

Annual Treasury Management Report 2013/14

For noting by Cabinet 29 July 2014

1 Introduction

1.1 The Council's Treasury Management Strategy for 2013/14 was approved by Council on 27 February 2013. 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 presented to Cabinet within six months of the end of the financial year, and that it is also 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 2013/14 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 recently been provided to Members (Budget & Performance Panel 04 March 2014) and this also continues to be an important part of the CIPFA Code. 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 2013/14

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

- Major timing uncertainties linked to the surrender of the Lancaster Market headlease and the sale of land at south Lancaster meant that the majority of investment balances were kept in immediate access accounts for the most of the year.
- A fixed term deposit of £3m was placed with Lloyds Bank in Qtr 4 following the stabilisation of cash balances; this was the first fixed term deposit placed with any bank "post-Iceland".
- A scheduled £1.04m loan repayment was made in relation to the HRA self financing loan.
- The Council's claim to recover a deposit held with the Icelandic bank Landsbanki was sold through an auction facilitated through the Local Government Association. The reserve bid price of 92% was achieved.

- Withheld tax in relation to the Council's Glitnir deposit (still held in escrow) has now been repaid. The claim totalled £3.6K and the Council now has exempt status, which means that it will no-longer have a tax liability in this regard.
- No temporary borrowings have been required to support day to day cash flow. The Council ended the year with healthy cash balances of £22M, reflecting many net liabilities as well as backing various provisions and reserves.
- The Council has stayed within its prudential limits for investments and has not breached any of the criteria set out in the approved strategy.

3 **Economic Background (supplied by Capita Asset Services)**

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 Qtr 1 2015. This forecast rise was later pushed back to a start in Qtr 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 the Bank Rate ended the year unchanged at 0.5% for the fifth successive year. While Consumer Prices Index (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.

Gilt yields were on a sharply rising trend during 2013 but volatility returned in the first quarter of 2014 (as various fears sparked an increase in demand for gilts from investors). 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.

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

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 had improved after the European Central Bank stated 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.

4 Icelandic Investments

The position as at 31 March 2014 is as follows.

	KSF £000	Glitnir £000	Landsbanki £000	Total £000
Original Deposit	2,000	3,000	1,000	6,000
Claim	2,048	3,173	1,121	6,342
GBP Payments received	1,669	2,508	1,021	5,198
Amounts still held in escrow account	0	615	0	615
Total anticipated recovery (%)	85.25%	100%	92%	
Further payments due (%)	3.75%	0%	0%	
Further payments due (£)	77	0	0	77
Total anticipated receipts	1,746	3,123	1,021	5,890

Key points to note are:

- The KSF recovery rate has now increased to 85.25% from the previous estimate of 83.5%. The balance outstanding is now £77K. As payments are still outstanding 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.
- The Glitnir claim has been settled. However, amounts paid in Icelandic Krona (ISK) still cannot leave Iceland, due to the currency controls imposed by the Central Bank of Iceland. These amounts have therefore been paid into Icelandic escrow accounts (similar to client accounts at a solicitors). These are earning 4.2% interest but are also subject to gains and losses due to fluctuations in the exchange rate between Sterling and ISK. The amount stated in the table above uses the exchange rate between ISK and GBP as at the 31 March 2014. 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, £6K was recorded in the 2013/14 final accounts as an exchange rate gain.
- The Landsbanki claim has been settled at 92% and no further amounts are outstanding. This has resulted in a favourable position at outturn as future expected receipts of £143K have now been accounted for in 2013/14.
- When compared with the original £6M invested, the Council expects to recover £5.890M or 98.2%. This does not allow for interest losses, but the current position does mean that the vast majority of the capital sum has now been recovered.

5 Borrowing and Capital Expenditure

5.1 Capital Expenditure and Financing

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. In essence, it 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 2013/14 the figures were as follows:

	£000
Opening CFR	83,276
Closing CFR*	78,449
Average CFR	80,862
Weighted average borrowings	69,068
Weighted average finance lease liability	1,415
Weighted average investments*	20,581
Net borrowings	40,902

* Average investment balance excludes Icelandic deposits

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

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

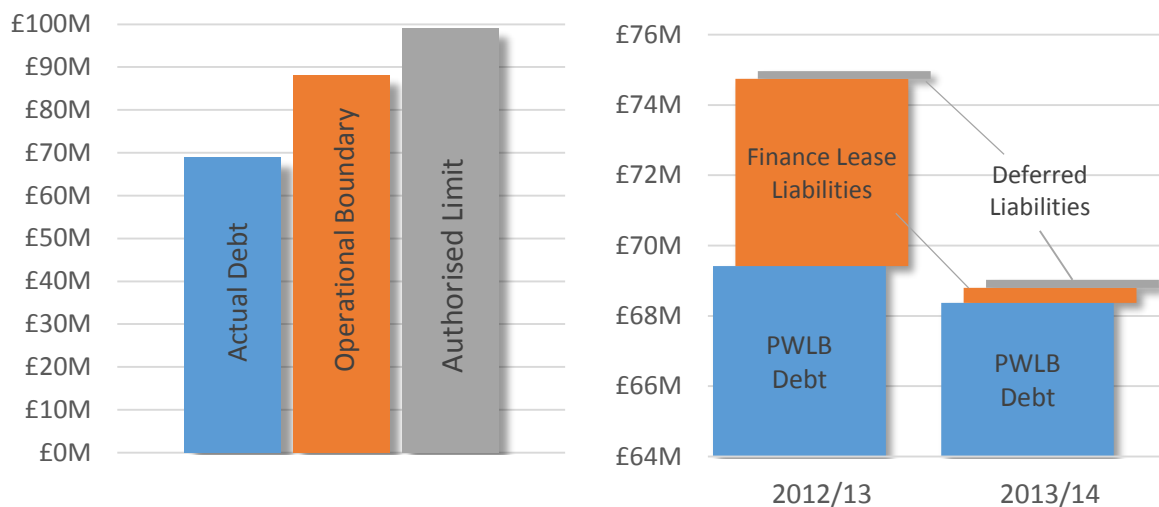
	2012/13	2013/14
	Actual	Actual
	£000	£000
Opening Capital Financing Requirement	83,188	83,276
<i>Capital investment:</i>		
Property, Plant and Equipment	7,739	18,631
Re-assessment of finance lease liability	195	0
Investment Properties	90	7
Intangible Assets	54	36
Revenue Expenditure Funded from Capital Under Statute	1,031	1,564
<i>Sources of financing:</i>		
Capital receipts	(442)	(8,323)
Government Grants and other contributions	(1,017)	(3,333)
Direct revenue contributions	(1,425)	(1,452)
Minimum Revenue Provision (MRP)	(2,702)	(7,851)
Major Repairs Reserve	(3,435)	(4,106)
Closing Capital Financing Requirement	83,276	78,449
<i>Explanation of movements in year:</i>		
Increase in underlying need to borrow (unsupported by government financial assistance)	88	(4,827)
Increase/(decrease) in Capital Financing Requirement	88	(4,827)

The figures stated above shows a net decrease in CFR of £4.827M, which is after allowing for MRP of £7.851M. Excluding MRP, the underlying need to borrow has increased by £3.024M, in order to help finance 2013/14 capital investment. This is some £1.238M less than budgeted, mainly due to slippage on capital schemes.

5.2 Borrowing levels

To control the actual level of borrowing, 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 31/03/14	Operational Boundary	Authorised Limit
	£000's	£000's	£000's
Deferred Liabilities	223	--	--
Long term Finance lease liability	427	--	--
PWLB Debt	68,374	--	--
Total	69,024	83,000	99,000

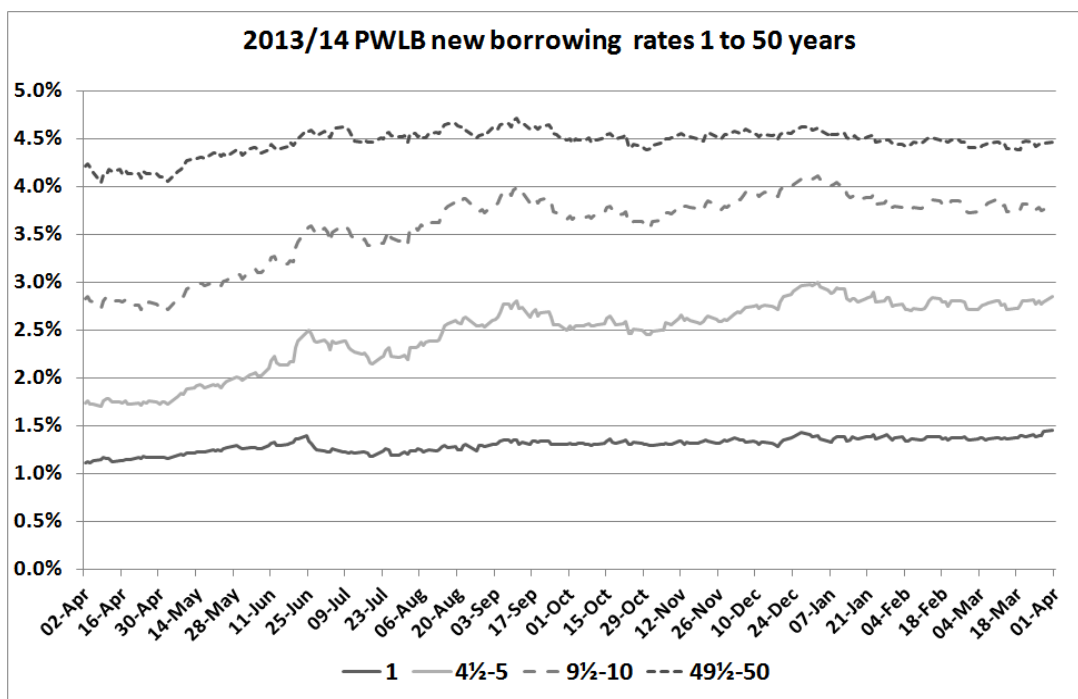


The actual debt, as calculated in accordance with the Prudential Code, includes the liability associated with finance leases. When set, the operational boundary included an element in relation to the Lancaster Market headlease, and hence its surrender accounts for the significant debt headroom as at 31 March 2014.

5.3 PWLB Interest Rate Movements

All of the Council's long term borrowings are held with the Public Works Loan Board (PWLB). The preferential loan rate of 3.03%, associated with the HRA Self Financing loan, remains below the prevailing rate associated with loans of this term.

The following chart illustrates the movement on PWLB fixed term rates over the year. This clearly shows the spread of rates depending on length of loan. It shows a slight upward trend of rates especially in relation to loan terms greater than 1 year but less than 10 years.



Where it can be facilitated and future needs and expectations support it, repayment of PWLB debt is still an attractive option in the current climate, where a council holds a grossed up position of higher borrowings matched by higher investment balances.

5.4 Debt Maturity (or Repayment) Profile

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 below shows these profiles at the beginning and end of the year against the indicator. The only change is due to the repayment of an element of the HRA loan.

	Treasury Indicator	Actual 31/3/13	Actual 31/3/14
Under 12 months	0 - 50%	1.5%	1.52%
12 – 24 Months	0 - 50%	1.5%	1.52%
3 – 5 years	0 - 50%	4.5%	4.57%
6 – 10 years	0 - 50%	7.5%	7.62%
11 -15 years	0 -100%	7.5%	7.62%
16 – 25 years	0 - 100%	15.0%	15.23%
26 – 50 years	50 - 100%	64.0%	61.92%

Of the total loan balance, 43% relates to an Equal Instalment of Principal (EIP) loan and 57% is made up of maturity loans. Therefore the short term percentages will increase as the total debt balance decreases.

The actual profile of the debt is well within the approved limits (liabilities in relation to finance leases are not included within this indicator).

5.5 Interest Payable on Longer Term Borrowing

The average rate of interest payable on PWLB debt in 2013/14 was 4.57%. A total of £3.134M interest was incurred, of which £2.080M was recharged to the HRA in respect of the self-financing loan.

	£'000
2013/14 Estimate	3,155
2013/14 Actual*	3,134
Variance	(21)

There was also £43.4K of interest in relation to finance leases under IFRS accounting. This is a cost that in previous years has been presented within service expenditure. It is purely a presentational change with no impact on the bottom line.

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 set by Members 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

Finance leases are also classed as fixed, as the interest rates implicit in any such agreement are fixed at their inception date.

6 Investment Activities

6.1 Performance against Prudential Indicators

In 2013/14 all investments were placed in accordance with the approved Investment Strategy; there have been no breaches of the investment criteria.

The Council made (or holds) no investments with a maturity of longer than 365 days; the investment strategy prohibited such long term investments. Most 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. The only fixed term bank deposit was placed with Lloyds for 3 months commencing 09 January 2014. Details of the average balances held during the year along with the year end position is given in **Annex A**.

As noted in section 4, part of the repayment from Glitnir is currently held in ISK in an escrow account in Iceland. Strictly speaking, this would be classed as a foreign exchange investment that would normally be prohibited under the Investment Strategy, but clearly the Council has had no choice but to accept this arrangement. Furthermore, it will have to await relaxation of the currency controls in place in Iceland before these sums can be brought back under the Council's direct control. The total amount placed in escrow is £615K attracting interest at 4.2%.

6.2 Performance against budget and external benchmarks.

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

Indicator (mean value)	2013/14	2012/13
Base Rate	0.50%	0.50%
3 Month LIBID	0.50%	0.50%
Lancaster CC investments	0.47%	0.50%

The return is slightly below the Bank of England base rate, due to all investments being held in high credit quality accounts and all immediately available. A fixed term deposit of £3M was invested with Lloyds in the last quarter of the year with an interest rate of 0.6%.

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

Annual budget	£129K
Actual to date	£100K (see details in Annex B)
<u>Icelandic interest to date</u>	<u>£131K</u> (see details in Annex B)
Total	£231K
Variance	£102K favourable

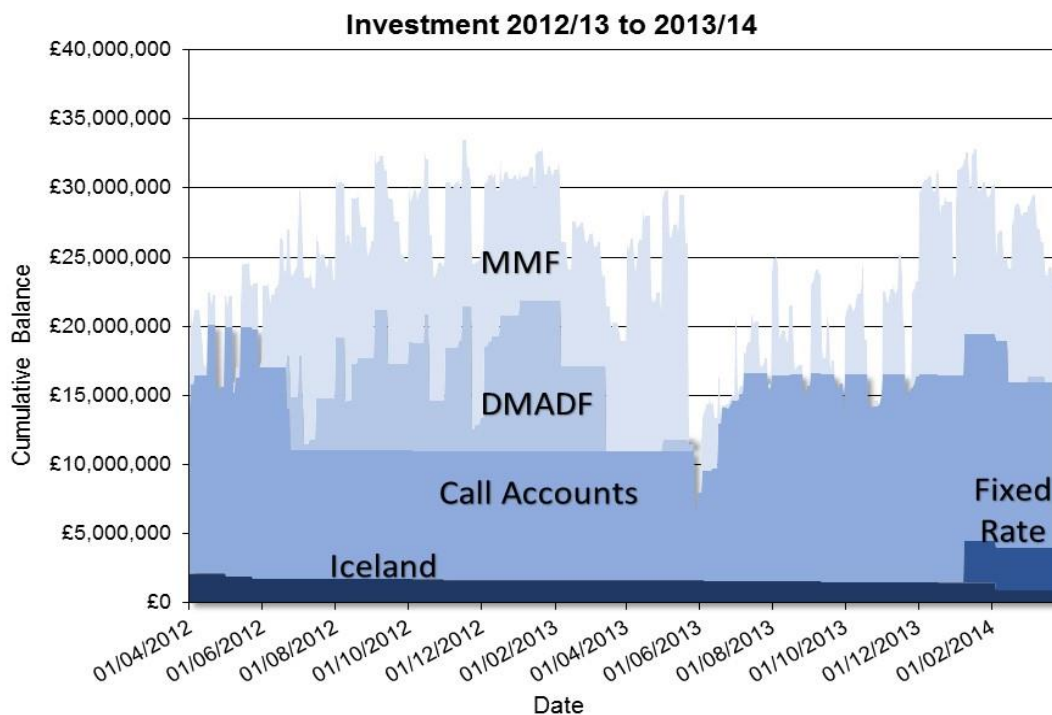
This higher than expected investment return was due to the requirement to recognise, at the time of sale, all interest associated with the Landsbanki claim. Prior to the sale, on the balance sheet the Icelandic investments were accounted for on a discounted cash flow basis. As the investment was recovered earlier than expected, the discounting impact was reduced, giving rise to a greater value of interest to be recognised.

As illustrated in the table below, the short term projection for rates is flat; it is anticipated that the position on low investment interest rates will hold for the next financial year.

Date	Bank Rate Projection (%)
Mar-14	0.50
Jun-14	0.50
Sep-14	0.50
Dec-14	0.50
Mar-15	0.75

Source: Capita Asset Services, June 2014

The Investment Strategy for 2013/14 continued with the more cautious approach to managing surplus cash, this being in place since the banking crisis. In practice, most deposits were placed on instant access in either call accounts or Money Market Funds (MMFs) with limited use of the DMO account. The pattern of these investments over 2013/14 and the prior year can be seen in more detail in the following graph:



7 Other Risk Management Issues

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

The Authority's Investment Strategy is designed to engineer risk management into investment activity largely by reference to credit ratings and the 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 2013/14 complied with the latest Code of Practice (November 2011) and relevant Government investment guidance.

8 Other Prudential Indicators

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

9 Conclusion

The Council's treasury activities were in line with its approved policies and strategies. Investment rates fell marginally, given the Council's low risk appetite, and allowing for the downgrading of key counterparties and Government offering low rates. Furthermore, uncertainties surrounding the timing of key transactions have also inhibited investment decisions and have meant that predominantly, only very short-term investment were made. Those specific uncertainties have been concluded during 2013/14 and so this should allow greater predictability to a degree in terms of cash flow, although other uncertainties may well come into play in 2014/15.

Counterparties used during 2013/14

Counterparty	Type	Average £	Maximum £	Year End £
DMO	Fixed Term	76,285	890,000	0
Lloyds	Fixed Term	673,973	3,000,000	3,000,000
Blackrock (Gov)	MMF	685,140	5,990,000	0
Blackrock (Liquidity)	MMF	3,753,501	6,000,000	6,000,000
Insight	MMF	3,026,570	6,000,000	326,000
Lancashire County Council	Call	10,970,208	12,000,000	12,000,000
RBS	Call	2,068,978	3,000,000	0
			TOTAL	21,326,000

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.
E.g. 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.
- **Capita Asset Services** – they 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*.

PRUDENTIAL INDICATORS - LANCASTER CITY COUNCIL

For Noting by Cabinet 29 July 2014

2012/13 Actual	2013/14 Estimate	2013/14 Actual
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AFFORDABILITY

PI 2: Actual ratio of financing cost to net revenue stream	Non - HRA	16.2%	12.8%	31.3%
	HRA	24.0%	23.3%	23.3%
	Overall	19.3%	17.1%	28.5%

CAPITAL EXPENDITURE

	£'000	£'000	£'000
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PI 6: Actual capital expenditure	Non - HRA	5,320	17,290	15,954
	HRA	3,590	4,870	4,284
	Total	8,910	22,160	20,238

PI 8: Actual Capital Financing Requirement	Non - HRA	45,503	40,281	44,462
	HRA	37,773	44,473	33,987
	Total	83,276	84,754	78,449