MEETING:	**AUDIT COMMITTEE**
DATE:	**25 SEPTEMBER 2014**
TITLE:	**TREASURY MANAGEMENT 2013/14**
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:	**CAROLINE ROBERTS, INVESTMENT MANAGER**

Executive Summary

During 2013/14 the Council's borrowing remained well within the limits originally set, total interest received on deposits was £399,757 which was below the budgeted level of £555,980. 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 1st 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 that which was expected. It is considered that the Audit Committee is the appropriate body to consider this report.

This report compares our actual performance for 2013/14 against the strategy which was set out in February 2013 for the financial year (approved by the full Council at its meeting on 28/02/2013). The report looks at:

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

The Authority's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which requires 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.

This report fulfils the Authority's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the Welsh Government's Investment Guidance.

The Authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

2. External Context

Economic background: At the beginning of the 2013-14 financial year markets were concerned about lacklustre growth in the Eurozone, the UK and Japan. Lack of growth in the UK economy, the threat of a 'triple-dip' alongside falling real wages (i.e. after inflation) and the paucity of business investment were a concern for the Bank of England's Monetary Policy Committee. Only two major economies – the US and Germany – had growth above pre financial crisis levels, albeit these were still below trend. The Eurozone had navigated through a turbulent period for its disparate sovereigns and the likelihood of a near-term disorderly collapse had significantly diminished. The US government had just managed to avoid the fiscal cliff and a technical default in early 2013, only for the problem to re-emerge later in the year.

With new Governor Mark Carney at the helm, the Bank of England unveiled forward guidance in August pledging to not consider raising interest rates until the ILO unemployment rate fell below the 7% threshold. In the Bank's initial forecast, this level was only expected to be reached in 2016. Although the Bank stressed that this level was a ***threshold*** for consideration of rate increase rather an automatic trigger, markets began pricing in a much earlier rise than was warranted and, as a result, gilt yields rose aggressively.

The recovery in the UK surprised with strong economic activity and growth. Q4 2013 GDP showed year-on-year growth of 2.7%. Much of the improvement was down to the dominant service sector, and an increase in household consumption buoyed by the pick-up in housing transactions which were driven by higher consumer confidence, greater availability of credit and strengthening house prices which were partly boosted by government initiatives such as Help-to-Buy. However, business investment had yet to recover convincingly and the recovery was not accompanied by meaningful productivity growth. Worries of a housing bubble were tempered by evidence that net mortgage lending was up by only around 1% annually.

CPI fell from 2.8% in March 2013 to 1.7% in February 2014, the lowest rate since October 2009, helped largely by the easing commodity prices and discounting by retailers, reducing the pressure on the Bank to raise rates. Although the fall in unemployment (down from 7.8% in March 2013 to 7.2% in January 2014) was faster than the Bank of England or indeed many analysts had forecast, it hid a stubbornly high level of underemployment. Importantly, average earnings growth remained muted and real wage growth (i.e. after inflation) was negative. In February the Bank stepped back from forward guidance relying on a single indicator – the unemployment rate – to more complex measures which included spare capacity within the economy. The Bank also implied that when official interest rates were raised, the increases would be gradual – this helped underpin the 'low for longer' interest rate outlook despite the momentum in the economy.

The Office of Budget Responsibility's 2.7% forecast for economic growth in 2014 forecast a quicker fall in public borrowing over the next few years. However, the Chancellor resisted the temptation to spend some of the proceeds of higher economic growth. In his 2013 Autumn Statement and the 2014 Budget, apart from the rise in the personal tax allowance and pension changes, there were no significant giveaways and the coalition's austerity measures remained on track.

The Federal Reserve's then Chairman Ben Bernanke's announcement in May that the Fed's quantitative easing (QE) programme may be 'tapered' caught markets by surprise. Investors began to factor in not just an end to QE but also rapid rises in interest rates. 'Tapering' (a slowing in the rate of QE) began in December 2013. By March 2014, asset purchases had been cut from $75bn to $55bn per month with expectation that QE would end by October 2014. This had particular implications for global markets which had hitherto benefited from, and got very accustomed to, the high levels of global liquidity afforded by QE. The impact went further than a rise in the dollar and higher US treasury bond yields. Gilt yields also rose as a consequence and emerging markets, which had previously benefited as investors searched for yield through riskier asset, suffered large capital outflows in December and January.

With the Eurozone struggling to show sustainable growth, the European Central Bank cut main policy interest rates by 0.25% to 0.25% and the deposit rate to zero. Markets were disappointed by the lack of action by the ECB despite CPI inflation below 1% and a looming threat of deflation. Data pointed to an economic slowdown in China which, alongside a weakening property market and a highly leveraged shadow banking sector, could prove challenging for its authorities.

Russia's annexation of the Ukraine in March heightened geopolitical tensions and risk. The response from the West which began with sanctions against Russia which is the second largest gas producer in the world and which supplies nearly 30% of European natural gas needs and is also a significant supplier of crude oil – any major disruption to their supply would have serious ramifications for energy prices.

Gilt Yields and Money Market Rates: Gilt yields ended the year higher than the start in April. The peak in yields was during autumn 2013. The biggest increase was in 5-year gilt yields which increased by nearly 1.3% from 0.70% to 1.97%. 10-year gilt yields rose by nearly 1% ending the year at 2.73%. The increase was less pronounced for longer dated gilts; 20-year yields rose from 2.74% to 3.37% and 50-year yields rose from 3.23% to 3.44%.

3-month, 6-month and 12-month Libid rates remained at levels below 1% through the year.

3. The Borrowing Requirement and Debt Management

	Balance on 01/04/13 £'000	New Borrowing £'000	Maturing Debt £'000	Transfer between long and short term £'000	Balance on 31/03/14 £'000	Average Rate %
CFR	165,924				173,309	
Short Term Borrowing	17,437	26	(1,263)	(15,007)	1,193	8.61
Long Term Borrowing	95,811	397	0	15,007	111,215	5.74
TOTAL BORROWING	**113,248**	**423**	**(1,263)**	**0**	**112,408**	5.77
Other Long Term Liabilities	29	2,547	(92)	0	2,484	6.17
TOTAL EXTERNAL DEBT	**113,277**	**2,970**	**(1,355)**	**0**	**114,892**	**5.78**
Increase/ (Decrease) in Borrowing £m					**1,615**	

The Authority's underlying need to borrow as measured by the Capital Financing Requirement (CFR) at 31/03/2014 was £173 million. Usable reserves and working capital, which are the internal resources available for investment, were £68 million.

Given the significant cuts to public expenditure and in particular to local government funding, the Authority's borrowing strategy continued to address the key issue of affordability without compromising the longer-term stability of the debt portfolio.

At 1st April 2013 the Authority held £113 million of loans, as part of its strategy for funding previous years' capital programmes.

The Council expects it will need to borrow £5 million for capital purposes by 2015/16. The benefits of internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose assisted the Authority with this "cost of carry" analysis.

Total borrowing at 31st March 2014 was £114.9million.

Changes in the debt portfolio achieved a reduction in credit risk by repaying debt with existing investments.

4. **Investment Activity**

Both the CIPFA and the Welsh Government Investment Guidance require the Authority to invest prudently and have regard to the security and liquidity of investments before seeking the optimum yield.

Investment Counterparty	**Balance on 01/04/13 £'000**	**Investments Made £'000**	**Maturities/ Investments Sold £'000**	**Balance on 31/03/14 £'000**	**Avg Rate %**
Banks and building societies - Short-term	35,629	208,200	(216,746)	27,083	0.63
TOTAL INVESTMENTS	**35,629**	**208,200**	**(216,746)**	**27,083**	**0.63**
Increase/ (Decrease) in Investments £m				(8,546)	

Security of capital remained the Authority's main investment objective. This was maintained by following the Authority's counterparty policy as set out in its Treasury Management Strategy Statement for 2013/14 which defined "high credit quality" organisations as those having a long-term credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher.

Investments with banks and building societies included call accounts, fixed-rate term deposits and certificates of deposit. The maximum duration of these investments was 12 months in line with the prevailing credit outlook during the year as well as market conditions.

Credit developments and credit risk management

The Authority assessed and monitored counterparty credit quality 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 and share price. The minimum long-term counterparty credit rating determined by the Authority for the 2013/14 treasury strategy was A- across rating agencies Fitch, S&P and Moody's.

The debt crisis in Cyprus was resolved by its government enforcing a 'haircut' on unsecured investments and bank deposits over €100,000. This resolution mechanism, in stark contrast to the bail-outs during the 2008/2009 financial crisis, sent shockwaves through Europe but allowed banking regulators to progress reform which would in future force losses on investors through a 'bail-in' before taxpayers were asked to support failing banks.

The Financial Services (Banking Reform) Act 2013 gained Royal Assent in December, legislating for the separation of retail and investment banks and for the introduction of mandatory bail-in in the UK to wind up or restructure failing financial institutions. EU finance ministers agreed further steps towards banking union, and the Single Resolution Mechanism (SRM) for resolving problems with troubled large banks which will shift the burden of future restructurings/rescues to the institution's shareholders, bondholders and unsecured investors.

Proposals were also announced for EU regulatory reforms to Money Market Funds which may result in these funds moving to a VNAV (variable net asset value) basis and losing their 'triple-A' credit rating wrapper in the future.

The material changes to UK banks' creditworthiness were (a) the strong progress made by the Lloyds Banking Group in strengthening its balance sheet, profitability and funding positions and the government reducing its shareholding in the Group to under 25%, (b) the announcement by Royal Bank of Scotland of the creation of an internal bad bank to house its riskiest assets (this amounted to a material extension of RBS' long-running restructuring, further delaying the bank's return to profitability) and (c) substantial losses at Co-op Bank which forced the bank to undertake a liability management exercise to raise further capital and a debt restructure which entailed junior bondholders being bailed-in as part of the restructuring.

In July Moody's placed the A3 long-term ratings of Royal Bank of Scotland and NatWest Bank and the D+ standalone financial strength rating of RBS on review for downgrade amid concerns about the impact of any potential breakup of the bank on creditors. As a precautionary measure the Authority reduced its duration to overnight for new investments with the bank(s). In March Moody's downgraded the long-term ratings of both banks to Baa1. As this rating is below the Authority's minimum credit criterion of A-, the banks were withdrawn from the counterparty list for further investment.

The Co-op's long-term ratings were downgraded by Moody's and Fitch to Caa1 and B respectively, both sub-investment grade ratings. The Co-op Bank's capital raising plans to plug a capital shortfall include a contribution from the Co-op Group which is committed to injecting £313m in 2014 of which £50m has been paid so far. However, in order to cover future expected losses and to meet the Prudential Regulation Authority's capital targets, a further £400m is being sought from shareholders, of which Co-operative Group's share is approximately £120m. Given the Co-op Group's own financial position, payment of these sums is by no means certain, leaving the bank with a precarious capital position.

The Authority's counterparty credit quality has weakened as demonstrated by the Credit Score Analysis summarised below. The table in Appendix 3 explains the credit score.

Credit Score Analysis 2013/14

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)
31/03/2013	5.17	A+	4.97	A+	81
30/06/2013	5.18	A+	5.30	A+	42
30/09/2013	5.44	A+	4.66	A+	68
31/12/2013	5.72	A	5.55	A	110
31/03/2014	5.69	A	5.80	A	102

Liquidity Management

In keeping with the Welsh Government Guidance on Investments, the Authority maintained a sufficient level of liquidity, averaging £63.8m through the use of Money Market Funds, overnight deposits and call accounts. The Authority uses cash flow forecasting to determine the maximum period for which funds may prudently be committed.

Yield

The UK Bank Rate was maintained at 0.5% through the year. Short term money market rates also remained at very low levels which continued to have a significant impact on investment income. The average 3-month LIBID rate during 2013/14 was 0.45%, the 6-month LIBID rate averaged 0.53% and the 1-year LIBID rate averaged 0.78%. The low rates of return on the Authority's short-dated money market investments reflect prevailing market conditions and the Authority's objective of optimising returns commensurate with the principles of security and liquidity.

The funds' performance and continued suitability in meeting the Authority's investment objectives are monitored regularly.

The Authority's budgeted investment income for the year had been estimated at £0.56m. The average cash balances representing the Authority's reserves, working balances etc. were £63.8m during the period and interest earned was £0.40m.

Update on Investment with Heritable Bank

The authority has now recovered 94% of its investments in Heritable Bank. It is likely that further distributions will be received, although the administrators have not made any further estimate of final recoveries yet.

CIPFA issued further guidance on the accounting treatment surrounding these transactions in September 2013 when LAAP 82 (update 8) was issued. CIPFA has no plans to issue any additional updates.

5. Compliance

The Authority confirms that it has complied with its **Prudential Indicators** for 2013/14, which were approved on 28 February 2013 as part of the Authority's Treasury Management Strategy Statement (which can be accessed through the following link http://www.gwynedd.gov.uk/gwy_pwyllgorau.asp?cat=7551&doc=28275&Language=1). Details can be found in Appendix 2.

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 2013/14. None of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

The Authority also confirms that during 2013/14 it complied with its **Treasury Management Policy Statement** and **Treasury Management Practices**.

6. Other Items

Investment Training: The needs of the Authority's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

During 2013/14 staff attended training courses, seminars and conferences provided by Arlingclose and CIPFA.

Appendix 1

Debt and Investment Portfolio Position 31/03/14

	Actual Portfolio 31/03/14 £m	Average Rate 31/03/14 %
External Borrowing:		
PWLB – Fixed Rate	95,294	6.09
Salix* – Interest Free	914	0.00
LOBO Loans	16,200	4.22
Total External Borrowing	**112,408**	**5.77**
Other Long Term Liabilities:		
Finance Leases	2,484	6.17
Total Gross External Debt	**114,892**	**5.78**
Investments:		
Short-term investments	(27,083)	(0.63)
Total Investments	**(27,083)**	**(0.63)**
Net Debt	**87,809**	**7.64**

*Energy Saving Schemes

Appendix 2

Prudential Indicators

(a) Capital Financing Requirement (CFR)

Estimates of the Authority's cumulative maximum external borrowing requirement for 2013/14 to 2015/16 are shown in the table below:

Capital Financing Requirement	Approved 31/03/14 £m	Revised 31/03/14 £m	Actual 31/03/14 £m	Estimate 31/03/15 £m	Estimate 31/03/16 £m
General Fund	160.4	169.0	173.3	182.1	188.7

Gross Debt and the Capital Financing Requirement: In order to ensure that over the medium term debt will only be for a capital purpose, the Authority should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Debt	Approved 31/03/14 £m	Revised 31/03/14 £m	Actual 31/03/14 £m	Estimate 31/03/15 £m	Estimate 31/03/16 £m
Borrowing	190.0	190.0	112.4	195.0	195.0
Finance leases	0.0	0.0	2.5	0.0	0.0
Total Debt	**190.0**	**190.0**	**114.9**	**195.0**	**195.0**
Borrowing in excess of CFR?	No	No	No	No	No

Total debt is expected to remain below the CFR during the forecast period.

(b) Authorised Limit and Operational Boundary for External Debt

The Operational Boundary for External Debt is based on the Authority's estimate of most likely, i.e. prudent, but not worst case scenario for external debt. It links directly to the Authority's estimates of capital expenditure, the capital financing requirement and cash flow requirements and is a key management tool for in-year monitoring. Other long-term liabilities comprise finance lease, Private Finance Initiative and other liabilities that are not borrowing but form part of the Authority's debt.

The Authorised Limit for External Debt is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Authority can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

The Head of Finance confirms that there were no breaches to the Authorised Limit and the Operational Boundary during 2013/14; borrowing at its peak was £113.2m.

	Operational Boundary (Approved) 31/03/14 £'000	**Authorised Limit (Approved) 31/03/14 £'000**	**Actual External Debt 31/03/14 £'000**
Borrowing	175,000	195,000	112,408
Other Long-term Liabilities	0	0	2,484
Total	**175,000**	**195,000**	**114,892**

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

This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed.

	Approved Limits for 2013/14	**Maximum during 2013/14**
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

(d) 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 at 31/03/14 £'000**	**Percentage Fixed Rate Borrowing at 31/03/14 %**	**Compliance with Set Limits?**
under 12 months	25%	0%	**1,193**	1.1	Yes
12 months and within 24 months	25%	0%	**199**	0.2	Yes
24 months and within 5 years	50%	0%	**20,825**	18.5	Yes
5 years and within 10 years	75%	0%	**8,069**	7.2	Yes
10 years and within 20 years	100%	0%	**39,305**	34.9	Yes
20 years and within 30 years	100%	0%	**15,464**	13.8	Yes
30 years and within 40 years	100%	0%	**0**	0.0	Yes
40 years and above	100%	0%	**27,352**	24.3	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. The Council's LOBO loan is included in the '24 months and within 5 years' category above.

(e) 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 31/03/14 £m**	**Revised 31/03/14 £m**	**Actual 31/03/14 £m**	**Estimate 31/03/15 £m**	**Estimate 31/03/16 £m**
Total	**50.7**	**46.7**	**45.0**	**48.3**	**26.4**

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

Capital Financing	**Approved 31/03/14 £m**	**Revised 31/03/14 £m**	**Actual 31/03/14 £m**	**Estimate 31/03/15 £m**	**Estimate 31/03/16 £m**
Capital receipts	1.1	1.3	1.4	1.8	0.9
Government Grants	25.7	23.8	22.4	19.7	5.7
Revenue contributions	13.4	11.4	10.5	10.8	5.9
Total Financing	**40.2**	**36.5**	**34.3**	**32.3**	**12.5**
Supported borrowing	4.2	4.2	4.2	6.6	6.6
Unsupported borrowing	6.3	6.0	6.5	9.4	7.3
Total Funding	**10.5**	**10.2**	**10.7**	**16.0**	**13.9**
Total Financing and Funding	**50.7**	**46.7**	**45.0**	**48.3**	**26.4**

(f) 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, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	**Approved 31/03/14 %**	**Revised 31/03/14 %**	**Actual 31/03/14 %**	**Estimate 31/03/15 %**	**Estimate 31/03/16 %**
Total	**5.24**	**5.84**	**4.86**	**5.59**	**5.78**

(g) Adoption of the CIPFA Treasury Management Code

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

The Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* on 3rd March 2011.

(h) 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 31/03/2014 £m	**Revised 31/03/2014 £m**	**Actual 31/03/2014 £m**	**Estimate 31/03/2015 £m**	**Estimate 31/03/16 £m**
Total	**35.0**	**35.0**	**0.0**	**30.0**	**20.0**

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.

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

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