ANNUAL TREASURY MANAGEMENT REPORT 2013/14

Finance and Resources Advisory Committee – 2 September 2014

Report of the:	Chief Finance Officer
Status:	For Consideration
Also considered by:	Cabinet – 11 September 2014
Key Decision:	No

Executive Summary: This report provides the customary review of investment activity during 2013/14 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 2013/14.

Recommendation to Cabinet: It be RESOLVED that the Annual Treasury Management Report for 2013/14 be approved.

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 2013/14. 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 2013/14 the minimum reporting requirements were that the Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 19/2/2013)
- a mid year (minimum) treasury update report (Finance and Resources Advisory Committee 12/11/13, Cabinet 5/12/13)
- an annual report following the year describing the activity compared to the strategy (this report)

3 In addition, regular reports on progress were presented to the Finance and Resources Advisory Committee. The Council's treasury management advisers, Capita Asset Services Ltd, also provided monthly reviews of our investment performance which were forwarded to Members.

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 2013/14 continued the challenging environment of previous years with low investment returns. Counterparty risk has improved somewhat, but is still an area for close scrutiny.

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 2013/14;

(c) the economy and interest rates in 2013/14;

(d) compliance with treasury limits and prudential indicators;

(e) investment rates in 2013/14;

(f) investment outturn for 2013/14 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 2013/14

9 The expectation for interest rates within the strategy for 2013/14 anticipated low but rising Bank Rate (starting in quarter 1 of 2015), and gradual rises in medium and longer term fixed interest rates over 2013/14. 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 low 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 were on a sharply rising trend during 2013 as markets anticipated the start of tapering of asset purchases by the US Federal Reserve (the Fed). This duly started in December 2013 and the Fed adopted a future course of monthly reductions of $10bn (from a starting position of $85bn), meaning that asset purchases were likely to stop by the end of 2014. However, volatility set in during the first quarter of 2014 as fears around emerging markets, various vulnerabilities in the Chinese economy, the increasing danger for the Eurozone to drop into a deflationary spiral and the situation in Ukraine, caused rates to dip down, reflecting a flight to quality into UK gilts.

11 The strategy adopted in the original Treasury Management Strategy Report for 2013/14 approved by the Council on 19 February 2013 was not subject to revision during the year. However, counterparty credit ratings were kept under constant review to ensure that any investment decisions met minimum lending requirements.

The economy and interest rates in 2013/14

12 The financial year 2013/14 continued the challenging investment environment of previous years, namely low investment returns, although levels of counterparty risk had subsided somewhat. The original expectation for 2013/14 was that Bank Rate would not rise during the year and for it only to start gently rising from quarter 1 2015. This forecast rise has now been pushed back to a start in quarter 3 2015. Economic growth (GDP) in the UK was virtually flat during 2012/13 but surged strongly during the year. Consequently, there was no additional quantitative easing during 2013/14 and Bank Rate ended the year unchanged at 0.5% for the fifth successive year. While CPI inflation had remained stubbornly high and substantially above the 2% target during 2012, by January 2014 it had, at last, fallen below the target rate to 1.9% and then fell further to 1.7% in February. It is also expected to remain slightly below the target rate for most of the two years ahead.

13 Gilt yields were on a sharply rising trend during 2013 but volatility returned in the first quarter of 2014 as various fears sparked a flight to quality (see paragraph 10.) The Funding for Lending Scheme, announced in July 2012, resulted in a flood of cheap credit being made available to banks which then resulted in money market investment rates falling drastically in the second half of that year and continuing into 2013/14. That part of the Scheme which supported the provision of credit for mortgages was terminated in the first quarter of 2014 as concerns rose over resurging house prices.

14 The UK coalition Government maintained its tight fiscal policy stance but recent strong economic growth has led to a cumulative, (in the Autumn Statement and the March Budget), reduction in the forecasts for total borrowing, of £97bn over the next five years, culminating in a £5bn surplus in 2018/19.

15 The EU sovereign debt crisis subsided during the year and confidence in the ability of the Eurozone to remain intact increased substantially. Perceptions of counterparty risk improved after the European Central Bank (ECB) statement in July 2012 that it would do "whatever it takes" to support struggling Eurozone countries. This led to a return of confidence in its banking system which has continued into 2013/14 and led to a move away from only very short term investing. However, this is not to say that the problems of the Eurozone, or its banks, have ended as the zone faces the likelihood of weak growth over the next few years at a time when the total size of government debt for some nations is likely to continue rising. Upcoming stress tests of Eurozone banks could also reveal some areas of concern.

Compliance with treasury limits and prudential indicators

16 During 2013/14, 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:

	2012/13 Actual (£000)	2013/14 Original (£000)	2013/14 Actual (£000)
Capital expenditure	1,337	1,424	2,114
Total Capital Financing Requirement:			
• Non-HRA	-	-	-
• HRA	-	-	-
• Total	-	-	-
Net borrowing	-	-	-
External debt	-	-	-
Investments			
• Longer than 1 year	-		-
• Under 1 year	26,856		33,050
• Total	26,856		33,050

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.

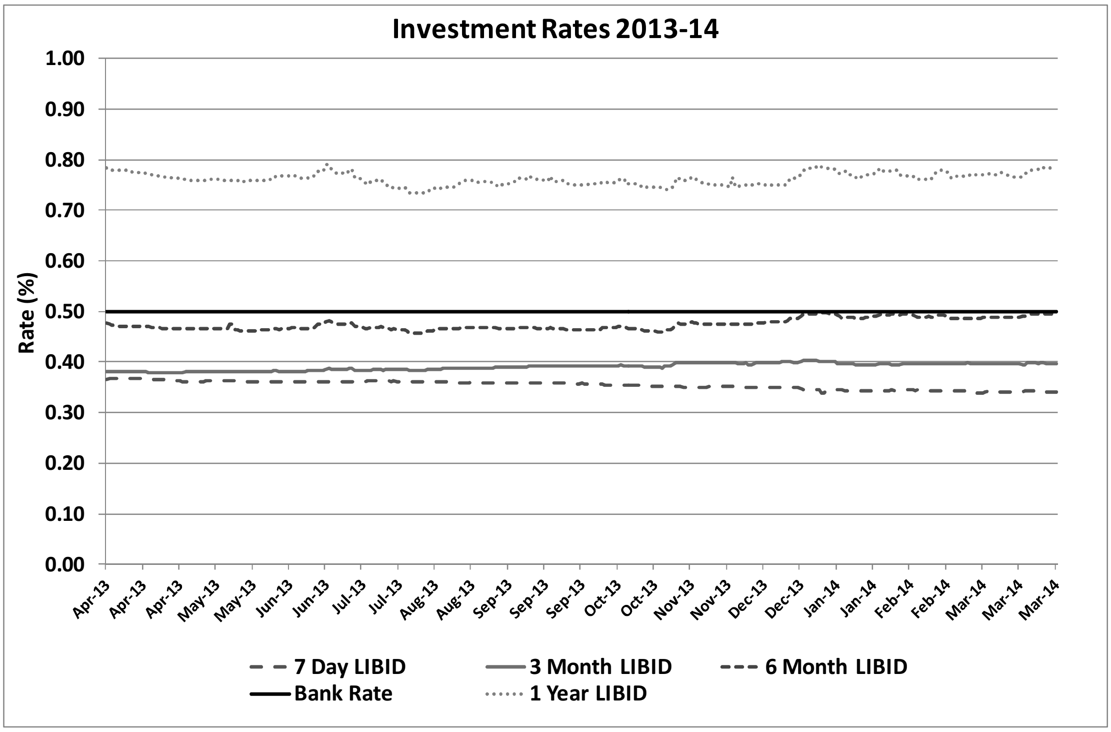
17 During the year the Council operated within the treasury limits and prudential indicators set out in its Treasury Policy Statement and Annual Treasury Strategy Statement.

18 The lending list was kept under constant review throughout the year in response to credit rating changes as and when they arose.

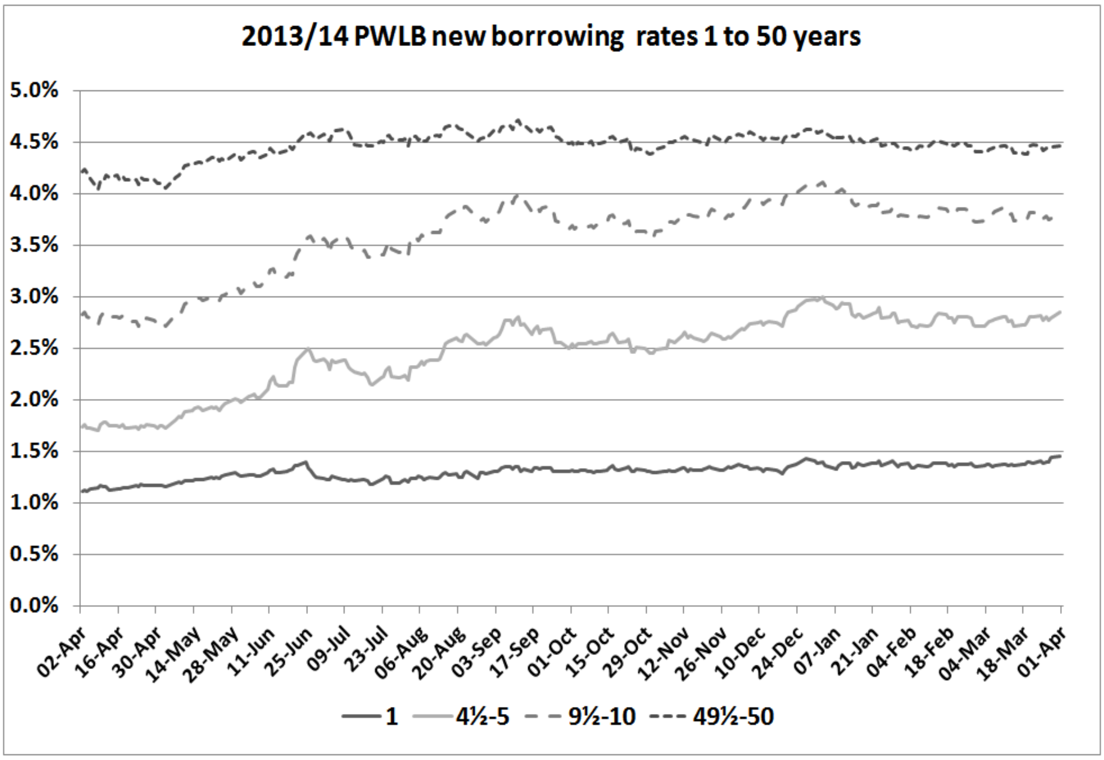
19 No institutions in which investments were made during 2013/14 had any difficulty in repaying investments and interest in full during the year.

Investment rates in 2013/14

20 Bank Rate remained at its historic low of 0.5% throughout the year; it has now remained unchanged for five years. Market expectations as to the timing of the start of monetary tightening ended up unchanged at early 2015. The Funding for Lending Scheme resulted in deposit rates remaining depressed during the whole of the year, although the part of the scheme supporting provision of credit for mortgages came to an end in the first quarter of 2014.



21 For comparison purposes, the graph below shows how PWLB Certainty Rates have from historically low levels during the year.



Investment outturn for 2013/14 and performance

22 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 19 February 2013. 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).

23 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.

24 Appendix C shows the performance of the fund during 2013/14 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.

25 The graph shows actual monthly receipts for 2011/12, 2012/13 and 2013/14 plus budgeted monthly receipts for 2013/14. The monthly interest budget has been profiled in line with the previous year's monthly weighted average principal.

26 Over the course of the year interest receipts amounted to £0.268m compared with a budget of £0.260m.

27 In 2013/14 the average return on the Council's investments was in line with that of one of our neighbouring authorities. Our overall rate of return was 0.71% compared with 0.61% for Tonbridge & Malling Borough Council and 1.55% 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 by investing in a Property Fund, an option which has been rejected at Sevenoaks so far.

28 Our treasury management advisers 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 our advisers for these two benchmarks are as follows:

- 7-day LIBID uncompounded 0.354%
- 3-month LIBID uncompounded 0.391%

Icelandic bank defaults

29 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. The bank went into administration during the global financial crisis in October 2008.

30 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 has been coordinating the efforts of all UK authorities with Icelandic investments.

31 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 rank as priority claims. The Administrators have now commenced the process of dividend payments and four such payments have been received amounting to approximately 54% of our claim. The latest assumption is that 100% of the Council's investment (and interest up to 22 April 2009) will be recovered in the period up to 2018/19.

32 In January and February 2014, a large number of local authorities sold their collective claims against the Landsbanki estate via a competitive auction process. The price at which the sale was concluded did not meet the Council's reserve and hence we remain part of a small group of authorities still holding their claims.

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

Key Implications

Financial

34 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

35 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.

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

37 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.

38 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	No	

Consideration of impacts under the Public Sector Equality Duty:		
Question	Answer	Explanation / Evidence
through this paper have the potential to promote equality of opportunity?		
c. What steps can be taken to mitigate, reduce, avoid or minimise the impacts identified above?		No mitigating steps are required.

Conclusions

39 The overall return on the Council's investments exceeded the budget in 2013/14 by approximately £7,000.

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

41 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 2013/14

Background Papers:

Treasury Management Strategy for 2013/14 - Council 19 February 2013

Adrian Rowbotham
Chief Finance Officer