MEETING:	**AUDIT COMMITTEE**
DATE:	**26 SEPTEMBER 2013**
TITLE:	**TREASURY MANAGEMENT 2012/13**
PURPOSE:	**CIPFA's Code of Practice requires that a report on the results of the Council's actual Treasury Management is produced.**
RECOMMENDATION:	**RECEIVE THE REPORT FOR INFORMATION**
AUTHOR:	**DAFYDD L EDWARDS, HEAD OF FINANCE**

Executive Summary

During 2012/13 the Council's borrowing remained well within the limits originally set, total interest received on deposits was £673,244 which was below the budgeted level of £729,030. There were no new defaults by banks in which the Council deposited money.

1. Introduction and Background

CIPFA's revised Code of Practice on Treasury Management was adopted by the Council on the 1st of March 2011 and the Council fully complies with its requirements. The Code requires that I report on the results of the Council's actual treasury management in the previous financial year against expectations. The Audit Committee is the appropriate body to consider this report.

This report compares our actual performance for 2012/13 against the strategy which was set out in February 2012 for the financial year (approved by the full Council at its meeting on the 1st of March 2012). The report looks at:

- the economic background;
- the borrowing requirement and debt management;
- investment activity; and
- compliance with Prudential Indicators.

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 scrutiny of treasury policy, strategy and activity is delegated to the Audit 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.

2. Economic Background

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 G7 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.

3. The Borrowing Requirement and Debt Management

PWLB Certainty Rate

The Certainty Rate was introduced by the PWLB in November 2012, allowing the authority to borrow at a reduction of 20bps on the Standard Rate.

Borrowing Activity in 2012/13

	Balance on 01/04/2012 £'000	New Borrowing £'000	Debt Maturing £'000	Transfer to short term £'000	Balance on 31/03/2013 £'000	Average Rate %
CFR	152,241				165,924	
Short Term Borrowing	1,341	8	(1,349)	17,437	17,437	4.58
Long Term Borrowing	113,000	248	0	(17,437)	95,811	6.05
TOTAL BORROWING	**114,341**	**256**	**(1,349)**	**0**	**113,248**	5.83
Other Long Term Liabilities	49	0	(20)	0	29	2.42
TOTAL EXTERNAL DEBT	**114,390**	**256**	**(1,369)**	**0**	**113,277**	5.83
Increase/ (Decrease) in Borrowing £m					**(1,113)**	

The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31/3/2013 was estimated at £165.9m. The Council's (additional) borrowing requirement during the year was £0m.

Internal Borrowing

Given the significant cuts to local government funding putting pressure on Council finances, the strategy followed was to minimise debt interest payments without compromising the longer-term stability of the portfolio. The differential between the cost of new longer-term debt and the return generated on the Council's temporary investment returns was significant (between 3% and 4%). The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding £10.91m of capital expenditure.

This has, for the time being, lowered overall treasury risk by reducing both external debt and temporary investments. Whilst this position is expected to continue in 2013/14, it will not be sustainable over the medium term. The Council expects it will need to borrow £5m for capital purposes by 2014/15.

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. This change is reflected in Appendix 1, paragraph (c).

4. Investment Activity

The Welsh Government's Investment Guidance requires local authorities to focus on security and liquidity, rather than yield.

Investment Activity in 2012/13

Investments	Balance on 01/04/2012 £'000	Investments Made £'000	Maturities/ Investments Sold £'000	Balance on 31/03/2013 £'000	Average Rate %
Short Term Investments	35,883	203,821	(204,075)	35,629	1.05
Investments in Pooled Funds	0	0	0	0	0
TOTAL INVESTMENTS	**35,883**	**203,821**	**(204,075)**	**35,629**	1.05
Increase/ (Decrease) in Investments £m				(254)	

Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2012/13. Investments during the year included:

- Deposits with other Local Authorities;
- Investments in AAA-rated Constant & Variable Net Asset Value Money Market Funds;
- Call accounts and deposits with Banks and Building Societies systemically important to each country's banking system (UK, Australia, Canada, Finland, France, Germany, Netherlands, Spain, Switzerland and the US).

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.

Counterparty credit quality has been maintained as demonstrated by the Credit Score Analysis summarised below. The table in Appendix 2 explains the credit score.

Credit Score Analysis 2012/13

Date	Value Weighted Average Credit Risk Score	Value Weighted Average Credit Rating	Time Weighted Average Credit Risk Score	Time Weighted Average Credit Rating	Average Life (days)
31/03/2012	4.98	A+	4.93	A+	27
30/06/2012	5.19	A+	3.00	AA	36
30/09/2012	3.74	AA-	3.48	AA	68
31/12/2012	5.54	A	5.31	A+	146
31/03/2013	5.17	A+	4.97	A+	81

Liquidity
In keeping with the WG Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds, overnight deposits and 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.

The Council's budgeted investment income for the year was estimated at £0.729m. The average cash balances representing the Council's reserves, working balances, etc, were £74.578m during the period and interest earned was £0.673m.

Update on the Council's Investment with Heritable Bank

It is still expected that 88p/£ will be recovered overall. 77.25% has been recovered to date, and a further 10.8% is expected in 2013/14.

CIPFA issued further updated guidance on the accounting treatment surrounding these transactions in May 2013 and this was used for the 2012/13 accounts.

5. Compliance

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

The Council can confirm that during 2012/13 it complied with its **Treasury Management Policy Statement** and **Treasury Management Practices**.

6. Recommendation

The Audit Committee is asked to receive the report for information.

APPENDIX 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:

	Approved 31/03/2013 £000	**Actual 31/03/2013 £000**	**Estimate 31/03/2014 £000**	**Estimate 31/03/2015 £000**
Gross CFR	162,030	165,924	170,160	175,216
Less: Other Long Term Liabilities	(29)	(29)	(15)	0
Borrowing CFR	**162,001**	**165,895**	**170,145**	**175,216**
Less: Existing Profile of Borrowing	(112,811)	(113,248)	(112,191)	(116,035)
Gross Borrowing Requirement/Internal Borrowing	**49,190**	**52,647**	**57,954**	**59,181**
Usable Reserves	**(58,880)**	**(65,725)**	**(60,587)**	**(53,077)**
Long term provision	**0**	**(9,865)**	**(9,865)**	**(9,865)**
Net Borrowing Requirement/Investment Capacity	**(9,690)**	**(22,943)**	**(12,498)**	**(3,761)**

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

	Approved 31/03/2013 £000	**Actual 31/03/2013 £000**	**Estimate 31/03/2014 £000**	**Estimate 31/03/2015 £000**
CFR	162,030	165,924	170,160	175,216
Gross Debt	(112,840)	(113,227)	(112,206)	(116,035)
Difference	**49,190**	**52,647**	**57,954**	**59,181**
Borrowed in excess of CFR?	**No**	**No**	**No**	**No**

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 Authorised Borrowing Limit was set at £190m 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 £170m.

The Head of Finance confirms that there were no breaches to the Authorised Limit and the Operational Boundary during the year; borrowing at its peak was £114.39m.

	Operational Boundary (Approved) 31/03/2013 £m	**Authorised Limit (Approved) 31/03/2013 £m**	**Actual External Debt 31/03/2013 £m**
Borrowing	169.75	189.75	113.25
Other Long-term Liabilities	0.25	0.25	0.03
Total	**170.00**	**190.00**	**113.28**

(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.

	Approved 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	50%	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%	17,541	15.40%	Yes
12 months and within 24 months	25%	0%	1,203	0.99%	Yes
24 months and within 5 years	50%	0%	3,020	3.96%	Yes
5 years and within 10 years	75%	0%	6,970	5.21%	Yes
10 years and within 20 years	100%	0%	23,661	22.58%	Yes
20 years and within 30 years	100%	0%	34,594	27.71%	Yes
30 years and within 40 years	100%	0%	0	0.00%	Yes
40 years and within 50 years	100%	0%	27,352	24.15%	Yes
50 years and above	100%	0%	0	0.00%	Yes
TOTAL			**113,865**	**100.00%**	

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.

(d) **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.

Capital Expenditure	Approved 2012/13 £m	Actual 2012/13 £m	Estimate 2013/14 £000s	Estimate 2014/15 £000s
General Fund	61.44	40.33	48.50	34.47

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

Capital Financing	Approved 2012/13 £m	Actual 2012/13 £m	Estimate 2013/14 £000s	Estimate 2014/15 £000s
Capital receipts	1.89	2.34	1.57	1.10
Government Grants	31.13	21.15	25.68	15.28
Revenue contributions	13.92	5.93	12.87	7.23
Total Financing	**46.94**	**29.42**	**40.12**	**23.61**
Supported borrowing	4.89	4.37	4.17	4.17
Unsupported borrowing	9.61	6.54	4.21	6.69
Total Funding	**14.50**	**10.91**	**8.38**	**10.86**
Total Financing and Funding	**61.44**	**40.33**	**48.50**	**34.47**

The table shows that the capital expenditure plans of the Authority could not be funded entirely from sources other than external borrowing.

(e) **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.

	Approved 2012/13 %	**Actual 2012/13 %**	**Estimate 2013/14 %**	**Estimate 2014/15 %**
Ratio of Financing Costs to Net Revenue Stream	5.65	5.20	5.16	5.24

(f) **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 full Council meeting on 1 March 2012.

(g) **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.

	Approved 2012/13 £m	**Actual 2012/13 £m**	**Approved 2013/14 £m**	**Approved 2014/15 £m**
Upper Limit for total principal sums invested over 364 days	40.00	0.00	40.00	40.00

The Council's policy response since the onset of the credit crunch in 2007 has been to keep investment maturities to a maximum of 1 year. No principal sums were invested over 364 days.

APPENDIX 2

Credit Score Analysis

Scoring:

Long-Term Credit Rating	**Score**
AAA	1
AA+	2
AA	3
AA-	4
A+	5
A	6
A-	7
BBB+	8
BBB	9
BBB-	10
Not rated	11
BB	12
CCC	13
C	14
D	15

The value weighted average reflects the credit quality of investments according to the size of the deposit. The time weighted average reflects the credit quality of investments according to the maturity of the deposit

The Council aimed to achieve a score of 7 or lower, to reflect the Council's overriding priority of security of monies invested and the minimum credit rating of threshold of A- for investment counterparties.