



Audit Committee
26 June 2014

Report from the Chief Finance Officer

Wards Affected:
ALL

2013/14 Treasury Management Outturn Report

1. INTRODUCTION

- 1.1 This report updates members on Treasury Management activity and confirms that the Council has complied with its Prudential Indicators for 2013/14.

2. RECOMMENDATION

- 2.1 The Committee is asked to consider the 2013/14 Treasury Management outturn report, which will also be submitted to the Cabinet and Full Council.

3. BACKGROUND

- 3.1 The Council'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.
- 3.2 This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the CLG Investment Guidance.
- 3.3 The Council has borrowed money over the long term to support investment in the Council's infrastructure and also invests balances held for short periods. It 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 Council's treasury management strategy.

Economic background

- 3.4 The recovery in the UK surprised with strong economic activity and growth. Q4 2014 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. 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 6.6% in April 2014) was faster than the Bank of England had forecast, the real level of unemployment, and therefore the amount of excess capacity, remains uncertain making it difficult to be confident how much inflationary pressure is in the economy.
- 3.5 At present it is difficult to be confident that present levels of growth can be sustained due to:
- The Federal Reserve's then Chairman Ben Bernanke's announcement in May 2013 that the Fed's quantitative easing (QE) programme may be 'tapered'
 - the Eurozone struggling to show sustainable growth
 - uncertainty arising from the situation in the Ukraine and the Middle East
 - evidence of strains to the Chinese economy

Gilt Yields and Money Market Rates

- 3.6 Gilt yields (the rate of interest on UK government borrowing) ended the year higher than in April 2013. 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%.
- 3.7 Interest rates on short term inter-bank lending remained below 1% through the year.

The Borrowing Requirement and Debt Management

- 3.8 The table below summarises the Council's borrowing activity during 2013/14. The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) at 31/03/2014 was £582 million.

	Balance 01/04/2013 (£m)	New Borrowing (£m)	Borrowing Repaid (£m)	Balance 31/03/2014 (£m)	Average Rate (%)	Average Life (Years)
CFR	591			582		
Short Term Borrowing	0	422	422	0	0	
Long Term Borrowing	432	0	4	428	4.68	37.8
TOTAL BORROWING	432	422	426	428	4.68	37.8

- 3.9 At 1 April 2013 the Council had £432 million of long-term borrowing, to finance its previous years' capital programmes. With short-term interest rates being much lower than long-term rates, it was more cost effective in the short-term to use internal resources and borrow on a short-term basis (mainly from other local authorities), rather than undertake further long-term borrowing. By doing so, the Council has been able to reduce net borrowing costs and reduced overall treasury risk.
- 3.10 The Treasury Management Strategy approved by the Council in March 2014 includes provision for borrowing to progress towards CFR over a period of 2 – 3 years. The rate of progress will depend on the perceived risks of lending surplus cash, the Council's cash flow and the prospective path of interest rates.
- 3.11 No debt was restructured during the year and no lenders exercised options to vary the terms of loans on LOBO (Lender Option, Borrower Option) terms.

Investment Activity

- 3.12 Both CIPFA and the CLG Investment Guidance require the Council to invest prudently and have regard to the security and liquidity of investments before seeking the optimum yield. The table below summarises investment activity during 2013/14.

Investments	Balance on 01/04/2013 (£m)	Investments made (£m)	Investments repaid (£m)	Balance on 31/03/2013 (£m)	Average Rate (%)
Fixed Term Deposits	48	136	122	62	0.7
Market Funds	17	550	518	49	0.4
TOTAL INVESTMENTS	65	686	640	111	0.6

- 3.11 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 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 overseas where the sovereign rating is AA+ or higher.
- 3.12 Investments with banks and building societies were primarily fixed-rate term deposits. 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

- 3.13 The Council 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 Council for the 2013/14 treasury strategy was A- across rating agencies Fitch, S&P and Moody's.

- 3.14 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 has implications throughout Europe and has already been incorporated into UK legislation through the Financial Services (Banking Reform) Act 2013. The risk of loss is currently felt to be low in the UK, but the Council has taken a number of actions in response to this, and continues to monitor risks, with advice from Arlingclose.
- 3.15 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.
- 3.16 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.
- 3.17 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 Council 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 Council's minimum credit criterion of A-, the banks were withdrawn from the counterparty list for further investment. Natwest are the Council's bankers, and having reviewed their position and taken advice from Arlingclose, they will continue to be used for operational and liquidity purposes.
- 3.18 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 had been paid [as at 16 April 2014]. However, in order to cover future expected losses and to meet the Prudential Regulation Council's capital targets, a further £400m is being sought from shareholders, of which Co-operative Group's share is approximately £120m.

Liquidity Management

- 3.19 At current rates it is appropriate to make use of opportunities to lend to secure counterparties for up to a year (and limited amounts beyond that). Over the last year, largely due to the pattern of government grant distribution, net available balances

have fluctuated considerably. At peak periods, mindful of the primacy of security as a criterion for decision making, substantial balances may be held in short term investments, particularly Money Market Funds. The use of short term borrowing at times of lower cash balances is judged to maintain a prudent balance between maintaining security and liquidity and achieving a reasonable yield on investments.

Yield

- 3.20 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 Council's short-dated money market investments reflect prevailing market conditions and the Council's objective of optimising returns commensurate with the principles of security and liquidity.
- 3.21 The Council's budgeted investment income for the year had been estimated at £0.2m. The average cash balance during the year was £97m during the period and interest earned was £0.6m.

Update on Investments with Icelandic Banks

- 3.22 **Heritable** – The Council has now recovered 94% of its £10 million deposit with Heritable Bank. It is likely that further distributions will be received, although the administrators have not made any further estimate of final recoveries yet.
- 3.23 **Glitnir** – The Council has received £4 million of its deposit with Glitnir Bank, and approximately £1m is held in a bank account in Iceland until authorisation is received from the Central Bank of Iceland to convert it into sterling. It is earning interest at a rate of 4.2%, but that is also not convertible. The amount which will, in due course, be realised from this deposit will depend on the exchange rate when it becomes convertible.

Compliance

- 3.24 The Council confirms that it has complied with its Prudential Indicators for 2013/14, which were approved by the Council on 25 February 2013 as part of the Council's Treasury Management Strategy Statement.
- 3.25 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. Further information is set out in Appendix 2.

Investment Training

- 3.27 The needs of the Council's treasury management staff for training in investment management are kept under review and considered as part of the staff appraisal

process, and additionally when the responsibilities of individual members of staff change.

3.28 During 2013/14 staff attended training courses, seminars and conferences provided by Arlingclose and CIPFA and opportunities which may arise with other organisations are considered.

3.29 A member training session on treasury management was held on 2 July 2013 which outlined the overall treasury management framework with a particular focus on the management of risks.

4. FINANCIAL IMPLICATIONS

4.1 The Council's incurred interest costs of £20.2m in 2013/14 in respect of its long-term borrowing and earned interest of £0.6m on its investments. The approach taken to minimise net interest costs enabled the Council to reduce its capital financing requirement by £4.6m, thereby providing ongoing annual contribution of at least £550k towards the savings needed in the Council's medium term financial strategy.

5. LEGAL IMPLICATIONS

5.1 None identified.

6. DIVERSITY IMPLICATIONS

6.1 None identified.

7. STAFFING IMPLICATIONS

7.1 None identified.

8. BACKGROUND INFORMATION

Treasury Management Strategy Report to Council – 25 February 2013
2013/14 Mid Year Treasury Report to Council – 18 November 2013

9. CONTACT OFFICERS

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Appendix 1 - Debt and Investment Portfolio Position 31/3/2014

	31/3/2014 Actual Portfolio £m	31/3/2014 Average Rate %
External Borrowing:		
PWLB – Maturity	288	2.6
PWLB – Equal Instalments of Premium	44	5.0
LOBO Loans	96	4.7
Total External Borrowing	428	4.7
Other Long Term Liabilities:		
PFI	36	9.5
Total Gross External Debt	464	5.1
Investments:		
Deposits	62	0.7
Money Market Funds	49	0.4
Total Investments	111	0.6
Net Debt	353	4.8

Appendix 2 – Prudential Indicators

(a) Capital Financing Requirement (CFR)

The Council's cumulative maximum external borrowing requirement for 2013/14 is shown in the table below:

Capital Financing Requirement	31/03/2014 Estimate £m	31/03/2014 Actual £m
General Fund	478	445
HRA	137	137
Total CFR	615	582

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 Council 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	31/03/2014 Estimate £m	31/03/2014 Actual £m
Borrowing		428
PFI liabilities		36
Total Debt	615	464
Borrowing in excess of CFR?	No	No

(b) Authorised Limit and Operational Boundary for External Debt

The Operational Boundary for External Debt is based on the Council's estimate of most likely, i.e. prudent, but not worst case scenario for external debt. It links directly to the Council'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 Council'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 Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

The Director of Finance confirms that there were no breaches to the Authorised Limit and the Operational Boundary during 2013/14.

	Operational Boundary (Approved) 31/03/2014	Authorised Limit (Approved) 31/03/2014	Actual External Debt 31/03/2014
Borrowing			428
Other Long-term Liabilities			36
Total	700	800	464

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

This indicator is set to control the Council'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 Proportion %	Maximum during 2013/14 Proportion %
Upper Limit for Fixed Rate Exposure	100	100
Compliance with Limits:	Yes	Yes
Upper Limit for Variable Rate Exposure	40	14
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 31/03/2014 £m	% Fixed Rate Borrowing at 31/03/2014	Compliance with Set Limits?
under 12 months	40	0	19	5	Yes
12 months and within 24 months	20	0	29	7	Yes
24 months and within 5 years	20	0	64	15	Yes
5 years and within 10 years	60	0	27	6	Yes
10 years and within 20 years	100	0	8	2	Yes
20 years and within 30 years	100	0	20	4	Yes
30 years and within 40 years	100	0	89	21	Yes
40 years and within 50 years	100	0	172	40	Yes
50 years and above	100	0	0	0	Yes

(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 and in the case of the HRA, housing rent levels.

Capital Expenditure	31/03/2014 Estimate £m	31/03/2014 Actual £m
Non-HRA	85	73
HRA	17	16
Total	102	89

(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	31/03/2014 Estimate %	31/03/2014 Actual %
Non-HRA	8.83	8.74
HRA*	20.34	19.33
Total	10.56	10.33

(g) Adoption of the CIPFA Treasury Management Code

This indicator demonstrates that the Council 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* in February 2013

(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 Council having to seek early repayment of the sums invested.

	31/03/2014 Approved £m	31/03/2014 Actual £m
	20	5

(i) HRA Limit on Indebtedness

HRA Debt Cap (as prescribed by CLG)	£199m	
	31/03/2014 Estimate £m	31/03/2014 Actual £m
HRA CFR	137	137