OVERVIEW AND SCRUTINY	**6th June 2013**
CABINET	**20th June 2013**
COUNCIL	**26th June 2013**

TREASURY MANAGEMENT ANNUAL REPORT 2012/13
(Report by the Accountancy Manager)

1. INTRODUCTION

1.1 Council approves the Treasury Management Strategy for the coming year when it approves the budget and MTP each February. It also receives a mid-year report and an annual report after the end of the financial year. The Strategy is scrutinised by the Economic Well-being Panel.

1.2 The key points in the 2012/13 Strategy were:

- To invest any available funds in a manner that balanced low risk of default by the borrower with a fair rate of interest.
- To ensure there was sufficient cash to meet day-to-day obligations.
- To borrow when necessary to fund capital expenditure and to borrow in advance if rates were considered to be low. It envisaged the need for further borrowing in the range of £4.4m to £14.0m.

2. ECONOMIC REVIEW

2.1 An economic review of the year provided by our Treasury Management advisors is attached as Annex A.

3. PERFORMANCE OF FUNDS

3.1 The following table summarises the treasury management transactions undertaken during the 2012/13 financial year and the details of the investments and loans held as at 31 March 2013 are shown in Annex B.

	Principal Amount £m	Interest Rate %
Investments		
at 31st March 2012	10.4	4.29
less matured in year	-132.9	
plus arranged in year	+128.9	
at 31st March 2013	6.4	3.93
Average Investments	**14.7**	**2.96**
Borrowing		
at 31st March 2012	14.5	2.82
less repaid in year	-34.4	
plus arranged in year	+35.9	
at 31st March 2013	16.0	2.56
Average Borrowing	**11.9**	**3.32**

3.2 The average rate of interest on all investments of 2.96% was 2.63% above the 7-day benchmark rate of 0.33%. This very good performance was due to £5m of the investments being locked into higher rates before the year started together with the use of liquidity accounts with major banks and building societies which gave the added safety of instant access together with interest rates in excess of the benchmark

3.3 If only short-term cash flow investment activity is considered, the rate of interest on investments was 0.87% and still more than double the 7-day benchmark rate of 0.33%.

3.4 The Council's exposure to interest rate risk at the end of the year was the £10m long term PWLB borrowing from 4 years ago which is still well below current long term rates and £1.9m short term borrowing for less than 2 months at a mixture of 0.31% and 0.4%. This gave an average borrowing rate of 3.32%.

3.5 The actual net investment interest (after deduction of interest payable on loans) was a credit of £39,186, which is more than three times the estimated credit budget of £11,000 for the year. This has occurred due to higher than estimated interest rates and levels of reserves.

4. STRATEGY – BORROWING

4.1 **Long-term borrowing**. The strategy allowed for 'must borrow' to finance that part of the capital programme that could not be met from internal funds. There was also a provision for 'may borrow' which allowed borrowing in anticipation of need, based on whether longer term rates seemed low compared with future likely levels. No long-term borrowing was carried out as the rates were not deemed to be low enough, short-term borrowing rates were very low, and for most of the year much of the funding need was covered by internal funding.

4.2 **Short-term borrowing**. The Authority needed to borrow short-term during the year to manage its cash flow; it averaged £1.9m.

5. STRATEGY - INVESTMENTS

5.1 The Council's strategy for 2012/13 was based on all investments being managed in-house. The investments were of three types:

- time deposits,
- liquidity (call) accounts (with banks with a high credit rating and the top 25 building societies by asset value), and
- money market funds

The strategy included limits on the size of investments with each organisation and country limits. The limits are shown in Annex C**.**

5.2 The strategy was reviewed during the course of the year and the mid-year report was reported to Council on the 19th December 2012.

6. RISK MANAGEMENT

6.1 The Council's primary objectives for the management of its investments are to give priority to the security and liquidity of its funds before seeking the best rate of return.

6.2 **Security** is managed by investing short-term with highly-rated banks, building societies and local authorities in the UK. The Authority received regular updates from its advisors, Arlingclose, sometimes daily, on changes to the credit rating of counterparties. This allowed the Council to amend its counterparty list and not invest where there is concern about the credit rating.

6.3 **Liquidity.** In December 2008, the Council invested £10m in time deposits, however £5m was repaid in December 2012 and the remaining £5m will be repaid in December 2013. The majority of the Council's funds were in liquidity accounts which have a rate or interest above base rate and provide instant access to funds.

6.4 Overall, liquidity was managed by producing cash flow forecasts that help set the limit on the duration of the investments in time deposits. The projections turned out to be cautious which sometimes resulted in funds being available before they were needed with any surplus being invested on a temporary basis.

6.5 On the 4th July 2012 the Council approved an amendment to the 2012/13 Treasury Management Strategy that reduced the minimum credit ratings for Liquidity Accounts to F2. The reason for this amendment was because general reductions in credit ratings had started to reduce the accounts that the Council could use.

6.6 **Return on investments.** Security and liquidity took precedence over the return on investments, which resulted in investments during 2012/13 generally being of short duration due to the benefit of good rates on liquidity and growing concerns over the credit rating of counterparties.

6.7 When the Authority borrowed £10M in advance in December 2008 it invested the funds at marginally higher interest rates thus protecting the Council from any short term loss of interest.

7. COMPLIANCE WITH REGULATIONS AND CODES

7.1 All the treasury management activity undertaken during the financial year complied with the approved strategy, the CIPFA Code of Practice, and relevant legislation.

7.2 The Code requires the Council to approve both Treasury Management and Prudential Indicators. Those for 2012/13 were approved at the Council meeting on 22nd February 2012. At the mid-year report, a revised Treasury Management Indicator in respect of Interest Rate Exposure was approved; Annex D shows the relevant indicators and the actual results.

8 CONCLUSION

8.1 The performance of the funds in a year when rates stayed very low was pleasing, significantly exceeding the benchmark and the budgeted investment interest.

8.2 In a year of uncertainty in the financial markets all of the Council's investments were repaid in full and on time.

8.3 The Authority has carried out its treasury management activities with due regard to minimising risk, and in accordance with legislation. During the year it reviewed its strategy in the light of external events in the markets.

9 RECOMMENDATION

9.1 It is recommended that Cabinet note this report prior to its submission to Council.

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ANNEX A

ECONOMIC REVIEW OF 2012/13

1.1 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.

1.2 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.

1.3 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.

1.4 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.

1.5 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.

1.6 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.

1.7 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.

1.8 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.

1.9 **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.

1.10 **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.

1.11 ***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.

1.12 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.

ANNEX B

BORROWING AND INVESTMENTS AT 31 MARCH 2013

	Short Term Rating		Date Invested/ Borrowed	Amount		Interest Rate	Repayment Date	Year of Maturity
	Fitch	Moody		£m	£m	%		
BORROWING								
Short-term								
Worcestershire County Council	Not rated			5.0		0.31	29-Apr-13	2013/14
London Borough of Merton	Not rated			1.0		0.40	30-Apr-13	2013/14
					6.0			
Long Term								
PWLB				5.0		3.91	19-Dec-57	2057/58
PWLB				5.0		3.90	19-Dec-58	2058/59
					10.0			
TOTAL BORROWING					**16.0**			
INVESTMENTS IN-HOUSE								
Short-term								
NatWest Liquidity	F1	P2		1.3		0.60		2012/13
Cambridgeshire BS Call Account	Not rated			0.1		0.50		2012/13
Skipton BS	F3			5.0		4.85	19-Dec-13	2013/14
					6.4			
TOTAL INVESTMENTS					**6.4**			
NET BORROWING					**9.6**			

ANNEX C

IN-HOUSE FUND MANAGEMENT 2012/13
(IF NO FURTHER BORROWING IN ANTICIPATION)

Duration of investments	No investment shall be longer than 5 years. Maximum duration for a Building Society with no rating is 1 month.
Types of investments	Fixed term Deposits Deposits at call, two or seven day notice Corporate bonds Money market funds UK Government bonds and Supranational Bank bonds.
Credit Ratings	**Building Societies** All Building Societies with ratings of BBB or above. Building Societies with no ratings. **Money Market Funds** AAA credit rating **Local Authorities or UK Government** No rating required **Non-Building Societies** Short term rating F1 by Fitch or equivalent. Short term rating F2 by Fitch or equivalent for liquidity accounts. Long-term rating of AA- by Fitch or equivalent if the investment is longer than 1 year.
Maximum limits per counterparty (group), country or non-specified category	F1+ or have a legal position that guarantees repayment for the period of the investment £5m F1 £4M Building Society with assets over £2bn in top 25 (Currently 10) £5M Building Society with assets over £1bn if in top 25 (Currently 3) £4M Building Society with assets under £1bn in top 25 £3M Liquidity (Call) Account with a credit rating of F2 or with a legal position that guarantees repayment or a Building Society. £5M BUT total invested with counterparty/group shall not exceed £8M Money market fund AAA Credit rating £4m **Limit for Non-specified investments** – £10M in time deposits more than one year – £5M in corporate bonds – £10M in any other types. – £15M in total **Country limits** – UK - unlimited – £5M in a country outside the EU – £10M in a country within the EU (excluding UK) – £20M in EU countries combined (excluding UK) No investment will be made in country with a sovereign rating of less than AA. These limits will be applied when considering any new investment from 23 February 2012. Lower limits may be set during the course of the year or for later years to avoid too high a proportion of the Council's funds being with any counterparty.
Benchmark	LGC 7 day rate

Annex D

CIPFA Prudential Indicators for Capital Finance in Local Authorities
Prudential Indications and Treasury Management Indications for 2012/13
Comparison of actual results with limits

PRUDENTIAL MANAGEMENT INDICATORS

1. Actual and Estimated Capital Expenditure.

	2012/13 Estimate £000	2012/13 Actual £000
Gross	19.5	8.3
Net	10.4	6.5

2. The proportion of the budget financed from government grants and council tax that is spent on interest and the provision for debt repayment.

2012/13 Estimate	2012/13 Actual
4.1%	**3.6%**

3. The impact of schemes with capital expenditure on the level of council tax.

This item is only provided to demonstrate affordability at budget setting and has already been superseded by the equivalent figure in the 2013/14 indicators.

4. The capital financing requirement.

This represents the estimated need for the Authority to borrow to finance capital expenditure less the estimated provision for redemption of debt (the MRP) with no allowance for funding in advance.

2012/13 Estimate £m	2012/13 Actual £m
32.0	**27.0**

5. Net borrowing and the capital financing requirement.

Net external borrowing as at the 31st March 2013, was £20.0m, this is £7.0m less that than the capital financing requirement. Thereby confirming that the council has not borrowed for revenue purposes other than in the short-term for cash flow purposes.

6. **The actual external long-term borrowing at 31 March 2013**

£10m

7. **Adoption of the CIPFA Code**

The Council has adopted the 2011 edition of the CIPFA Treasury Management Code of Practice.

TREASURY MANAGEMENT INDICATORS

8. **The authorised limit for external debt.**

This is the maximum limit for borrowing and is based on a worst-case scenario.

	2012/13 Limit £m	2012/13 **Actual** **£m**
Short-Term	20	6
Long Term assuming maximum borrowing in advance	51	10
Other long-term liabilities (leases)	5	4
Total	**76**	**20**

9. **The operational boundary for external debt.**

This reflects a less extreme position. Although the figure can be exceeded without further approval, it represents an early warning monitoring device to ensure that the authorised limit (above) is not exceeded.

	2012/13 Limit £000	2012/13 **Actual** **£000**
Short-Term	15	6
Long Term	41	10
Other long-term liabilities (leases)	5	4
Total	**61**	**20**

Both of these actual results reflect the fact that long term rates were not considered low enough to borrow in anticipation of need

10. Exposure to investments with fixed interest and variable interest.

These limits are given as a percentage of total investments. Investments of less than 12 months count as variable rate.

		Limits		Actual
		Max.	Min.	As at 31.3.13
Borrowing:				
longer than 1 year	Fixed	100%	75%	100%
	Variable	25%	0%	0%
Investments:				
longer than 1 year	Fixed	100%	100%	100%
	Variable	0%	0%	0%

11. Borrowing Repayment Profile

The proportion of 2012/13 borrowing that matured in successive periods.

Borrowing	Upper limit	Lower limit	Actual As at 31.3.13
Under 12 months	86%	0%	37%
12 months and within 24 months	86%	0%	0%
24 months and within 5 years	86%	0%	0%
5 years and within 10 years	86%	0%	0%
10 years and above	100%	14%	63%

12. Investment Repayment Profile

Limit on the value of investments that cannot be redeemed within 364 days.

	Limit £m	**Actual £m**
Limit on principal invested beyond year end (31 March 2013)	32.0	5.0