ANNUAL TREASURY MANAGEMENT REPORT 2012/13

Cabinet – 12 September 2013

Report of the: Group Manager Financial Services

Status: For Consideration

Also considered by: **Finance and Resources Advisory Committee – 29 August 2013**

Key Decision: No

Executive Summary: This report provides the customary review of investment activity during 2012/13 as required by the Council's Financial Procedure Rules. The report outlines the strategy adopted during the year, shows the position of the investment portfolio at the beginning and the end of the year and gives details of how the fund performed in comparison with previous years and against various benchmarks.

This report supports the Key Aim of Effective Management of Council Resources.

Portfolio Holder Cllr. Ramsay

Contact Officer Roy Parsons, Principal Accountant - Ext 7204

Recommendation to Finance and Resources Advisory Committee: That Cabinet be asked to approve the Annual Treasury Management Report for 2012/13.

Recommendation to Cabinet: It be RESOLVED that the Annual Treasury Management Report for 2012/13 be approved

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Reason for recommendation: As required by both the Council's Financial Procedure Rules and the CIPFA Code, an annual report of treasury management activity is to be presented to Members for approval.

Background

1 The Council is required through regulations issued under the Local Government Act 2003 to produce an annual treasury report reviewing treasury management activities and the actual prudential and treasury indicators for 2012/13. This report meets the requirements of both the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

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

- an annual treasury strategy in advance of the year (Council 21/2/2012)
- a mid year (minimum) treasury update report (Performance and Governance Committee 13/11/12, Cabinet 6/12/12)
- an annual report following the year describing the activity compared to the strategy (this report)

3 In addition, the Council received a quarterly treasury management update report (Performance and Governance Committee 18/9/12) and regular reports on progress were presented to the Finance Advisory Group.

4 The regulatory environment places responsibility on Members for the review and scrutiny of treasury management policy and activities. This report is 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 This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to treasury management reports before they were reported to the full Council. Member training on treasury management issues was undertaken on 27 January 2010 in order to support Members' scrutiny role.

6 The financial year 2012/13 continued the challenging environment of previous years with low investment returns and ongoing counterparty risk.

Introduction

7 This **annual treasury report** covers:

(a) The Council's treasury position at the beginning and end of the financial year;

(b) Investment Strategy for 2012/13;

(c) the economy and interest rates in 2012/13;

(d) compliance with treasury limits and prudential indicators;

(e) investment rates in 2012/13;

(f) investment outturn for 2012/13 and performance; and

(g) Icelandic bank defaults.

Treasury position at the beginning and end of the financial year

8 The Council's investment portfolio at the beginning and end of the financial year appears at Appendix A, whilst an analysis by maturity and repayment due dates appears at Appendix B.

Investment Strategy for 2012/13

9 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 interest 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.

10 The actual movement in gilt yields meant that Public Works Loan Board (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 also from shares, as investors became concerned about the potential for a Lehmans type crisis in the 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.

11 **Change in strategy during the year** – the strategy adopted in the original Treasury Management Strategy Report for 2012/13 approved by the Council on 21 February 2012 was subject to revision during the year due to the downgrading of counterparty credit ratings. The Council's minimum rating criteria for lending were reduced and the counterparty cash limit was increased as a result of a smaller pool of institutions meeting the minimum rating requirement.

The economy and interest rates in 2012/13

12 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 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 Bank of England's Monetary Policy Committee increasing quantitative easing (QE) 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 the forecast for 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.

13 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 to come, combined to keep PWLB rates depressed for much of the year at historically very low levels.

14 As far as investment rates were concerned, 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 European Central Bank 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.

Compliance with treasury limits and prudential indicators

15 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:

	2011/12 Actual (£000)	2012/13 Original (£000)	2012/13 Actual (£000)
Capital expenditure	2,348	1,423	1,337
Total Capital Financing Requirement:			
• Non-HRA	-	-	-
• HRA	-	-	-
• Total	-	-	-
Net borrowing	-	-	-
External debt	-	-	-
Investments			
• Longer than 1 year	-		-
• Under 1 year	24,231		26,856
• Total	24,231		26,856

16 The investment figures relate to the time left to maturity, not the length at the commencement date and exclude accrued interest. The Landsbanki investment has also been excluded.

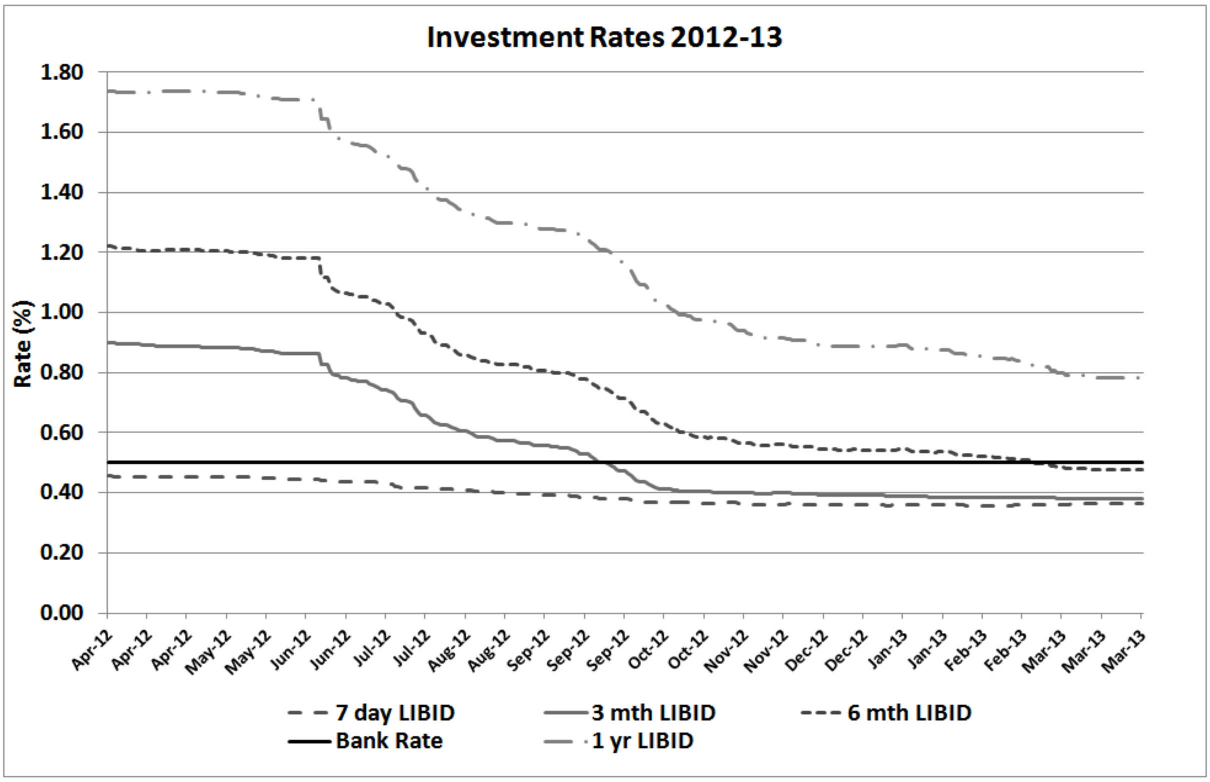
17 During the year the Council operated within the treasury limits and prudential indicators set out in its Treasury Policy Statement and Annual Treasury Strategy Statement with one exception. Over the weekend from 28 September 2012 to 1 October 2012, the sum of £4.4m was held in the Business Premium Account with Barclays. Together with fixed deposits of £2m, the total held with Barclays was £6.4m, compared with the limit of £6m. This situation was corrected on 1 October 2012.

18 The lending list was kept under constant review throughout the year in response to credit rating changes as and when they arose. In order to provide further diversification, the opportunity was taken to open two Money Market Funds, initially with £1m in each and later increased to £3m. The strategy already allowed for investments of up £5m in any Money Market Fund.

19 No institutions in which investments were made during 2012/13 had any difficulty in repaying investments and interest in full during the year.

Investment rates in 2012/13

20 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.



Investment outturn for 2012/13 and performance

21 The Council's investment policy is governed by Department of Communities and Local Government (CLG) guidance, which has been implemented in the annual investment strategy approved by the Council on 21 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.). The strategy was amended later in the financial year, as mentioned earlier in this report, to deal with issues around the restricted number of counterparties.

22 With the one exception mentioned above, the investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties, which might have led to the need to borrow.

23 Appendix C shows the performance of the fund during 2012/13 both in table and graphical form. The table shows the average percentage return on the fund, both monthly and for the whole year and compares them with the average 7-day and 3-month London Interbank Bid (LIBID) rates. The average return achieved by each broker is only a very basic measure of performance, because returns will depend on the number and length of each investment he/she is asked to carry out. If a particular broker is only asked to place short term investments, he/she may well not achieve the same overall rate as a broker who predominantly handles longer term investments for us.

24 The graph shows actual monthly receipts for 2010/11, 2011/12 and 2012/13 plus budgeted monthly receipts for 2012/13. The monthly interest budget has been profiled in line with the previous year's monthly weighted average principal.

25 Over the course of the year interest receipts amounted to £0.323m compared with a budget of £0.206m. The main reasons why the budget was exceeded were that the Council still had some longer investments at higher interest rates than planned for in the budget, the positive impact on cash flow of delayed capital expenditure and additional capital receipts.

26 In 2012/13 the average return on the Council's investments was marginally lower than that of our neighbouring authorities. Our overall rate of return was 1.04% compared with 1.09% for Tonbridge & Malling Borough Council and 1.93% for Tunbridge Wells Borough Council. It should be noted, however, that investment returns are notoriously difficult to compare as they have often been compiled on a different basis (for example, whether or not interest has been compounded, whether or not cashflow generated balances have been included, whether or not externally managed funds have been included and whether or not the figures are net of borrowings). In addition, although we had locked into a few longer term investments at higher interest rates, it appears that the higher average rate of return has been achieved by committing a substantial part of the portfolio to such investments and to a limited number of counterparties.

27 Our treasury management advisers, Sector Treasury Services Ltd, recommend the 3-month LIBID figure as a benchmark. This reflects a more realistic neutral investment position for core investments with a medium term horizon and a rate

which is more stable with less fluctuation caused by market liquidity. Historically, this rate has been slightly higher than the 7-day rate and therefore more challenging a comparator, but one which does not necessitate a significantly increased level of risk. The figures calculated by Sector for these two benchmarks are as follows:

- 7-day LIBID uncompounded 0.394%
- 3-month LIBID uncompounded 0.564%

Icelandic bank defaults

28 This authority currently has an investment of £1m frozen in Landsbanki Islands hf. The investment was placed on 25 June 2007 at 6.32%, to mature on 25 June 2009.

29 The Icelandic Government has stated its intention to honour all its commitments as a result of their banks being placed into receivership. The UK Government, Administrators and other agencies continue to work with the Icelandic Government to help bring this about. The Local Government Association is coordinating the efforts of all UK authorities with Icelandic investments.

30 At the current time, the process of recovering assets is still ongoing with the Administrators. Following the successful outcome of legal test cases in the Icelandic Supreme Court in late 2011, the deposits made by local authorities will rank as priority claims. The Administrators have now commenced the process of dividend payments and three such payments have been received amounting to approximately 50% of our claim. The latest assumption is that 100% of the Council's investment (and interest up to 22 April 2009) will be recovered.

31 Members have been updated periodically on the latest developments in these efforts.

Key Implications

Financial

32 The management of the Council's investment portfolio and cash-flow generated balances plays an important part in the financial planning of the authority. The security of its capital and liquidity of its investments is of paramount importance.

Legal Implications and Risk Assessment Statement

33 Under Section 151 of the Local Government Act 1972, the Section 151 Officer has statutory duties in relation to the financial administration and stewardship of the authority, including securing effective arrangements for treasury management.

34 This annual review report fulfils the requirements of The Chartered Institute of Public Finance & Accountancy's Code of Practice on Treasury Management 2009.

35 Treasury management has two main risks :

- Fluctuations in interest rates can result in a reduction in income from investments; and

- A counterparty to which the Council has lent money fails to repay the loan at the required time.

36 Consideration of risk is integral in our approach to treasury management. However, this particular report has no specific risk implications as it is not proposing any new actions, but merely reporting performance over the last year.

Equality Impacts

Consideration of impacts under the Public Sector Equality Duty:		
Question	Answer	Explanation / Evidence
a. Does the decision being made or recommended through this paper have potential to disadvantage or discriminate against different groups in the community?	No	The recommendation is concerned with investment management and does not directly impact upon a service provided to the community.
b. Does the decision being made or recommended through this paper have the potential to promote equality of opportunity?	No	
c. What steps can be taken to mitigate, reduce, avoid or minimise the impacts identified above?		No mitigating steps are required.

Conclusions

37 The overall return on the Council's investments exceeded the budget in 2012/13 by approximately £117,000.

38 The economic situation both globally and within the Eurozone in particular remains volatile with inevitable consequences for the UK economy. Treasury management in the past financial year was conducted against this background and with a cautious investment approach.

39 Recovery of the Icelandic deposit is ongoing and further updates will be provided as and when monies are received.

Appendices:

Appendix A – Investment portfolio at start and end of financial year

Appendix B – Analysis of investment portfolio by

	maturity and repayment due dates
	Appendix C - Investment performance in 2012/13
Background Papers:	Treasury Management Strategy for 2012/13 - Council 21 February 2012

Adrian Rowbotham
Chief Finance Officer