APPENDIX B

Annual Treasury Management Report 2012/13

Council 11 September 2013

1 Introduction

1.1 The Council's Treasury Management Strategy for 2012/13 was approved by Council on 29 February 2012. This report sets out the related performance of the treasury function by providing details of:

a) long term and short term borrowing (i.e. debt that the Council *owes*)
b) investment activities
c) relevant borrowing limits and prudential indicators.

It is a requirement of the CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice on Treasury Management in Local Authorities that such a report be made to the Cabinet within six months of the end of the financial year, and that it also be reported to Council for information.

1.2 The aim of the Treasury Management Policy and associated activity is to ensure that the investment of surplus cash is managed in line with the guidance issued by both CIPFA and Government, as well as in line with the Council's appetite for risk. For 2012/13 the appetite for risk remained low given the continued volatility in the national economy and the Eurozone.

1.3 Treasury management is a technical area. Training has been provided in the past to Members and this continues to be an important part of the CIPFA code of practice (November 2009, further updated November 2011). To assist with the understanding of this report, a glossary of terms commonly used in Treasury Management is attached at ***Annex B***. In addition, the Councillor's Guide to Local Government Finance also has a section on Treasury and Cash Management, and this is available through the Member Information section on the Intranet.

2 Summary: Headline Messages for 2012/13

2.1 The key points arising from this report are as follows:

- The Council has stayed within its Prudential limits for investments and has not breached any of the criteria set out in the approved Strategy.

- As a result of the downgrading of various banks during the year, the number of such counterparties on the Council's investment list diminished. Other investment options were put in place during the year to provide alternatives, and avoid reliance on using the Government's deposit facility (through the Debt Management Office).

- A further £468K was received during 2012/13 in relation to Icelandic investments. One final repayment (£154K) in relation to the KSF deposit is expected in January 2014 and repayments totalling £578K are expected to be received over the following five years in relation to the deposit with Landsbanki.

- A scheduled repayment of £1.04M has been made in relation to the HRA self-financing loan.

- Investment returns fell below the budgeted figure by £6K. This was, in-part, linked to changes in the Council's investment counterparty list, in order to protect investment security.

- No temporary borrowings have been required to support day to day cash flow. The Council ended the year with healthy cash balances. The exact timing of the surrender of the leasehold interest in Lancaster Market has been the major factor in terms of the Council's cashflow position.

3 Economic Background (*Supplied by Sector)*

The original expectation for 2012/13 was that the Bank Rate would not rise in 2012/13 or 2013/14 and for it to start gently rising from quarter 4 IN 2014. This forecast rise has now been pushed back to start in Quarter 1 2015 at the earliest. Economic growth (GDP) in the UK was virtually flat during 2012/13, due to the UK austerity programme, subdued domestic consumer expenditure, a lack of rebalancing of the UK economy to exporting and weak growth in our biggest export market - the European Union (EU). This weak UK growth resulted in the Monetary Policy Committee increasing quantitative easing (QE) by £50BN in July, to a total of £375BN. The Bank Rate, therefore, ended the year unchanged at 0.5%, while Consumer Price Index (CPI) inflation has remained stubbornly high and above the 2% target, starting the year at 3.0% and still being at 2.8% in March. It is, however, forecast to fall to 2% in three years' time. The EU sovereign debt crisis was an ongoing saga during the year, with an eventual very protracted agreement of a second bailout for Greece in December, followed by a second major crisis, this time over Cyprus, towards the end of the year.

Gilt yields fluctuated during the year as events in the ongoing Eurozone debt crisis ebbed and flowed, causing corresponding fluctuations in safe haven flows into and out of UK gilts. This, together with the further £50BN of QE in July and widely expected further QE still to come, combined to keep PWLB rates depressed for much of the year at historically low levels.

The Funding for Lending Scheme, announced in July, has resulted in a flood of cheap credit being made available to banks and this has resulted in money market investment rates falling drastically in the second half of the year. However, perceptions of counterparty risk have improved after the ECB 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.

The UK 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 in March.

4 Borrowing and Capital Expenditure

4.1 Capital Expenditure and Financing

4.1.1 Long term borrowing is an important part of the Council's capital financing. Under the Prudential Code a key indicator is the Capital Financing Requirement (CFR). This figure is calculated from the Council's balance sheet and represents, in broad terms, the gap between the value of fixed assets and that of capital reserves. In essence, this gap may be viewed as the cumulative amount of capital investment that may need to be funded through external borrowing (i.e. the amount of capital investment that has not been funded from other sources such as grants, revenue contributions and capital receipts). Borrowing should not then exceed the CFR on a long term basis, as this would indicate that borrowing is being used to fund expenditure other than capital. For 2012/13 the figures were as follows:

	£000
Opening CFR	83,188
Closing CFR	83,276
Average CFR	**83,232**
Weighted average borrowings*	69,935
Weighted average finance lease liability	5,790
Weighted average investments	24,541
Net borrowings	**51,184**

4.1.2 From this it is clear that net borrowings are well below the Council's CFR. This indicates that long term borrowing has not been used to fund revenue activities.

4.1.3 In terms of capital expenditure and funding in the year, this can be summarised as follows:

	2011/12 £000	2012/13 £000
Opening Capital Financing Requirement	**50,819**	**83,188**
Capital investment		
Property, Plant and Equipment	7,479	7,739
Re-assessment of finance lease liability	2,474	195
Investment Properties	20	90
Intangible Assets	67	54
Reversal of Icelandic bank impairment	(1,363)	0
HRA self financing payment	31,241	0
Revenue Expenditure Funded from Capital Under Statute	1,199	1,031
Sources of financing		
Capital receipts	(760)	(442)
Government Grants and other Contributions	(1,462)	(1,017)
Direct revenue contributions	(2,295)	(1,425)
Minimum Revenue Provision	(1,906)	(2,702)
Major Repairs Reserve	(2,325)	(3,435)
Closing Capital Financing Requirement	**83,188**	**83,276**

*A further summary of the capital expenditure is given in the prudential indicators in Annex C.

4.1.4 With regard to in-year capital investment, at outturn the increase required in the CFR amounted to £2.594M, which was £140K higher than budgeted, primarily due to delays in generating capital receipts. This variance should be offset in the new year. In terms of Minimum Revenue Provision (MRP) charged to revenue, the outturn was in line with the Revised Budget. The re-assessment of finance lease liabilities also affected the closing CFR.

4.2 Borrowing Levels

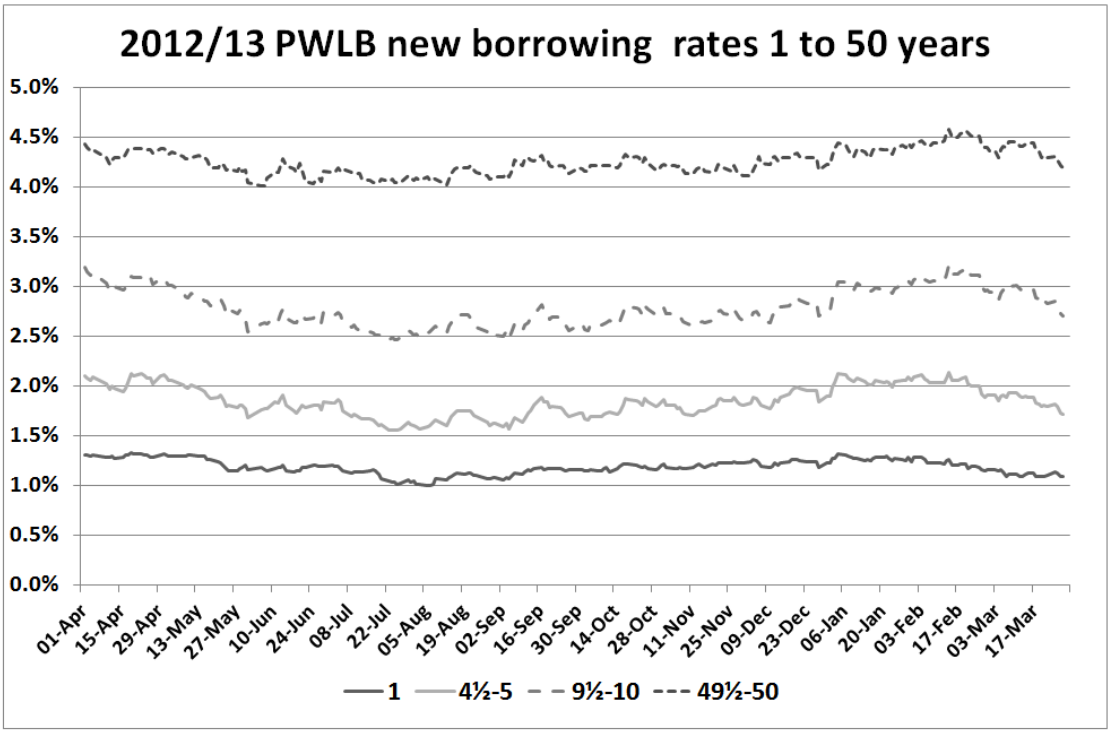
4.2.1 To control the actual level of borrowing, Prudential Indicators are set on both the absolute allowable amount of debt (the Authorised limit) and expected gross debt allowing for day to day cash management (Operational Boundary).

	Actual Debt 31/03/13	**Operational Boundary**	**Authorised Limit**
	£000's	**£000's**	**£000's**
Deferred Liabilities	223		
Long term Finance lease liability	5,327		
PWLB Debt	69,415		
Total	74,965	78,200	80,500

4.2.2 The actual debt, as calculated in accordance with the prudential code, includes the liability associated with finance leases. The operation boundary, when originally set in February 2012, did not include the finance lease element in relation to the Indoor Market building lease. The operational boundary and authorised limit has since been updated to reflect this.

4.3 PWLB Interest Rate Movements

4.3.1 All of the Council's long term borrowings are held with the Public Works Loan Board (PWLB). The chart below illustrates the movement on PWLB fixed term rates over the year. This clearly shows the spread of rates depending on length of loan. It also shows a slight downward trend of all rates, from an already low starting point.



4.3.2 Repayment of PWLB debt is still an attractive option in the current climate, if the Council's cashflow supports such action. This will, however be dependent on future expenditure plans, completing key land sales and future movement in interest rates.

4.4 Debt Maturity (or Repayment) Profile

4.4.1 The Council is exposed to "liquidity" risks if high value loans mature (i.e. become due for repayment) at the same time, making a large demand on cash. One Treasury Indicator which is used to manage this risk is the maturity structure of borrowing. This indicator introduces limits to help reduce the Council's exposure to large fixed rate sums falling due for repayment (and potentially re-financing) all at once. The table overleaf shows these profiles at the beginning and end of the year. The only change is due to the scheduled repayment against the HRA self-financing loan.

	Treasury Indicator	Actual 31/3/12	Actual 31/3/13
Under 12 months	0 - 50%	1.5%	1.5%
12 – 24 Months	0 – 50%	1.5%	1.5%
3 – 5 years	0 – 50%	4.4%	4.5%
6 – 10 years	0 – 50%	7.4%	7.5%
11 -15 years	0 – 100%	7.4%	7.5%
16 – 25 years	0 - 100%	14.8%	15.0%
26 – 50 years	50 – 100%	63.0%	64.0%

4.4.2 Of the total loans outstanding, 44% are repayable through Equal Instalments of Principal (EIP), with the rest being maturity loans, hence the profiling shown above. The actual profile of the debt is well within the approved limits.

4.5 Interest Payable on Longer Term Borrowing

4.5.1 The average rate of interest payable on PWLB debt in 2012/13 was 4.53%, which is on budget. In addition, there was also £667K of interest in relation to finance leases under IFRS accounting. This is a cost that in previous years has been presented within service expenditure.

	£'000
2012/13 Estimate	3,166
2012/13 Actual	3,166 (of which £2,104K was re-charged to the HRA)
Variance	0

4.5.2 Prudential Indicators also provide exposure limits that identify the maximum limit for variable / fixed interest rate exposure, based upon the debt position. The table below shows that the outturn position was within the limits approved at the beginning of the year. The Council currently only has fixed interest rate debt, although again this could change in future if market conditions warrant or facilitate it.

	Prudential Indicator	**Actual**
	%	**%**
Fixed Rate	100	100
Variable Rate	30	0

5 Investment Activities

5.1 Performance against Prudential Indicators

5.1.1 In 2012/13 all investments were placed in accordance with the approved Investment Strategy; there have been no breaches of the investment criteria.

5.1.2 The Council has made no investments and held no investments with a maturity of longer than 365 days from the end of 2012/13; the investment strategy prohibited such long term investments. All deposits have been made either to instant access call accounts and money market funds or have been placed as term deposits with the Debt Management Office (DMO), part of Her Majesty's Treasury. A summary of the average balances held during the year along with the year end position is given in ***Annex A***.

5.2 Icelandic Investments

5.2.1 The following table summarises the recovery position for Icelandic investments, to 31 March 2013, taking account of very recent reassessments undertaken in closing last year's accounts.

	KSF £000	Glitnir £000	Landsbanki £000	Total £000
Deposit	2,000	3,000	1,000	6,000
Claim	2,048	3,173	1,121	6,342
GB £ Repayments received	1,556	2,508	529	4,593
Repayments held in ISK (£)		609	8	617
Total anticipated recovery (% of claim, excluding FX movement)	83.50%	100%	100%	
Further est. payments due (%)	7.51%	0%	52%	
Further est. payments due (£)	154	0	578	732
Total anticipated receipts	**1,710**	**3,117**	**1,115**	**5,942**

5.2.2 During 2012/13 the Council recovered a further £468K of its claim in respect of Icelandic investments and this is reflected in the above table. In very simple terms:

- The original claim was for £6.342M, made up of £6M originally invested plus £342K claimable interest.
- As at 31 March 2013, the Council had received back £4.593M of its claim and in addition, the equivalent of around £617K was held as Icelandic Krona (ISK) in escrow (see 5.2.4 below above).
- This gives total equivalent repayments of £5.210M to 31 March.

5.2.3 In the new financial year, the Council has received a further £61K to date. In total, it expects to recover around £5.942M of its total claim, resulting in losses of £400K or 6.3%.

5.2.4 The repayments from Landsbanki and Glitnir were made in a range of currencies reflecting the assets of the banks. Whilst this clearly involves foreign currency, the Council had no choice but to accept the arrangement. Of these, amounts paid in ISK cannot currently leave Iceland due to currency controls imposed by the Central Bank of Iceland. These amounts have been paid into escrow accounts (similar to client accounts held by solicitors) in Iceland. These are earning 3.4% interest but they are also subject to gains and losses due to fluctuations in the exchange rate between Sterling and ISK. Once the currency controls are removed, these amounts will be paid back into the Council's UK bank account, although there is currently no clear timeframe for this to happen. Due to a weakening of the Icelandic krona against the pound, £39K was recorded in the 2012/13 final accounts as an exchange rate gain.

5.2.5 Also, as repayments are still outstanding for KSF and Landsbanki, there may be small adjustments at subsequent year ends to reflect any changes to anticipated recoveries or repayment profiles, but it is not anticipated that these will be material.

5.3 Performance Against Budget and External Benchmarks

5.3.1 In terms of performance against external benchmarks, the return on investments (not including notional Icelandic interest) compared to the LIBID and bank rates over the year to date is as follows:

Indicator (mean value)	2011/12	2012/13
Base Rate	0.50%	0.50%
3 Month LIBID	0.97%	0.50%
Lancaster CC investment	0.63%	0.50%

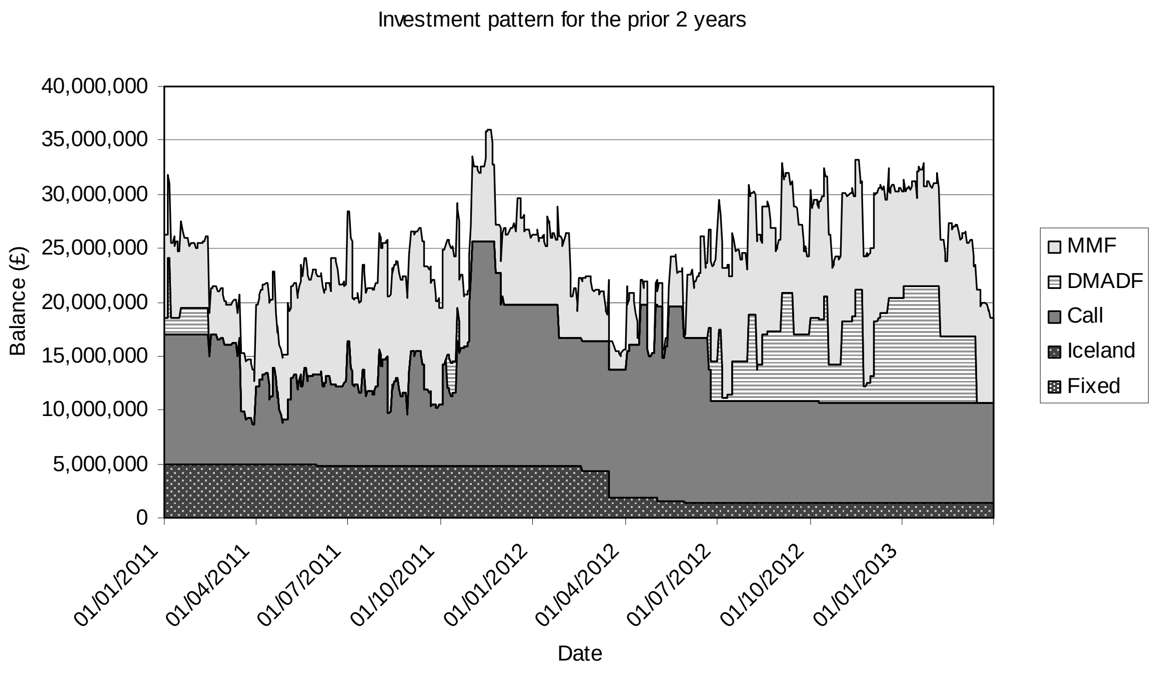
5.3.2 The return is in line with the current Bank of England base rate. Money Market Funds now lag behind the underlying base rate as part of their funds are held in longer term deposits, for which returns are now reducing.

5.3.3 In terms of performance against budget, the details are as follows:

Annual budget	£162K
Actual investment interest	£121K
"Icelandic" interest	£35K
Total	£156K
Variance	£6K adverse

5.3.4 This lower than budgeted return is mainly due to the downgrading of several banks by the credit rating agencies, which has diminished the pool of approved counterparties. On average during the year, 18% of cash balances were deposited with the Government's Debt Management Office (DMO), with an associated yield of 0.25%. However by the end of the financial year, the reliance on the DMO had been removed.

5.3.5 The Investment Strategy for 2012/13 continued with the more cautious approach to managing surplus cash; this approach has been in place since the banking crisis. The arrangements have restricted the term of deposits, reduced the counterparty limits and removed the option to make non EU deposits. In practice, deposits were placed on instant access in either call accounts or Money Market Funds (MMFs) with limit use of the DMO account. The pattern of these investments over 2011/12 and the prior year can be seen in more detail below.



5.3.6 Looking forward, the short term projection for rates is flat; it is anticipated that the position on low investment interest rates will hold for the medium term.

Date	Bank rate projection (%)
01/06/2013	0.50
01/06/2014	0.60
01/03/2015	0.08
01/06/2015	1.10
01/09/2015	1.40

Source: Sector, June 2013

6 Other Risk Management Issues

6.1 Many of the risks in relation to treasury management are managed through the setting and monitoring performance against the relevant Prudential and Treasury Indicators and the approved investment strategy, as discussed above.

6.2 The Authority's Investment Strategy is designed to engineer risk management into investment activity largely by reference to credit ratings and length of deposit to generate a pool of counterparties, together with consideration of non credit rating information to refine investment decisions. This strategy is required under the CIPFA Treasury Management Code, the adoption of which is another Prudential Indicator. The strategy for 2012/13 complied with updated code (November 2011) of practice and DCLG investment guidance. The Code was updated again during 2011/12 although there were no material changes in terms of how the Authority approaches risk management for its Treasury activities.

7 Other Prudential Indicators

7.1 As required under the Prudential Code, certain other year end Prudential Indicators must be calculated. Those not included within the body of this report are presented at ***Annex C*** for noting by Cabinet and approval by Council.

Annex A

Counterparties used during 2012/13

Counterparty	Type	Average	Max	Year End
DMO	Fixed Term	£ 5,026,506.85	£10,870,000.00	£ -
Blackrock (Gov)	MMF	£ 3,244,019.18	£ 6,000,000.00	£ -
Blackrock (Liquidity)	MMF	£ 5,304,863.01	£ 6,000,000.00	£3,595,000.00
Lancashire County Council	Call	£ 9,341,632.88	£12,000,000.00	£9,300,000.00
RBS	Call	£ 673,972.60	£ 3,000,000.00	£ -
Barclays	Call	£ 649,315.07	£ 3,000,000.00	£ -
Insight	MMF	£ 192,273.97	£ 4,370,000.00	£4,370,000.00

Annex B

Treasury Management Glossary of Terms

- **Annuity** – method of repaying a loan where the payment amount remains uniform throughout the life of the loan, therefore the split varies such that the proportion of the payment relating to the principal increases as the amount of interest decreases.

- **CIPFA** – the Chartered Institute of Public Finance and Accountancy, is the professional body for accountants working in Local Government and other public sector organisations, also the standard setting organisation for Local Government Finance.

- **Call account** – instant access deposit account.

- **Counterparty** – an institution (e.g. a bank) with whom a borrowing or investment transaction is made.

- **Credit Rating** – is an opinion on the credit-worthiness of an institution, based on judgements about the future status of that institution. It is based on any information available regarding the institution: published results, Shareholders' reports, reports from trading partners, and also an analysis of the environment in which the institution operates (e.g. its home economy, and its market sector). The main rating agencies are Fitch, Standard and Poor's, and Moody's. They analyse credit worthiness under four headings:

  - **Short Term Rating** – the perceived ability of the organisation to meet its obligations in the short term, this will be based on measures of liquidity.

  - **Long Term Rating** – the ability of the organisation to repay its debts in the long term, based on opinions regarding future stability, e.g. its exposure to 'risky' markets.

  - **Individual/Financial Strength Rating** – a measure of an institution's soundness on a stand-alone basis based on its structure, past performance and credit profile.

  - **Legal Support Rating** – a view of the likelihood, in the case of a financial institution failing, that its obligations would be met, in whole or part, by its shareholders, central bank, or national government.

  The rating agencies constantly monitor information received regarding financial institutions, and will amend the credit ratings assigned as necessary.

- **DMADF and the DMO –** The DMADF is the 'Debt Management Account Deposit Facility'; this is highly secure fixed term deposit account with the Debt Management Office (DMO), part of Her Majesty's Treasury.

- **EIP –** Equal Instalments of Principal, a type of loan where each payment includes an equal amount in respect of loan principal, therefore the interest due with each payment reduces as the principal is eroded, and so the total amount reduces with each instalment.

- **Gilts** – the name given to bonds issued by the U K Government. Gilts are issued bearing interest at a specified rate, however they are then traded on the markets like shares and their value rises or falls accordingly. The Yield on a gilt is the interest paid divided by the Market Value of that gilt.

Eg. a 30 year gilt is issued in 1994 at £1, bearing interest of 8%. In 1999 the market value of the gilt is £1.45. The yield on that gilt is calculated as 8%/1.45 = 5.5%.
See also PWLB.

- **LIBID** – The London Inter-Bank Bid Rate, the rate which banks would have to bid to borrow funds from other banks for a given period. The official rate is published by the Bank of England at 11am each day based on trades up to that time.

- **LIBOR** – The London Inter-Bank Offer Rate, the rate at which banks with surplus funds are offering to lend them to other banks, again published at 11am each day.

- **Liquidity** – Relates to the amount of readily available or short term investment money which can be used for either day to day or unforeseen expenses. For example Call Accounts allow instant daily access to invested funds.

- **Maturity** – Type of loan where only payments of interest are made during the life of the loan, with the total amount of principal falling due at the end of the loan period.

- **Money Market Fund (MMF)** – Type of investment where the Council purchases a share of a cash fund that makes short term deposits with a broad range of high quality counterparties. These are highly regulated in terms of average length of deposit and counterparty quality, to ensure AAA rated status.

- **Policy and Strategy Documents** – documents required by the CIPFA Code of Practice on Treasury Management in Local Authorities. These set out the framework for treasury management operations during the year.

- **Public Works Loans Board (PWLB)** – a central government agency providing long and short term loans to Local Authorities. Rates are set daily at a margin over the Gilt yield (see Gilts above). Loans may be taken at fixed or variable rates and as Annuity, Maturity, or EIP loans (see separate definitions) over periods of up to fifty years. Financing is also available from the money markets, however because of its nature the PWLB is generally able to offer better terms.

- **Sector** – Sector are the City Council's Treasury Management advisors. They provide advice on borrowing strategy, investment strategy, and vetting of investment counterparties, in addition to ad hoc guidance throughout the year.

- **Yield** – see Gilts

Members may also wish to make reference to *The Councillor's Guide to Local Government Finance.*

Annex C

Prudential Indicators

		11/12	12/13
		£'000	£'000
Capital Expenditure			
Actual Capital Expenditure	HRA	34,816	3,591
	GF	5,190	5,323
	Consolidated	40,006	8,914
Capital Financing Requirement	HRA	46,544	45,221
	GF	36,644	38,055
	Consolidated	83,188	83,276