Appendix A

Treasury Management Annual Report 2012/13

Introduction and Background

The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which requires local authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities at least twice a year. The Cabinet receive an annual report and regular updates through the Quarterly Financial Performance Reports. The scrutiny of treasury policy, strategy and activity is delegated to the Audit and Governance Committee.

Treasury management is defined as: "The management of the local authority'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."

Overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

This report:

a) is prepared in accordance with the revised CIPFA Treasury Management Code and the revised Prudential Code;
b) presents details of capital financing, borrowing, debt rescheduling and investment transactions;
c) reports on the risk implications of treasury decisions and transactions;
d) gives details of the outturn position on treasury management transactions in 2012/13;
e) confirms compliance with treasury limits and Prudential Indicators.

1. Treasury Year End Position

The amount of investments outstanding at 31st March 2013 was £68.5m as follows:

	31/03/12	31/03/13
	£m	**£m**
BANKS (Fixed Deposits)		
Lloyds TSB	3.1	6.0
Standard Chartered Bank	-	2.0
MONEY MARKET FUNDS		
Prime Rate	5.0	6.5
IGNIS	4.5	8.5
Deutsche	4.0	3.0
Scottish Widows	3.5	3.9
INSTANT ACCESS ACCOUNTS		
Royal Bank of Scotland	5.0	5.5
Santander (UK)	5.0	8.5
Co-op Reserve	-	1.5
NOTICE ACCOUNTS		
Royal Bank of Scotland	-	3.0
MANAGED FUNDS		
Investec – Pooled Funds	20.0	20.1
TOTAL	**50.1**	**68.5**

The net investment income received in 2012/2013 after allowing for fees and interest due to the Growing Places fund was £567,000. This is favourable compared to the budget of £300,000. The investment income includes £34,000 relating to deposits made by the former Cheshire County Council with the Icelandic Heritable Bank which were received in 2012/13.

The overall average rate of interest on all investments in 2012/13 was 0.74% compared to the benchmark 7 day LIBID return of 0.49%. The base rate remained at 0.50% for the full year.

Investment income forms part of the capital financing budget, which also includes the amount charged in respect of the repayment of outstanding debt and the amount of interest payable on the Council's portfolio of long term loans. The capital financing budget for 2012/13 was £14.8m which accounts for 6% of the Council's total revenue budget. Overall the budget was under spent by £0.9m, this is due to the levels of capital expenditure being lower than originally forecast which reduced the level of debt repayment and savings on external interest payments as a result of maximising the use of the Council's internal borrowing capacity.

We will continue to monitor performance during 2013/14 through the benchmarking service provided by the Council's Treasury Management Advisors, Arlingclose.

2. Icelandic Bank Deposits

Repayment of monies due from Heritable Bank has been continuing and in August 2011 the administrators announced that we are likely to receive around 88% of the original claim, an increase from the original estimate of 85%.

From the total claim of £4.62m we have now received £3.57m (77%).

Further repayments are forecast as follows:

2013/2014 - £0.44m

3. Interest Rates and Prospects for 2012/13

The Councils' treasury advisors, as part of their service assisted in formulating a view on interest rates. However, there has been no change to the bank base rate since March 2009.

	Q1 2012	**Q2 2012**	**Q3 2012**	**Q4 2012**	**Q1 2013**
Base Rate	**0.50%**	**0.50%**	**0.50%**	**0.50%**	**0.50%**

4. Compliance with Treasury Limits

During the financial year the Councils' operated within the treasury limits and Prudential Indicators set out in the Councils' Treasury Policy Statement and annual Treasury Strategy Statement (see section 8).

5. Investment Strategy for 2012/13

The Council had regard to the DCLG Guidance on Local Government Investments ("the Guidance") issued in March 2004 (revised in 2010) and the revised CIPFA Treasury Management Code and the revised Prudential Code ("the CIPFA TM Code").

Investment instruments identified for use in the financial year are listed under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits were set through the Councils' Treasury Management Strategy Statement and Investment Strategy.

Investment Objectives

All investments were in sterling. The general policy objective of the Council was the prudent investment of its treasury balances. The Councils' investment priorities are the security of capital and liquidity of its investments.

The Council aimed to achieve the optimum return on its investments commensurate with the proper levels of security and liquidity. The DCLG maintains that the borrowing of monies purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity.

Credit Risk

Counterparty credit quality was assessed and monitored with reference to credit ratings; credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; any potential support mechanisms and share price. The minimum long-term counterparty credit rating determined for the 2012/13 treasury strategy was A-/A-/A3 across rating agencies Fitch, S&P and Moody's.

In June Moody's downgraded a swathe of banks with global capital market operations, including the UK banks on the Council's lending list - Barclays, HSBC, Royal Bank of Scotland/Natwest, Lloyds TSB Bank/Bank of Scotland, Santander UK plc - as well as several non UK banks, but none of the ratings fell below the Council's minimum A-/A3 credit rating threshold.

Liquidity

In keeping with the CLG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds / overnight deposits/ the use of call accounts.

Yield

The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate was maintained at 0.5% through the year.

The 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 also remained at very low levels which had a significant impact on investment income.

Use of External Fund Managers

In May 2011 the Council placed £20m with Investec in pooled funds, for which the aim is to generate higher returns in a low interest rate environment through investment in a diverse range of instruments. The return on these funds after fees was 0.77%.

Whilst the performance of the fund since we joined is not as good as we originally hoped, these investments should be seen as a longer term investment so true performance can only be judged over a longer period of time.

6. Borrowing strategy

At the end of the year 2012/13 the Council had debt outstanding of £131.7m. Of this £17m represented loans raised from commercial banks whilst £114.5m represented loans from the PWLB.

The Council's capital financing requirement (CFR) currently exceeds the amounts actually borrowed with the shortfall being funded from cash balances. Borrowing is currently being repaid at a rate of £5.5m per year which means the gap between the CFR and actual borrowing is increasing which exposes the Council to interest rate risk in the future if cash balances were to fall and borrowing had to be taken at prevailing rates at the time. To reduce exposure to interest rate risk and prevent excessive use of internal resources a new loan of £5m was taken in 2012/13 to replace most of the maturing debt.

In accordance with the Treasury Management Strategy the Council sought to finance its capital expenditure through the use of its own existing cash balances rather than through the raising of long term loans. The benefits of this are twofold; firstly by reducing the amount of cash balances held by the Council it reduces the credit risk and secondly, the interest foregone on the cash balances use to finance capital expenditure payments was less than the amount of interest payable on any new loans that would have been raised.

In December 2012 the Council agreed to changes in the method of financing the capital programme and the use of capital receipts. The capital receipts reserve (£16.3m as at 31 March 2012) has been utilised to finance capital expenditure which has taken place in previous years and has been met from borrowing. This will reduce the capital financing requirement and therefore the level of revenue provision required for the repayment of debt in 2013/14 and future years.

7. Economic events of 2012/13

The global outlook stabilised mainly due to central banks maintaining low interest rates and expansionary monetary policy for an extended period. Equity market assets recovered sharply with the FTSE 100 registering a 9.1% increase over the year. This was despite economic growth in G-7 nations being either muted or disappointing.

In the UK the economy shrank in the first, second and fourth quarters of calendar 2012. It was the impressive 0.9% growth in the third quarter, aided by the summer Olympic Games, which allowed growth to register 0.2% over the calendar year 2012. The expected boost to net trade from the fall in the value of sterling did not materialise, but raised the price of imports, especially low margin goods such as food and energy. Avoiding a 'triple-dip' recession became contingent on upbeat services sector surveys translating into sufficient economic activity to overhaul contractions in the struggling manufacturing and construction sectors.

Household financial conditions and purchasing power were constrained as wage growth remained subdued at 1.2% and was outstripped by inflation. Annual CPI dipped below 3%, falling to 2.4% in June before ticking up to 2.8% in February 2013. Higher food and energy prices and higher transport costs were some of the principal contributors to inflation remaining above the Bank of England's 2% CPI target.

The lack of growth and the fall in inflation were persuasive enough for the Bank of England to maintain the Bank Rate at 0.5% and also sanction additional £50 billion asset purchases (QE) in July, taking total QE to £375 billion. The possibility of a rate cut was discussed at some of Bank's Monetary Policy Committee meetings, but was not implemented as the potential drawbacks outweighed the benefits of a reduction in the Bank Rate. In the March Budget the Bank's policy was revised to include the 2% CPI inflation remit alongside the flexibility to commit to intermediate targets.

The resilience of the labour market, with the ILO unemployment rate falling to 7.8%, was the main surprise given the challenging economic backdrop. Many of the gains in employment were through an increase in self-employment and part time working.

The Chancellor largely stuck to his fiscal plans with the austerity drive extending into 2018. In March the Office for Budgetary Responsibility (OBR) halved its forecast growth in 2013 to 0.6% which then resulted in the lowering of the forecast for tax revenues and an increase in the budget deficit. The government is now expected to borrow an additional £146bn and sees gross debt rising above 100% of GDP by 2015-16. The fall in debt as a percentage of GDP, which the coalition had targeted for 2015-16, was pushed two years beyond this horizon. With the national debt metrics out of kilter with a triple-A rating, it was not surprising that the UK's sovereign rating was downgraded by Moody's to Aa1. The AAA status was maintained by Fitch and S&P, albeit with a Rating Watch Negative and with a Negative Outlook respectively.

The government's Funding for Lending (FLS) initiative commenced in August which gave banks access to cheaper funding on the basis that it would then result in them passing this advantage to the wider economy. There was an improvement in the flow of credit to mortgagees, but was still below expectation for SMEs.

The big four banks in the UK – Barclays, RBS, Lloyds and HSBC – and several other global institutions including JP Morgan, Citibank, Rabobank, UBS, Credit Suisse and Deutsche came under investigation in the Libor rigging scandal which led to fines by and settlements with UK and US regulators. Banks' share prices recovered after the initial setback when the news first hit the headlines.

Europe: The Euro region suffered a further period of stress when Italian and Spanish government borrowing costs rose sharply and Spain was also forced to officially seek a bailout for its domestic banks. Markets were becalmed after the ECB's declaration that it would do whatever it takes to stabilise the Eurozone and the central bank's announcement in September of its Outright Monetary Transactions (OMT) facility, buying time for the necessary fiscal adjustments required. Neither the Italian elections which resulted in political gridlock nor the poorly-managed bailout of Cyprus which necessitated 'bailing-in' non-guaranteed depositors proved sufficient for a market downturn. Growth was hindered by the rebalancing processes under way in Euroland economies, most of which contracted in Q4 2012.

US: The US Federal Reserve extended quantitative easing through 'Operation Twist', in which it buys longer-dated bonds with the proceeds of shorter-dated US Treasuries. The Federal Reserve shifted policy to focus on the jobless rate with a pledge to keep rates low until unemployment falls below 6.5%. The country's extended fiscal and debt ceiling negotiations remained unresolved.

Gilt Yields and Money Market Rates: Gilt yields ended the year lower than the start in April. By September the 2-year gilt yield had fallen to 0.06%, raising the prospect that short-dated yields could turn negative. 10-year yields fell by nearly 0.5% ending the year at 1.72%. The reduction was less pronounced at the longer end; 30-year yields ended the year at 3.11%, around 25bp lower than in April. Despite the likelihood the DMO would revise up its gilt issuance for 2012/13, there were several gilt-supportive factors: the Bank of England's continued purchases of gilts under an extended QE programme; purchases by banks, insurance companies and pension funds driven by capital requirements and the preference for safe harbour government bonds.

One direct consequence of the Funding for Lending Scheme was the sharp drop in rates at which banks borrowed from local government. 3-month, 6-month and 12-month Libid rates which were 1%, 1.33% and 1.84% at the beginning of the financial year fell to 0.44%, 0.51% and 0.75% respectively.

8. Prudential Indicators 2012/13

The Council can confirm that it has complied with its Prudential Indicators for 2012/13, which were approved on 23rd February 2012 as part of the Council's Treasury Management Strategy Statement. Details can be found in Annex 1.

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 2012/13. None of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

9. Other Items

PWLB Project Rate

The 2012 Autumn Statement announced that the Government would make available a new concessionary public works loan rate to an infrastructure project nominated by each LEP (excluding London) in England, with total borrowing capped at £1.5 billion. The Government will provide a UK guarantee to allow the Mayor of London to borrow £1 billion at a new preferential rate to support the Northern Line Extension to Battersea.

The March 2013 Budget announced details of the “project rate” which will enable English local authorities (LAs) working with their Local Enterprise Partnership (LEP) to access cheaper borrowing on up to £1.5 billion of investment.

The Public Works Loan Board (PWLB) project rate has been set at 40 basis points below the standard rate across all loan types and maturities. It will be available to local authorities in England from 1 November 2013. This discounted borrowing is being made available to support strategic local capital investment projects. The Government is asking each LEP to work with LAs in their area to agree which project should benefit from the cheaper borrowing support. This will give LEPs, in consultation with LAs, the power to prioritise the projects that best support shared local goals. The Government is now seeking business cases from LEPs, agreed with LAs, setting out borrowing requirements for their chosen local project.

Annex 1

Capital Financing Requirement (CFR)
Estimates of the Council's cumulative maximum external borrowing requirement for 2012/13 to 2014/15 are shown in the table below:

	31/3/2013 Estimate £m	31/3/2013 Actual £m	31/3/2014 Estimate £m	31/3/2015 Estimate £m
Gross CFR	234	192	226	252
Less: Other Long Term Liabilities	24	27	26	24
Borrowing CFR	**210**	**165**	**200**	**228**
Less: Existing Profile of borrowing	128	134	134	128
Cumulative Maximum External Borrowing Requirement	**82**	**31**	**66**	**100**

In the Prudential Code Amendment (November 2012), it states that the Section 151 Officer should make arrangements for monitoring with respect to gross debt and the capital financing requirement such that any deviation is reported to her, since any such deviation may be significant and should lead to further investigation and action as appropriate.

	31/03/2013 Approved £000s	31/03/2013 Actual £000s	31/03/2014 Estimate £000s	31/03/15 Estimate £000s
CFR	210	165	200	228
Gross Debt	128	134	134	128
Difference	**82**	**31**	**66**	**100**
Borrowed in excess of CFR? (Y/N)	**N**	**N**	**N**	**N**

Usable Reserves
Estimates of the Council's level of Balances and Reserves for 2012/13 to 2014/15 are as follows:

	31/3/2013 Estimate £m	31/3/2013 Actual £m	31/3/2014 Estimate £m	31/3/2015 Estimate £m
Usable Reserves	37	53	51	49

Prudential Indicator Compliance

(a) Authorised Limit and Operational Boundary for External Debt

- The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of their indebted status. This is a statutory limit which should not be breached.
- The Council's Affordable Borrowing Limit was set at £268m for 2012/13.
- The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit.
- The Operational Boundary for 2012/13 was set at £258m.
- The Interim Chief Operating Officer confirms that there were no breaches to the Authorised Limit and the Operational Boundary during the year; borrowing at its peak was £137m.

(b) Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

- These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates.
- The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of investments.

	Limits for 2012/13 %	**Maximum during 2012/13 %**
Upper Limit for Fixed Rate Exposure	100%	100%
Compliance with Limits:	Yes	Yes
Upper Limit for Variable Rate Exposure	100%	0%
Compliance with Limits:	Yes	Yes

(c) Maturity Structure of Fixed Rate Borrowing

- This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

Maturity Structure of Fixed Rate Borrowing	**Upper Limit %**	**Lower Limit %**	**Actual Fixed Rate Borrowing as at 31/03/2013 £m**	**% Fixed Rate Borrowing as at 31/03/2013**	**Compliance with Set Limits?**
under 12 months	25%	0%	23.0	17%	Yes
12 months and within 24 months	25%	0%	11.1	8%	Yes
24 months and within 5 years	35%	0%	20.5	16%	Yes
5 years and within 10 years	50%	0%	16.8	13%	Yes
10 years and within 20 years	100%	0%	21.8	16%	Yes
20 years and within 30 years	100%	0%	14.2	11%	Yes
30 years and within 40 years	100%	0%	8.8	7%	Yes
40 years and within 50 years	100%	0%	15.3	12%	Yes
50 years and above	100%	0%	0	0%	Yes

The 2011 revision to the CIPFA Treasury Management Code now requires the prudential indicator relating to Maturity of Fixed Rate Borrowing to reference the maturity of LOBO loans to the earliest date on which the lender can require payment, i.e. the next call date[1]

(d) **Actual External Debt**

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

Actual External Debt as at 31/03/2013	**£m**
Borrowing	134
Other Long-term Liabilities	27
Total	**161**

(e) **Total principal sums invested for periods longer than 364 days**

- This indicator allows the Council to manage the risk inherent in investments longer than 364 days.
- The limit for 2012/13 was set at 40% of total investments.
- One investment of £2m was made in 2012/13 for a period of 365 days which represented a maximum of 4% of investments at any one time.

(f) **Capital Expenditure**

- This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits, and, in particular, to consider the impact on Council tax and in the case of the HRA, housing rent levels.

Capital Expenditure	**2012/13 Estimate £m**	**2012/13 Actual £m**	**2013/14 Estimate £m**	**2014/15 Estimate £m**
Total	**83.9**	**51.4**	**121.1**	**71.6**

- Capital expenditure has been and will be financed or funded as follows:

Capital Financing	**2012/13 Estimate £m**	**2012/13 Actual £m**	**2013/14 Estimate £m**	**2014/15 Estimate £m**
Capital receipts	14.3	12.1	10.0	5.0
Government Grants	36.1	29.7	46.9	10.5
External contributions	0.2	0.9	23.2	20.3
Revenue contributions	0.6	0.2	1.0	0
Supported borrowing	1.8	0.0	0.0	0
Unsupported borrowing	30.9	8.5	40.0	35.8
Total Financing and Funding	**83.9**	**51.4**	**121.1**	**71.6**

(g) **Ratio of Financing Costs to Net Revenue Stream**

- This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs.
- The ratio is based on costs net of investment income.

Ratio of Financing Costs to Net Revenue Stream	**2012/13 Estimate %**	**2012/13 Actual %**	**2013/14 Estimate %**	**2014/15 Estimate %**
Total	6.01	5.64	4.58	5.35

(h) **Incremental Impact of Capital Investment Decisions**

- This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax and Housing Rent levels. The incremental impact is calculated by comparing the total revenue budget requirement of the current approved capital programme with an equivalent calculation of the revenue budget requirement arising from the proposed capital programme.

Incremental Impact of Capital Investment Decisions	**2012/13 Approved £**	**2013/14 Estimate £**	**2014/15 Estimate £**
Increase in Band D Council Tax	6.02	11.92	10.77

(i) **Adoption of the CIPFA Treasury Management Code**

- This indicator demonstrates that the Authority adopted the principles of best practice.

Adoption of the CIPFA Code of Practice in Treasury Management
The Council approved the adoption of the CIPFA Treasury Management Code at its meeting on 23rd February 2012

(j) **Gross and Net Debt**

- The purpose of this treasury indicator is to highlight a situation where the Authority is planning to borrow in advance of need.

Upper Limit on Net Debt compared to Gross Debt	**2012/13 Actual £m**	**2013/14 Estimate £m**	**2014/15 Estimate £m**
Outstanding Borrowing (at nominal value)	132	208	228
Other Long-term Liabilities (at nominal value)	27	26	25
Gross Debt	**159**	**234**	**253**
Less: Investments	(68)	(68)	(68)
Net Debt	**91**	**166**	**185**

N.B. CIPFA has acknowledged that the upper limit does not work as was intended and is working on a revised indicator. This indicator will be amended once revised guidance has been received from CIPFA.

(k) **Upper Limit for Total Principal Sums Invested Over 364 Days**

- The purpose of this limit is to contain exposure to the possibility of loss that may arise as a result of the Authority having to seek early repayment of the sums invested.

Upper Limit for total principal sums invested over 364 days	2012/13 Approved £m	2012/13 Revised £m	2013/14 Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m
	40%	40%	40%	40%	40%