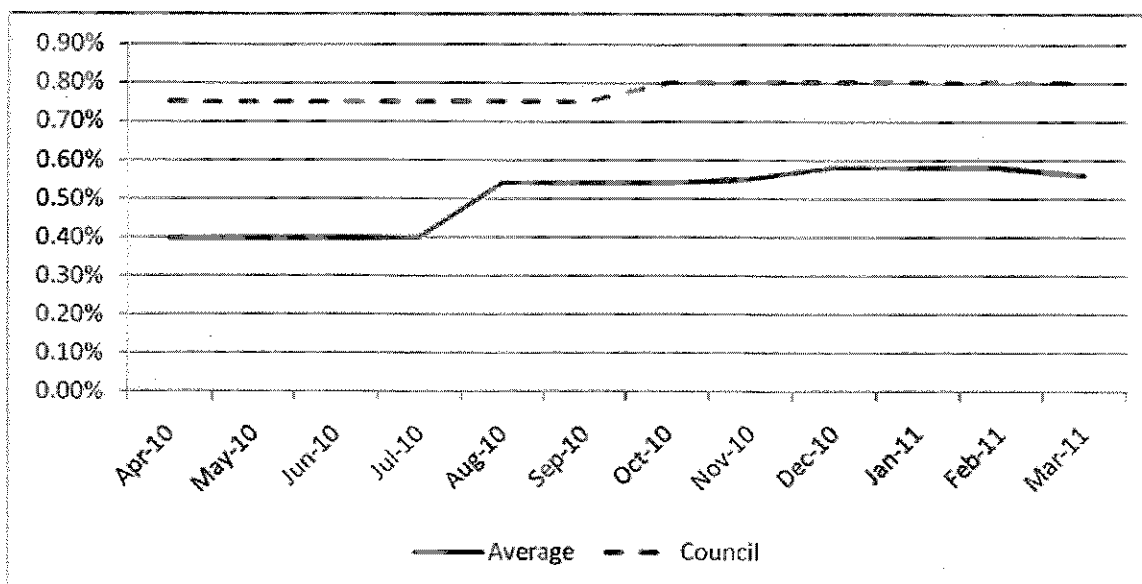
- 4.8 However, some short-term borrowing was undertaken towards the end of the financial year. This is normal and is mainly due to the fact that council tax is collected over the first 10 months of the year but payments continue for 12 months.
- 4.9 Overall, the Council continued to benefit from a positive cash flow position in 2010/11. However, given the low level of interest rates, the financial benefit in the form of interest earned is much reduced.
- 4.10 The Council's cash flow during 2010/11 with a comparison to that originally projected is shown in the graph below. In general, the actual pattern of cash flow followed that projected.
- 4.11 However, the amount of funds available was generally higher than estimated. The average cash balance during the year was approximately £4m compared to an estimate of £3.5m.

### Analysis of Cash Flow 2010/11 (in £'000s)



### Interest Rates

- 4.12 For the second consecutive year, the main bank base rate as set by the Bank of England remained at 0.5% throughout 2010/11. It has been at this level since 5<sup>th</sup> March 2009 and latest indications suggest that is not expected to change until the autumn of 2011.
- 4.13 The Council's budget for 2010/11 assumed an average rate earned on its deposits and investments of 0.75%. The Council's benchmark as approved in the Investment Strategy is to achieve at least the average 7-day market rate over the year. The performance during 2010/11 is shown in the following graph.



4.14 The above graph shows that the Council's achieved a rate that was generally in line with its budget of 0.75% for most of the year, out-turning at 0.78%. The average rate for comparison purposes was 0.51%. Interest paid on temporary borrowing at the year end was £0.75%.

4.15 Interest rates remained fairly static throughout the year with a slight movement upwards in October 2010.

### Temporary Borrowings

4.16 Besides the short-term borrowing undertaken at the year end, the Council holds money on deposit for Parish Councils. This money is classed as temporary as it can be recalled on immediate notice.

4.17 The Council pays 1% below the prevailing Bank of England Base rate. As this rate was 0.5% throughout the year, no payments were made on the outstanding principal of £133,000.

### Budgetary Implications

4.18 The level of interest actually received and paid is built into the General Fund Revenue Account. A proportion of this is recharged into the Housing Revenue Account (HRA) under a statutory calculation to recognise that some interest on debt/investments is attributable to the HRA.

4.19 The actual net interest received compared to that included in the approved budget is summarised below.

CASH FLOW INTEREST 2010/11	BUDGET £	ACTUAL £
Overall interest received from money on deposit	26,250	39,470
Less – Interest payments on temporary borrowings	0	(1,812)
<b>Net Interest Received</b>	<b>26,250</b>	<b>37,658</b>

4.20 The net effect is that overall interest received was higher compared to that budgeted by approximately £11,000, in line with that reported to the Committee in February 2011 as part of the 3<sup>rd</sup> quarter's monitoring report.

4.21 The additional amount received reflected the higher level of cash on deposit, together with a higher average interest rate compared to that estimated.

### Other Interest Paid and Received

4.22 In addition, the Council paid and received other interest during the year as set out in the following table. Overall, the Council's interest liability was better compared to that budgeted, although after adjusting for the recharge to the HRA, the General Fund was slightly worse.

<b>Analysis of Interest Paid and Received 2010/11 (£)</b>	<b>Budget</b>	<b>Actual</b>	<b>Variance</b>
Money Market Loan	48,750	48,483	-267
Temporary Loans	0	1,812	1,812
Bank Interest	1,400	2,564	1,164
Interest on Bonds and Trust Funds	615	2,095	1,480
Covenants	55,700	56,615	915
Transferred Debt	5,000	2,481	-2,519
Interest Received on Deposits	-26,250	-39,470	-13,220
Other Interest Received ("VAT Windfall")	-229,551	-229,637	-86
Interest Recharged to the HRA	-68,023	-46,433	21,590
<b>Net Interest Received</b>	<b>-212,359</b>	<b>-201,490</b>	<b>10,869</b>

### Money Market Debt

4.23 The only long-term debt still remaining is one money market loan for £1m. This borrowing was undertaken some years ago to fund capital commitments at that time. As the above table shows, the loan costs approximately £48,000 per year in interest charges at a fixed rate of 4.875%. It is due to mature in 2032.

4.24 Potentially, there is a break clause. The lender has the option of reviewing the interest rate at any time and increasing it if they so wish. However, the Council then has the option of rejecting this and can instead choose to repay without incurring any penalty.

4.25 In setting the borrowing strategy for 2010/11, it was approved that should the lender exercise their option to increase the interest rate, then the loan should be repaid at that time.

4.26 The lender did not invoke their option during the year and the situation will be kept under review. The same principle regarding this loan was adopted as part of the treasury management strategy for 2011/12.

## Investments 2010/11

- 4.27 The Council does not have any long-term investments, but the Council is required to maintain an investment strategy covering short-term investments such as the deposit of surplus funds.
- 4.28 The overall strategy in the year was to effectively invest surplus funds to meet cash flow requirements within the year. In addition, there was no proposal to enter into longer term and externally managed funds.
- 4.29 The Council invests surplus funds in accordance with an approved policy and associated lending list. This is summarised in the following table.

Institution	Limit
<b>Specified Investments</b>	
• UK Debt Management Office (DMO)	£10m
• Local, Police, Fire and Parish Authorities	£5m
• Other Bodies with a High Credit Rating of F1+/AA-	£7.5m
<b>Non-Specified Investments</b>	
• F1/AA Rated Bodies – First Call	£2m
• F1/A Rated Bodies – Second Call	£1m
• F2/A Rated Bodies – Third Call	£0.25m

### Definition of Credit Ratings

- 4.30 The long-term rating is based on an investment grade categorised by “Fitch” on the following scale:
- AAA: the best quality companies, reliable and stable
  - AA: quality companies, a bit higher risk than AAA
  - A: economic situation can affect finance
  - BBB: medium class companies which are satisfactory at the moment.
- 4.31 Intermediate modifiers are also used for each category between AAA and BBB (i.e. AA+, AA, AA-, A+, A, A-, etc.).
- 4.32 Short-term credit ratings indicate the potential level of default within a 12-month period, based on the following scale.
- F1+: best quality grade, indicating exceptionally strong capacity to meet financial commitments.
  - F1: best grade, indicating strong capacity to financial commitments.
  - F2: good quality grade with satisfactory capacity to financial commitments.
- 4.33 The scale then falls from F3 to B, then C and finally down to D, which indicates the institution is likely to, or as failed to meet its financial commitments.

## General Policy

- 4.34 As approved, priority is given to specified investments in any investment decision. The length of investment is made in accordance with overall cash flow requirements.
- 4.35 The Council's policy is to seek investments with those institutions graded at least AA and F1+.
- 4.36 All deposits made in the year were in accordance with the approved lending list and were all Specified Investments. The Council has no investments tied up in the Icelandic banking system.

## Performance Indicators

- 4.37 As previously highlighted, the main indicator is for the return on short-term investments to average over the year, **the local authority 7-Day Rate**, a standard measure of performance. The Council's performance for 2010/11 (with a comparison to recent years) is shown in the following table.

	2006/07	2007/08	2008/09	2009/10	2010/11
7-Day Rate (target)	4.82%	5.61%	3.57%	0.39%	0.51%
Actual Rate	4.86%	5.81%	4.38%	0.72%	0.78%

## Prudential Indicators

- 4.38 Under the Code of Practice for Capital Finance, the Council must set and regularly monitor Prudential Indicators. These indicators are designed to measure and place controls over the level of borrowing and capital financing during the year.
- 4.39 They are set following the annual budget round where the Section 151 (Chief Finance) Officer is required to provide an assessment of these indicators and the implications for the Council's spending plans and overall financial position.
- 4.40 The prudential system provides the flexibility for these indicators to be changed depending on local circumstances. It is the responsibility of the Section 151 Officer to advise the Council accordingly.
- 4.41 The actual indicators for 2010/11, together with further details on treasury management activity are detailed in **Appendix 1**. There were no major variations to the approved indicators during the year and the Council operated within its capital budgets and limits for external borrowing at all times.

## Minimum Revenue Provision (MRP) - Background

- 4.42 Local authorities are required each year to set-aside some of their revenues as a provision to repay any borrowings or other credit (shorthand this is technically called "debt"). This set-aside is known as MRP and is a charge on the Council's General Fund.

- 4.43 This requirement has existed for many years and is designed to ensure that authorities, prudently, make provision to meet their credit liabilities into the future. With effect from 2007/08, the regulations governing this were amended.
- 4.44 This was to ensure that authorities continue to make a sufficient and prudent provision in their accounts, in particular where they have made any unsupported borrowing under the (then) new Prudential System.
- 4.45 Under the previous regulations, the calculation of MRP was effectively a set formula, although there was provision to increase this amount if an authority so wished. Regulations now effectively force authorities to undertake their own calculation under 1 of 4 options, depending on local circumstances.
- 4.46 It is the responsibility of the Section 151 Officer to advise on the treatment of MRP and to recommend a suitable policy for adoption. Consequently, authorities are also required to prepare an annual statement on making a MRP.

### **The Calculation**

- 4.47 MRP traditionally had been calculated (at a rate of 4%) based on an authority's borrowing requirement. As highlighted previously, the Council has an underlying requirement based on past borrowing approvals issued by the Government.
- 4.48 However, due to its strong and positive cash flow position, the Council has financed this borrowing "internally." Therefore, over time, actual debt does not match the underlying requirement shown in the Council's accounts.
- 4.49 However, by charging a MRP into the accounts, this is reducing the requirement as effectively it is providing the resources to "repay" on a yearly basis.

### **The 4 Options**

- 4.50 The calculation is designed to ensure that a "prudent" provision is made for debt repayment. The 4 options are as follows:
- **Option 1** - For debt that is supported by the Government through the grant system, authorities may continue to use the formula in current regulations (4%), since revenue support grant is calculated on that basis. Technically however, this option has now been revoked, but has been maintained temporarily as a measure for capital expenditure incurred before 1<sup>st</sup> April 2008.
  - **Option 2** – A simplified method of option 1 that reflects supported debt based on an authority's capital financing requirement. This method has been in place since 2004 when the Prudential System was first introduced.



- **Option 3** – The method to use for new borrowing under the Prudential System for which no Government support is given, MRP being based on the life of the asset being purchased.
- **Option 4** – As above, but MRP relates to the depreciation charge on the asset purchased.

### **Effect on South Derbyshire**

4.51 The Council is operating under Option 2. Technically, the Council has been debt free under these regulations since 2004 (having repaid its Government borrowings). In addition, it has not entered into any new borrowing in recent years to finance its capital expenditure. Therefore, similar to previous years, the following statement is recommended for adoption.

#### **Council Statement on MRP**

4.52 The Council still has an assumed level of debt (or capital financing requirement) that is being subsidised through grant. Therefore, given no actual debt outstanding (other than the £1m money market loan) together with no unsupported borrowing, it is recommended that “prudence” be best achieved by continuing to provide a MRP under **Option 2**.

4.53 It is recommended that this policy be endorsed for 2010/11 and adopted for 2011/12. It will be kept under review depending on the Council’s future capital expenditure and financing requirements.

4.54 Any proposed changes will be reported as necessary to this Committee for consideration and recommendation to Council. The impact on the MRP will be considered in any decision to enter into any borrowing under the Prudential System.

### **5.0 Financial Implications**

5.1 As detailed in the report. As regards the MRP and the proposed Statement, there are no additional financial implications for the Council as the budget in the Medium Term Financial Plan has been calculated to reflect this approach. The MRP made in 2010/11 was £286,000.

### **6.0 Corporate Implications**

6.1 None directly.

### **7.0 Community Implications**

7.1 None directly.

### **8.0 Background Papers**

8.1 Local Government Act 2003 and associated Statutory Instruments detailing regulations under the Local Authorities (Capital Finance and Accounting England Regulations) of 2003, 2006 and 2008.

## ANNUAL REPORT ON THE TREASURY MANAGEMENT SERVICE AND PRUDENTIAL INDICATORS 2010/11

### 1.0 Introduction

1.1 The annual treasury report summarises:

- Confirmation of compliance with treasury limits and Prudential Indicators
- Capital activity for the year and how this was financed
- Impact on the Council's indebtedness for capital purposes
- The Council's overall treasury position
- The reporting of the required Prudential Indicators
- Summary of interest rate movements in the year
- Debt and investment activity

### 2.0 Regulatory Framework, Risk and Performance

- 2.1 The Council's treasury management activities are regulated by a variety of professional codes, statutes and guidance. These include the Local Government Act 2003, which provides the powers to borrow and invest as well as providing controls and limits on this activity.
- 2.2 The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing that may be undertaken; no restrictions were made in 2010/11.
- 2.3 Amended regulations develop the controls and powers within the Act and require the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities. It also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services.
- 2.4 Under the Act the Government have also issued Investment Guidance to structure and regulate the Council's investment activities.
- 2.5 The Council has complied with all of the above requirements, which limit 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.
- 2.6 There is little risk of volatility of costs for the current debt as the interest rate is fixed.
- 2.7 Shorter-term interest rates and likely movements in these rates in the future, predominantly determine the Council's investment return. These returns can therefore be volatile and whilst the risk of loss of principal is minimal through the annual investment strategy, accurately forecasting future returns can be difficult.

### 3.0 The Council's Capital Expenditure and Financing 2010/11

- 3.1 The Council undertakes capital expenditure on long-term assets. These activities may either be financed through revenue, capital receipts, capital grants, or borrowing.
- 3.2 Part of the Council's treasury activities is to address this borrowing need, either through borrowing from external bodies, or utilising temporary cash resources within the Council.
- 3.3 The actual capital expenditure is a key prudential indicator. The table below shows how the capital expenditure was financed.

<b>Capital Expenditure and Financing 2010/11</b>			
	<b>2009/10 Actual £000</b>	<b>2010/11 Estimate £000</b>	<b>2010/11 Actual £000</b>
<b>Capital Expenditure</b>			
General Fund	4,078	3,152	3,227
HRA	2,294	2,563	2,307
<b>Total Capital Expenditure</b>	<b>6,372</b>	<b>5,715</b>	<b>5,534</b>
<b>Financed by:</b>			
Capital receipts	1,670	909	724
Grants and Contributions	2,667	2,626	2,869
Capital reserves	1,763	2,111	1,933
Revenue Contributions	272	69	8
<b>Net Financing (Borrowing)</b>	<b>0</b>	<b>0</b>	<b>0</b>

### 4.0 The Council's Overall Borrowing Need

- 4.1 The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). The CFR is a measure of the Council's underlying need to borrow for capital investment and is based on the value of its assets contained in the Balance Sheet.
- 4.2 The capital expenditure that has not been immediately paid for will increase the CFR through additional borrowing. The Council is required to pay off an element of the accumulated General Fund CFR each year through a revenue charge called the Minimum Revenue Provision (MRP).
- 4.3 As the Council has no unsupported borrowing, MRP will continue to be based upon the assumed level of debt on introduction of the Prudential Code in 2004.

4.4 The Council's CFR for the year is shown below.

<b>Capital Financing Requirement (CFR)</b>			
	<b>2009/10 Actual £000</b>	<b>2010/11 Estimated £000</b>	<b>2010/11 Actual £000</b>
Net financing need for the year	0	0	0
MRP/VRP	296	286	286
Transferred Debt Repaid	19	18	20
<b>Total Movement in CFR</b>	<b>315</b>	<b>304</b>	<b>306</b>
CFR – General Fund	7,138	6,852	6,852
CFR – Housing	5,477	5,459	5,457
<b>Total CFR</b>	<b>12,615</b>	<b>12,311</b>	<b>12,309</b>

## 5.0 Treasury (Cash Flow) Position at 31 March 2011

5.1 The treasury position at 31 March 2011 compared with the previous year is shown in the following table.

<b>Treasury Position</b>	<b>31 March 2010</b>		<b>31 March 2011</b>	
	<b>Principal £000</b>	<b>Average Rate %</b>	<b>Principal £000</b>	<b>Average Rate %</b>
Fixed Interest Rate Debt	4,000	5.33%	6,000	5.625%
Variable Interest Rate Debt	184	0%	133	0%
<b>Total Debt</b>	<b>4,184</b>		<b>6,133</b>	
Fixed Interest Investments	0	0	0	0
Variable Interest Investments	1,009	0.75%	3,974	0.80%
<b>Total Investments</b>	<b>1,009</b>		<b>3,974</b>	
<b>Net Borrowing Position</b>	<b>3,175</b>		<b>2,159</b>	

5.2 At 31 March 2011 the Council's debt was approximately £6.1m (compared with £4.2m at 31 March 2010). The figure at 31 March 2011 includes the money market loan for £1m, temporary borrowings of £5m and £0.1m deposited by Parish Councils. Investments totaled £3.9m (compared with £1m at 31 March 2010).

5.3 The short term borrowing of £5m was taken out on 16 March 2011 in order to meet cash flow commitments. The loan was repaid on 16<sup>th</sup> June May 2011.

## 6.0 Prudential Indicators and Compliance Issues

6.1 The prudential indicators provide an overview and specific limits on treasury activity. These are detailed below.

- a) **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. Net borrowing should have not exceeded the CFR for 2010/11, plus the expected changes to the CFR over 2011/12 and 2012/13. The table below highlights the Council's net borrowing position against the CFR and demonstrates that the Council has complied with this prudential indicator.

<b>Capital Financing Requirement (CFR)</b>			
	<b>2009/10 Actual £000</b>	<b>2010/11 Estimated £000</b>	<b>2010/11 Actual £000</b>
Gross Borrowing	4,184	1,913	6,133
Less: Investments	1,009	0	3,974
<b>Net Borrowing</b>	<b>3,175</b>	<b>1,913</b>	<b>2,159</b>
<b>CFR</b>	<b>12,615</b>	<b>12,311</b>	<b>12,309</b>

- b) **The Authorised Limit** – is the 'affordable borrowing limit' required by Section 3 of the Local Government 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.
- c) **The Operational Boundary** – is based on the expected maximum external debt (as described above) during the course of the year, but it is not a limit. It is designed to help the Council's Chief Finance Officer to manage treasury activity on a daily basis and acts as an early warning sign of any potential issues.
- d) **Actual Financing Costs as a Proportion of Net Revenue Stream** – identifies the trend in the cost of capital (borrowing and other long-term obligation costs net of investment income) against the net revenue stream.

<b>Prudential Limits and Operational Boundaries</b>	<b>2010/11 Actual £000</b>
Authorised Limit	26,500
Maximum Gross Borrowing Position	6,133
Operational Boundary	12,320
Average Gross Borrowing Position	2,466
Minimum Gross Borrowing Position	1,133
Financing Costs as a Proportion of Net Revenue Stream:	
• Council Tax	0.61%
• Rent	1.57%

## **7.0 Economic Background**

- 7.1 Treasury activity is directed by both current market interest rates and expectations of future movements, which are influenced by inflation and demand/supply considerations.
- 7.2 During 2010/11 the Bank of England continued to keep interest rates low. This impacted on the Council's ability to generate income through investment of surplus funds.

## **8.0 The Strategy Approved for 2010/11**

- 8.1 The strategy approved for 2010/11 assumed that the uncertainty over the money markets increased the risk associated with treasury activity. As a result the Council maintained its general lending policy of giving priority to security and liquidity over yield.

## **9.0 Actual Debt Management Activity for 2010/11**

- 9.1 There were no loans drawn down to finance capital spend or maturing debt. Loans repaid during the year equated to £k. These related to sums deposited by Parish Councils and transferred debt.

## **10.0 Investment Performance**

- 10.1 The Council's investment policy is governed by Government Regulations, which has been implemented in the annual Investment Strategy, approved by Finance and Management Committee on 16th February 2010. The investment activity during the year conformed to the approved strategy and the Council had no liquidity difficulties.
- 10.2 The Council's longer-term cash balances comprise primarily unallocated revenue and capital reserves held as a contingency, earmarked reserves and usable capital receipts.
- 10.3 The low bank base rate has continued to have a detrimental impact on the Council's investment returns. The Council maintained an average cash balance of approximately £4m in 2010/11 and received an average return of 0.78%.
- 10.4 Investment interest received during the year was £39,470.