APPENDIX 3

Annual Treasury Management Report 2012/13

Purpose

This 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 CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

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

- an annual treasury strategy in advance of the year (Council 25/2/2013)
- a mid year treasury update report (Accounts, Audit & Risk Committee 05/12/12)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

The Accounts, Audit and Risk Committee has been nominated to scrutinise the treasury activity of the Council and it receives regular reports. In addition, this Council has received quarterly treasury management update reports by the Executive.

Recent changes in the regulatory environment place a much greater onus 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.

This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Accounts, Audit & Risk Committee before they were reported to the full Council.

Executive Summary

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:

Prudential and treasury indicators	2011/12 Actual £000	2012/13 Actual £000
Capital expenditure	4,816	11,172
Capital Financing Requirement:	(4,816)	(11,172)
Net borrowing	0	0
External debt	0	0
Investments • Longer than 1 year • Under 1 year • Total	 5,041 61,973 **67,014**	 0 64,415 **64,415**

Other prudential and treasury indicators calculated at the time of preparing our Treasury Strategy for 2013/14 are to be found in Annex 1 of this report. .

The financial year 2012/13 continued the challenging investment environment of previous years, namely low investment returns and continuing heightened levels of counterparty risk.

Introduction and Background

This report summarises:

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- Reporting of the required prudential and treasury indicators;
- Overall treasury position identifying the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed investment activity.

1. The Council's Capital Expenditure and Financing 2012/13

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed:

	2011/12 Actual £000s	**2012/13 Actual £000s**
Capital Expenditure	4,816	11,172
Total Capital expenditure	**4,816**	**11,172**
Resourced by		
Capital receipts	(3,938)	(9,617)
Government Grants & Other Contributions	(547)	(1,109)
Use of Reserves	(331)	(446)
Direct Revenue Financing		-
Total resources used	**4,816**	**11,172**

2. The Council's Overall Borrowing Need

The Council is debt free and does not currently have a borrowing requirement.

3. Treasury Position as at 31 March 2013

The Council's investment position is organised by the treasury management team in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the beginning and the end of 2012/13 the Council's treasury position was as follows:

	2011/12 Actual £000	2012/13 Actual £000
Investments		
Longer than 1 year	5,041	0
Under 1 year	61,973	64,415
Total	**67,014**	**64,415**

4. The Strategy for 2012/13

The Treasury Management Strategy Statement (TMSS) for 2012/13, which includes the Annual Investment Strategy, was approved by the Council on 25/2/2013. It sets out the Council's investment priorities as being:

- **Security of capital;**
- **Liquidity; and**
- **Yield**

The Council will also aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover short term cash flow needs but also to seek out value available in significantly higher rates in periods up to 12 months with highly credit rated financial institutions, using Sector's suggested creditworthiness approach, including sovereign credit rating and Credit Default Swap (CDS) overlay information provided by Sector.

5. The Economy

During the quarter ended 31 March: -

- Indicators suggest that the economy was very near to a second consecutive quarter of negative growth in GDP;
- Household spending strengthened, both on and off the high-street;
- Unemployment rose for the first time for a year;
- Inflation remained stubbornly above the MPC's 2% target;
- Three members of the MPC voted for further QE;
- UK equity prices rose and sterling fell;
- The US economic recovery gathered pace.

It remains touch-and-go whether the UK economy contracted again in the first quarter: if so, it would result in a triple-dip recession. On the basis of past form, the CIPS/Markit business surveys point to next to no growth in the first quarter of 2013 and the first official sets of output data have been fairly disappointing. Although the index of services rose by a monthly 0.3% in January, this did not fully reverse its drop in December. Meanwhile, industrial production posted a 1.2% monthly fall in January. This was partly driven by lower output in the volatile energy sector, but manufacturing output was down 1.5% on the month too. Note also that unusually bad weather at the end of the quarter may have depressed activity in certain sectors, such as retail and construction.

Household spending appears to have started the year on a stronger footing. The 2.1% monthly rise in retail sales in February more than offset January's 0.7% fall. Non-high street spending has been robust too, with new car registrations up by 7.9% in the year to February.

The latest data tentatively suggested that the labour market's recent resilience is coming to an end. Employment continued to grow, by 131,000 in the three months to January, but this was slower than the 175,000 gain seen in the fourth quarter. The unemployment data was also softer, with the ILO measure showing a 7,000 rise in unemployment in the three months to January, the first increase in a year. Admittedly, the timelier claimant count measure still fell in February, albeit by a trivial 1,500. Meanwhile, pay growth remained subdued, with the headline (3m average of the annual rate) measure of earnings falling to 1.2% in January.

Elsewhere, the housing market has been revived a bit by the Bank of England's Funding for Lending Scheme (FLS) which helped to bring down some mortgage rates, primarily on fixed products. The quoted interest rate on a 2-year fixed mortgage at a 90% loan-to-value ratio has fallen around 80 basis-points since the introduction of the FLS back in August.

This is helping to support house prices. Both the Halifax and Nationwide measures reported monthly gains in February, rising by 0.5% and 0.2% respectively. The Halifax measure rose by 1.9% on a 3-month-on-3-month basis, the fastest pace since the beginning of 2010. But there were some early signs of weakness in the housing market in the first quarter. Mortgage approvals as measured by the BBA fell in both January and February, and are now 8% lower compared with the end of last year. But this may be overstating the fall, as smaller lenders, not measured by the BBA figures, have been gaining market share recently. The broader Bank of England data, which also includes non-bank lenders, showed that approvals fell by just 1.6% in January.

On the fiscal front, the public borrowing figures for this year have been flattered by a number of one-offs, including the transfer of the Royal Mail pension fund and the revenues of interest generated by the Bank of England's Asset Purchase Facility. On an underlying basis, however, the OBR forecast net borrowing of £121.9bn in 2012/13, is basically unchanged from the outturn seen in the last financial year. Underlying borrowing is now not forecast to fall substantially until 2014/15.

This year's Budget contained many good individual measures, but they were on a small scale and their overall effect was fiscally neutral. The further 1p cut in corporation tax and the "employment allowance", which helps to reduce employers' national insurance contributions, were welcome moves that should help business. But giveaways were matched by further cuts, including a further 1% reduction in departmental spending in the next two fiscal years.

The Budget also contained a reaffirmation of the MPC's 2% inflation target along with some minor tweaks to the MPC's remit, which will allow the MPC more flexibility in the communication of its policy. This fell short of speculation that the government could suspend, or even scrap entirely, the 2% inflation target.

Inflation, meanwhile, remained high, with the CPI measure rising from 2.7% to 2.8% in February. The latest rises have been driven, mainly, by higher energy prices. This reflected a sharp rise in sterling oil prices as well as the final price rise from a “big six” utility company filtering through.

The MPC has said that it would “look through” the latest energy driven price rises when setting monetary policy. Indeed, the minutes of February’s meeting showed that three members of the MPC, including Governor, Mervyn King, voted for further quantitative easing. The size of the Bank’s asset purchase programme has remained at £375bn since November.

Turning to the markets, both UK and global equity prices have rallied since the start of the year, with the FTSE 100 rising from 5,897 to 6,400. Gilt prices were volatile over the quarter, with the yield on 10-year gilts hitting 2.2% in early March, before falling back to 1.72% at the end of the quarter, similar to the level seen at the start of the year.

Meanwhile, the pound has fallen sharply against the dollar, from $1.63 to $1.51. Sterling was slightly weaker against the euro, too, slipping from €1.23 to €1.19.

Internationally, the economic recovery in the US appeared to gather momentum over the first quarter. A weighted average of the ISM indices is consistent with annualised GDP growth of close to 3%. What is more, the growth in private payrolls accelerated to a 3-month average of 200,000 in February. While the expiry of the payroll tax cut at the start of the year will hit real incomes, the 0.4% rise in underlying retail sales in February looks consistent with consumption growth of 2% annualised.

The Eurozone crisis flared up again at the end of the quarter, after it was agreed that bank deposits could be subject to a “haircut” as part of an international bail-out package for Cyprus. While a bailout package agreed by European Finance Ministers should avert disaster, the episode has raised fears about the safety of bank deposits in other periphery countries. Meanwhile, the underlying Eurozone economy looks weak.

Abbreviation	
MPC	*Monetary Policy Committee*
QE	*Quantitative Easing*
ILO	*International Labour Organisation*
BBA	*British Banking Association*
OBR	*Office Budget Responsibility*

5. Interest Rate Forecast

The Council's treasury advisor, Sector, provides the following forecast:

	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%
5yr PWLB rate	1.80%	1.80%	1.80%	1.90%	2.00%	2.10%	2.20%	2.40%
10yr PWLB rate	2.90%	2.90%	2.90%	3.00%	3.10%	3.20%	3.30%	3.50%
25yr PWLB rate	4.10%	4.10%	4.10%	4.20%	4.20%	4.30%	4.40%	4.60%
50yr PWLB rate	4.20%	4.20%	4.20%	4.40%	4.40%	4.50%	4.60%	4.70%

Sector undertook a review of its interest rate forecasts following the issue of the latest Bank of England Inflation Report in February 2013. Sector has left unchanged its forecast for the first increase in Bank Rate to be in March 2015.

However, forecasts for PWLB rates have been increased as a result of the marked recovery in confidence in equity markets, anticipating stronger economic recovery in America, supported by growth in the Far East.

The rise in equity prices has, conversely, resulted in a selloff in bonds and some diminution of the UK as a safe haven from more risky assets. However, towards the end of March, the Cyprus crisis has partially reversed these general trends during the quarter, although this is likely to be a temporary phase – at least, until the next Eurozone crisis!

6. Investment Outturn for 2012/13

Investment Policy – the Council's investment policy is governed by CLG guidance, which was been implemented in the annual investment strategy approved by the Council on 25/02/2013. 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.).

The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

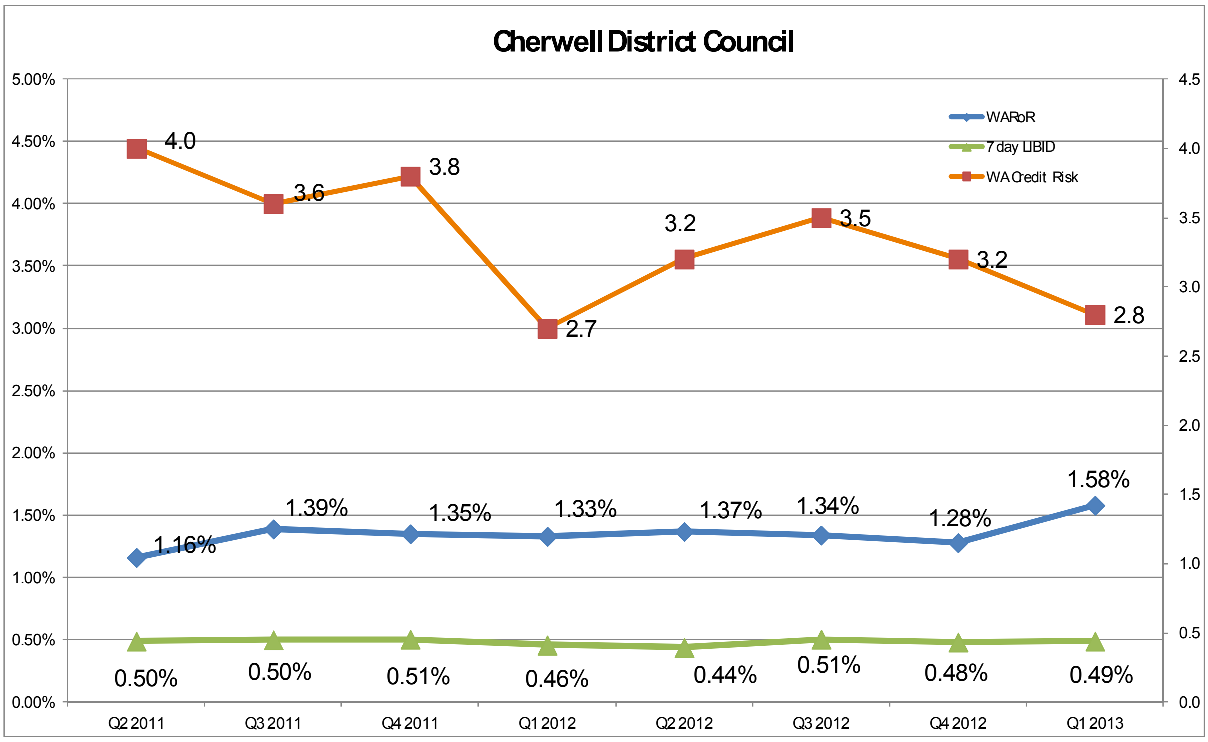
Investments held by fund managers – the Council used 2 external fund managers to invest part of its cash balances but this has reduced to 1 (Investec) during the course of 2012/13. The performance of the managers against the benchmark return was:

Fund Manager	Balance 01/04/2012	Balance 31/03/13	Return
In House	43,824	50,480	803
Tradition UK	10,500	0.00	106
Investec	11,548	11,840	119
Total	**£65,872m**	**£62,320m**	**£1,028m**

The actual return on investments for 2012/13 was £1.028m compared with a budget of £0.828m a positive variance of £199k. However approximately £144k of the interest received is in respect of the investment of Eco Town funds and this has been allocated back to the Eco Town funding pot.

The budget was based on an average investment balance of £62.5m and an interest rate of 1.33%. The actual average balance was £77.1m which attracted an average return of 1.40%.

The graph below shows that this rate of return has been successfully achieved whilst ensuring the overall credit risk to the council has been reducing steadily throughout 2012/13 over this current year.



7. Icelandic Bank Defaults

The Council was one of over 100 local authorities that were affected by the collapse of Icelandic banking institutions. The Council held a total of £6.5 million in 3 investments with Glitnir.

As reported previously out of the £6.5m original capital investment £5.7m has been returned to the Council. The remaining balance of £729k and the associated interest relating to the investment are still held within Iceland but are accruing interest on an annual basis.

We continue to have discussions with the LGA and Bevan Brittan on the potential for transfer to the UK.

Annex 1 Prudential and Treasury Indicators

(As per Treasury Management Strategy approved 25th February 2013)

Existing Investment & Debt Portfolio Position

	31/01/13 Actual Portfolio £m
External Borrowing:	
- Total External Borrowing	0
Other Long Term Liabilities:	
- Finance Leases	0
Total Gross External Debt	**0**
Investments:	
Managed in-house	
- Short-term monies (Deposits/ monies on call / MMFs)	64,159
- Long-term investments	5.000
Managed externally	
- By Fund Managers	11,700
- Pooled Funds (please list)	0
Total Investments	**80,859**

Background:

It is a requirement under the Local Government Act 2003 for local authorities to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the "CIPFA Prudential Code") when setting and reviewing their Prudential Indicators.

Net Borrowing and the Capital Financing Requirement:

This is a key indicator of prudence. In order to ensure that over the medium-term net borrowing will only be for a capital purposes, the local authority needs to ensure that the net external borrowing does not (except in the short term) exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional increases to the capital financing requirement for the current and next two financial years.

The Director of Resources reports that the authority had no difficulty meeting this requirement in 2012-13, nor is there any difficulties envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the approved budget.

Estimates of Capital Expenditure:

This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits and, in particular, considers the impact on Council Tax.

The Council's capital expenditure plans are summarised below and this forms the first of the prudential indicators. This total expenditure can be paid for immediately by resources such as capital receipts, capital grants etc. However, where these resources are insufficient any residual expenditure will form a borrowing need.

	2012/13 Actual £000s	**2013/14 Estimated £000s**	**2014/15 Estimated £000s**	**2015/16 Estimated £000s**
Capital Expenditure	5,817	9,483	5,484	1,397
Financed by:				
Capital receipts	(5,442)	(9,108)	(5,109)	(1,397)
Capital grants	(375)	(375)	(375)	-
Net financing need for the year	**-**	**-**	**-**	**-**

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.

The definition of financing costs is set out in the Prudential Code.

The ratio is based on costs net of investment income.

Ratio of Financing Costs to Net Revenue Stream	**2012-13 Approved %**	**2012-13 Revised%**	**2013-14 Estimate %**	**2014-15 Estimate %**	**2015-16 Estimate %**
Total	**0**	**0**	**0**	**0**	**0**

Capital Financing Requirement:

The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose. The calculation of the CFR is taken from the amounts held in the Balance Sheet relating to capital expenditure and it's financing.

The CFR is simply the total outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of Council's underlying borrowing need. The Council is required to pay off an element of the accumulated General Fund capital spend each year through a revenue charge (the Minimum Revenue Provision), although it is also allowed to undertake additional voluntary payments.

The Council is debt free and has no plans to enter into any long term debt arrangements. As such this section is largely irrelevant but is included for completeness if there was a decision to go back into debt. Therefore, the Council has a nil Minimum Revenue Provision for 2012/13.

The Council is asked to **approve a NIL CFR projection.**

Actual External Debt:

This indicator is obtained directly from the Council's balance sheet. It is the closing balance for actual gross borrowing plus other long-term liabilities. This Indicator is measured in a manner consistent for comparison with the Operational Boundary and Authorised Limit.

Actual External Debt as at 31/03/2012	**£m**
Borrowing	0
Other Long-term Liabilities	0
Total	**0**

Incremental Impact of Capital Investment Decisions:

This is an indicator of affordability that shows the impact of capital investment decisions on the Council Tax. The incremental impact is calculated by comparing the total revenue budget requirement of the current approved capital programme with an equivalent calculation of the revenue budget requirement arising from the proposed capital programme.

The Council's capital plans, as estimated in forthcoming financial years, have a neutral impact on council tax. This reflects the fact that capital expenditure is predominantly financed from internal resources (grants, contributions, revenue and capital receipts) and that any increase in the underlying need to borrow is supported through the Revenue Support Grant system.

Adoption of the CIPFA Treasury Management Code:

This indicator demonstrates that the Council has adopted the principles of best practice.

Adoption of the CIPFA Code of Practice in Treasury Management
The Council approved the adoption of the CIPFA Treasury Management Code at its Full Council meeting on 27th February 2012.

The Council has incorporated the changes from the revised CIPFA Code of Practice into its treasury policies, procedures and practices.

This Council is aware that there is now a new indicator on net debt which has been considered; however, this is not detailed further as the Council currently has no plans to go into debt during the 2013-14 financial year.

Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure:

These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates.

The upper limit for variable rate exposure has been set to ensure that the Council is not exposed to interest rate rises which could adversely impact on the revenue budget. The limit allows for the use of variable rate debt to offset exposure to changes in short-term rates on investments:

	Existing level (or Benchmark level) at 31/03/12 %	2012-13 Approved £m or %	2012-13 Revised £m or %	2013-14 Estimate £m or %	2014-15 Estimate £m or %	2015-16 Estimate £m or %
Upper Limit for Fixed Interest Rate Exposure	-£0.030	-£0.030	-£0.030	-£0.030	-£0.030	-£0.030
Upper Limit for Variable Interest Rate Exposure	-£0.012	-£0.012	-£0.012	-£0.012	-£0.012	-£0.012

The limits above provide the necessary flexibility within which decisions will be made for drawing down new loans on a fixed or variable rate basis; the decisions will ultimately be determined by expectations of anticipated interest rate movements as set out in the Council's treasury management strategy.

As the Council's investments are substantially in excess of its borrowing, these calculations have resulted in a negative figure.

Maturity Structure of Fixed Rate borrowing:

This indicator highlights the existence of any large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates and is designed to protect against excessive exposures to interest rate changes in any one period, in particular in the course of the next ten years.

It is calculated as the amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate. The maturity of borrowing is determined by reference to the earliest date on which the lender can require payment.

Maturity structure of fixed rate borrowing	Existing level (or Benchmark level) at 31/03/12 %	Lower Limit for 2013/14 %	Upper Limit for 2013/14 %
Less than twelve months	0%	0%	100%
12 months – 10 years	0%	0%	100%
10 years plus	0%	0%	100%

Credit Risk:
The Council considers security, liquidity and yield, in that order, when making investment decisions with Security the most important. With the uncertainty in market, the Council is seeking to place investments for a short term and is effectively forgoing return in order to protect capital.

Credit ratings remain an important element of assessing credit risk, but they are not a sole feature in the Council's assessment of counterparty credit risk.

The Council also considers alternative assessments of credit strength, and information on corporate developments of and market sentiment towards counterparties. The following key tools are used to assess credit risk:

- Published credit ratings of the financial institution
- Sovereign support mechanisms;
- Credit default swaps (where quoted);
- Share prices (where available);
- Economic fundamentals, such as a country's net debt as a percentage of its GDP);
- Corporate developments, news, articles, markets sentiment and momentum;
- Subjective overlay.

The only indicators with prescriptive values remain to be credit ratings. Other indicators of creditworthiness are considered in relative rather than absolute terms.

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.

Upper Limit for total principal sums invested over 364 days	2012-13 Approved £m	2012-13 Revised £m	2013-14 Estimate £m	2014-15 Estimate £m	2015-16 Estimate £m
	15.0	15.0	15.0	15.0	15.0