ITEM NO. 10.1

Report of:	**Head of Finance**
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Report Track:	**Audit & Governance 25/6/13 & Council 3/7/13**

AUDIT AND GOVERNANCE COMMITTEE

25 JUNE 2013

Annual Treasury Management Report 2012/13

1 Purpose of Report

1.1 To update members on treasury management activity and performance during the 2012/13 financial year.

2 Recommendation

2.1 To approve the actual 2012/13 prudential and treasury indicators in this report;

2.2 To note the annual treasury management report for 2012/13.

3 Key Issues and Reasons for Recommendations

3.1 Treasury management activity and performance during the 2012/13 financial year.

4 Relationship to Corporate Priorities

4.1 Treasury management and investment activity link in with all of the Council's priorities and their spending plans.

5 Report Detail

5.1 Background

5.1.1 The Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2012/13. 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).

5.1.2 During 2012/13 the minimum reporting requirements were that the full Council should receive the following reports:-

- an annual treasury strategy in advance of the year (Council 29 February 2012);
- an annual review following the end of the year describing the activity compared to the strategy (this report).

5.1.3 The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is therefore 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.

5.2 Executive Summary

5.2.1 During 2012/13, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:-

Prudential and treasury indicators	**2012/13 Actual £'000**	**2011/12 Actual £'000**
Capital expenditure	10,447	13,548
Capital Financing Requirement:	95,994	94,769
External debt as at 31 March	88,842	83,546
Investments as at 31 March (all under one year maturity)	10,767	6,862

5.2.2 The Head of Finance confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit (the authorised limit), was not breached in the year.

5.2.3 The financial year 2012/13 continued the challenging investment environment of previous years, with continuing low investment returns and heightened levels of counterparty risk.

5.2.4 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;
- Summary of interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity.

5.3 The Economy and Interest Rates

5.3.1 The financial year 2012/13 continued the challenging investment environment of previous years, namely low investment returns and continuing heightened levels of counterparty risk. The original expectation for 2012/13 was that Bank Rate would start gently rising from quarter 4 2014. However, economic growth in the UK was disappointing during the year due to the UK austerity programme, weak consumer confidence and spending, a lack of rebalancing of the UK economy to exporting and weak growth in our biggest export market - the European Union (EU). The UK coalition Government maintained its tight fiscal policy stance against a background of warnings from two credit rating agencies that the UK could lose its AAA credit rating. Moody's followed up this warning by actually downgrading the rating to AA+ in February 2013 and Fitch then placed their rating on negative watch, after the Budget statement in March. Key to retaining the AAA rating from Fitch and S&P will be a return to strong economic growth in order to reduce the national debt burden to a sustainable level, within a reasonable timeframe. Weak UK growth resulted in the Monetary Policy Committee increasing quantitative easing by £50bn in July to a total of £375bn. Bank Rate therefore ended the year unchanged at 0.5% while CPI inflation fell from 3% at the start of the year to end at 2.8% in March, with a fall back to below 2% pushed back to quarter 1 2016. The EU sovereign debt crisis was an ongoing saga during the year with first Greece and then Cyprus experiencing crises which were met with bailouts after difficult and fraught negotiations.

5.3.2 Gilt yields oscillated during the year as events in the ongoing Eurozone debt crisis ebbed and flowed, causing corresponding fluctuations in safe haven flows into / out of UK gilts. This, together with a further £50bn of QE in July and widely expected further QE still to come, combined to keep Public Works Loans Board (PWLB) rates depressed for much of the year at historically very low levels.

5.3.3 Deposit rates. The Funding for Lending Scheme, announced in July, resulted in a flood of cheap credit being made available to banks and this has resulted in money market investment rates falling sharply in the second half of the year. However, perceptions of counterparty risk have improved after the ECB statement in July that it would do "whatever it takes" to support struggling

Eurozone countries. This has resulted in some return of confidence to move away from only very short term investing.

5.4 Strategy for 2012/13

5.4.1 The expectation for interest rates within the strategy for 2012/13 anticipated low but rising Bank Rate (starting in quarter 4 of 2014) with similar gradual rises in medium and longer term fixed borrowing rates over 2012/13. Variable or short-term rates were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

5.4.2 In this scenario, the treasury strategy was to undertake borrowing while the cost is low to avoid the cost of undertaking borrowing at higher interest rates in the future.

5.4.3 The actual movement in gilt yields meant that PWLB rates fell during the first quarter of the year to historically low levels. This was caused by a flight to quality into UK gilts from EU sovereign debt, and from shares, as investors became concerned about the potential for a Lehman's type crisis of financial markets if the Greek debt crisis were to develop into a precipitous default and exit from the Euro. During the second and third quarters, rates rose gradually and agreement of a second bail out for Greece in December saw the flight to quality into gilts reverse somewhat, as confidence rose that the Eurozone crisis was finally subsiding. However, gilt yields then fell back again during February and March as Eurozone concerns returned, with the focus now shifting to Cyprus, and flight to quality flows into gilts resumed. This was a volatile year for PWLB rates, driven by events in the Eurozone which oscillated between crises and remedies.

5.5 Capital Expenditure and Financing

5.5.1 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.

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

	2012/13 Actual £'000	2011/12 Actual £'000
Capital expenditure	10,447	13,548
Resourced by:		
• Capital receipts	1,944	974
• Capital grants	864	2,608
• Capital Reserves		189
• Revenue contributions	1,314	2,362
• Major Repairs Reserve	4,393	283
Unfinanced capital expenditure	**1,932**	**7,132**

5.5.3 There was unfinanced capital expenditure in 2012/13 relating to the purchase of land at Mill Green, Chase Leisure Centre Enhancement and HRA expenditure on PRC Dwellings.

5.6 Borrowing Need

5.6.1 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

5.6.2 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 Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

5.6.3 Reducing the CFR - the Council's underlying borrowing need (CFR) 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 borrowing. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

5.6.4 The total CFR can also be reduced by:-
- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

5.6.5 The Council's 2012/13 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report for 2012/13 on 29 February 2012.

5.6.6 The Council's CFR for the year is shown below, and represents a key prudential indicator.

CFR	31 March 2013 Actual £'000	31 March 2012 Actual £'000
Opening balance	94,769	29,372
Add unfinanced capital expenditure	1,932	7,132
Add Self Financing settlement		59,245
Less Provisions / Finance Lease	(256)	(728)
Less MRP/principal repayments	(451)	(252)
Closing balance	95,994	94,769

5.6.7 Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

5.6.8 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 2012/13 plus the expected changes to the CFR over 2013/14 and 2014/15 from financing the capital programme. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2013 Actual £'000	31 March 2012 Actual £'000
Net borrowing position	78,075	76,684
CFR	95,994	94,769

5.6.9 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 2012/13 the Council has maintained gross borrowing within its authorised limit.

5.6.10 **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.

5.6.11 **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.

	2012/13 £'000
Authorised limit	101,773
Maximum gross borrowing position	88,842
Operational boundary	94,930
Average gross borrowing position	87,920
Financing costs as a proportion of net revenue stream	3.82%

5.7 Borrowing Outturn for 2012/13

5.7.1 A new loan of £4.7 million was drawn from the PWLB on 31 May 2012 at a rate of 4.05%. This loan will mature in May 2037. A new loan of £0.8 million was drawn from the PWLB on 28 Feb 2013 at a rate of 1.47%. This loan will mature in Feb 2017.

5.8 Treasury Position as at 31 March 2013

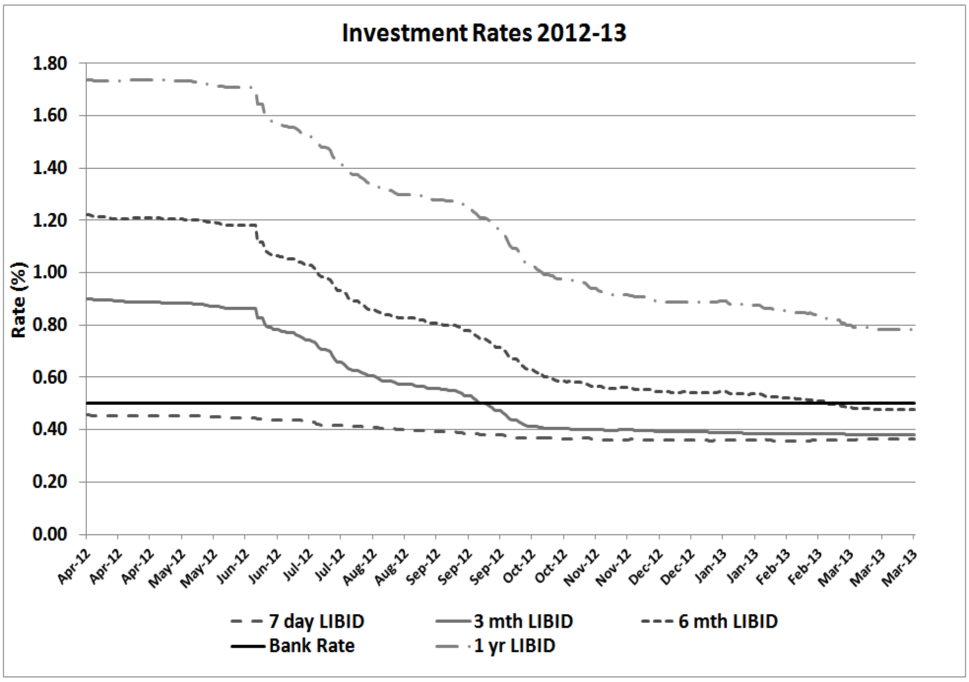
5.8.1 The Council's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives 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 2012/13 the Council's treasury position was as follows:-

Actual Debt v CFR	31 March 2013 Actual £'000	31 March 2012 Actual £'000
Fixed rate funding:		
-PWLB	88,805	83,506
-Market	37	40
-Lease liabilities	490	662
Total debt	89,332	84,208
CFR	95,994	94,769

5.9 Investment Rates in 2012/13

5.9.1 Bank Rate remained at its historic low of 0.5% throughout the year; it has now remained unchanged for four years. Market expectations of the start of monetary tightening were pushed back during the year to early 2015 at the earliest. The Funding for Lending Scheme resulted in a sharp fall in deposit rates in the second half of the year.



5.10 Investment Outturn for 2012/13

5.10.1 **Investment Policy** - the Council's investment policy is governed by CLG guidance, which was been implemented in the annual investment strategy approved by the Council on 29 February 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 by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

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

5.10.3 The Council's longer term cash balances comprise both revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources primarily comprised general balances, earmarked reserves and usable capital receipts.

5.10.4 The Council maintained an average balance of **£14.468 million**. The funds earned an average rate of return of **0.62%.** The comparable performance indicator is the average 3 month LIBID rate, which was **0.57%**. The Council's performance against this benchmark in another year of considerable turmoil is a reflection of the success of the strategy of investing a high proportion of the portfolio with UK Banks covered by the government's guarantee, coupled with comparatively good rates offered by call accounts.

5.10.5 Although the average rate of return exceeded the benchmark, overall investment earnings of **£90,000** were less than was predicted when the budget was set in February 2012 **(£122,000)**. This is primarily as a result of the continuing low bank rate which was expected to rise later in the year when the budget was set.

6 Implications

6.1 Financial

The financial implications have been referred to throughout the report.

6.2 Legal

The legal implications have been referred to throughout the report.

6.3 Human Resources

There are no human resource implications arising from this report.

6.4 Section 17 (Crime Prevention)

There are no implications arising from this report.

6.5 **Human Rights Act**

There are no identified implications in respect of the Human Rights Act 1998 arising from this report.

6.6 **Data Protection**

There are no implications arising from this report.

6.7 **Risk Management**

Treasury Management is a high risk area due to the large amounts of money dealt with on a daily basis. However, the Council has a Treasury Policy and Strategy in place which is approved each year for the following 12 months. The Council also has advice on investment and lending from the leading company in the field and has instituted a strict control and delegation of duties regime which reduces all risks to a minimum.

6.8 **Equality & Diversity**

There are no identified implications arising form this report.

6.9 **Best Value**

The strategy ensures that best value is provided to the Council.

Previous Consideration - Nil

Background Papers – Available in Financial Services