Item 7(i) on 3rd December 2013 Council Agenda

Strategic Management Team Lead Officer	Nick Gray, Strategic Director (Section 151 Officer)
Author	Graham Whiting, Senior Accountant (Treasury)
Telephone	Tel: 01306 879148
Email	graham.whiting@molevalley.gov.uk
Date	26th September 2013

Subject	Treasury Management – Annual Report and Prudential Indicators – 2012/2013

RECOMMENDATIONS

That Audit Committee is asked to recommend to Council;

1. That the Treasury Management Annual Outturn report for 2012/2013 be noted.
2. That the actual Prudential Indicators reported for 2012/2013, as detailed in Appendix A to this report, be approved.

EXECUTIVE SUMMARY

Treasury management is the control and management of all the Council's cash, regardless of its source. It covers management of the daily cash position and investments. The Council has no borrowings. Officers carry out this function within the parameters set by the Council each year in the Treasury Management Strategy Report.

This report reviews the performance of the Prudential Indicators and Treasury Management Strategy and Annual Plan 2012/2013 as agreed by Council on 21st February 2012.

The 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). The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003. The primary requirements of the Codes are the:

- Creation and maintenance of a Treasury Management Policy Statement (TMPS) that sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices (TMPs) that set out the manner in which the Council will seek to achieve those policies and objectives.

- Receipt by Council of an annual strategy report for the year, a mid-year treasury update report and a subsequent annual review report (this report) after the end of the financial year.

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.

Council have delegated the responsibilities for implementing and monitoring treasury management policies and practices to the Audit Committee and for the operation and administration of treasury management decisions to the Strategic Director (Section 151 Officer), who will act in accordance with the organisation's treasury management policy statement and TMP's, and CIPFA's Standard of Professional Practice on Treasury Management.

In summary, the Council's in-house team achieved a rate of return on investments of 1.06%. The Council achieved an overall return of £342,000 in 2012/13 and investment balances at balance sheet dates increased from £20.655m (31/03/12) to £24.452m (31/03/13). The 2012/13 financial year continued the challenging environment of previous years with low investment returns and continuing counterparty risk.

In conducting the treasury management activities of the Council there were no breaches of the agreed Strategy and the in-house team operated within the Prudential Indicators set by Council.

1. Background

1.1 Treasury management is defined as:

"The management of the local authority's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

1.2 The annual treasury management outturn report for 2012/13 covers:

- The economy and interest rates
- The Council's capital expenditure and financing
- Investment rates
- The borrowing strategy
- The borrowing outturn
- Compliance with treasury limits and Prudential Indicators
- Investment strategy
- Investment outturn
- Debt rescheduling
- Other issues

2. The economy and interest rates in 2012/13

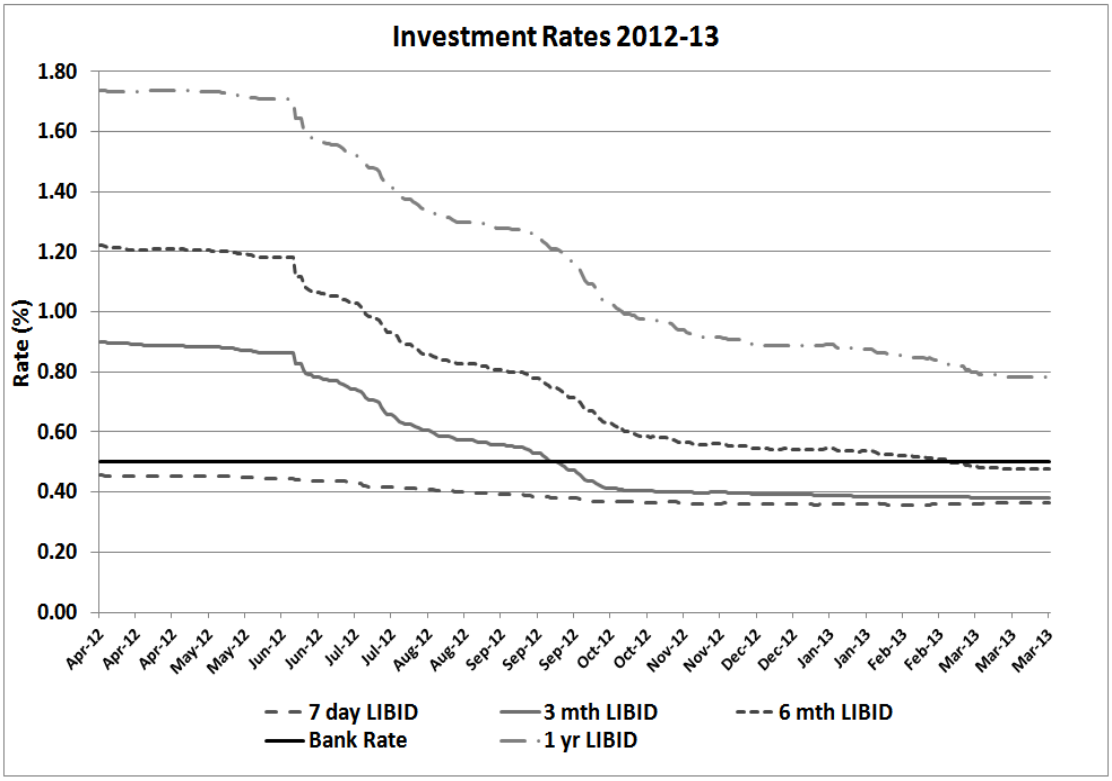
The financial year 2012/13 continued the challenging investment environment of previous years, namely low investment returns and continuing heightened levels of counterparty risk. The original expectation for 2012/13 was that the Bank Rate would start gently rising from quarter 4 2014. However, economic growth in the UK was disappointing during the year due to the UK austerity programme, weak consumer confidence and spending, a lack of rebalancing of the UK economy to exporting and weak growth in our biggest export market - the European Union (EU). The UK coalition Government maintained its tight fiscal policy stance against a background of warnings from two credit rating agencies that the UK could lose its AAA credit rating. Moody's followed up this warning by actually downgrading the rating to AA+ in February 2013 and Fitch then placed their rating on negative watch, after the Budget statement in March. Key to retaining the AAA rating from Fitch and Standard & Poors (S&P) will be a return to strong economic growth in order to reduce the national debt burden to a sustainable level, within a reasonable timeframe. Weak UK growth resulted in the Monetary Policy Committee (MPC) increasing quantitative easing (QE) by £50bn in July to a total of £375bn. The Bank Rate ended the year unchanged at 0.5% while Consumer Price Index (CPI) inflation fell from 3% at the start of the year to end at 2.8% in March, with a fall back to below 2% pushed back to quarter 1 2016. The EU sovereign debt crisis was an ongoing saga during the year with first Greece and then Cyprus experiencing crises which were met with bailouts after difficult and fraught negotiations.

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

Deposit rates. The Funding for Lending Scheme, announced in July, resulted in a flood of cheap credit being made available to banks and this has resulted in money market investment rates falling sharply in the second half of the year. However, perceptions of counterparty risk have improved after the ECB statement in July said 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 **Bank Rate** remained at its historic low of 0.5% throughout the year. It has now remained unchanged for four years. Market expectations at the start of monetary tightening were pushed back during the year to early 2015 at the earliest. The Funding for Lending Scheme was launched by the Government in July 2012 and was designed to incentivise banks and building societies to boost their lending to the UK economy. It provides funding to banks and building societies for an extended period, with both the price and quantity of funding provided linked to their lending performance. The Funding for Lending Scheme resulted in a sharp fall in deposit rates in the second half of the year.

Bank rate v London Interbank BID (LIBID) investment rates



3. **Capital Expenditure and Financing 2012/13**

3.1 The Council finances capital expenditure resulting in an increase in long-term assets. These may either be;

- Financed immediately through the application of capital receipts, capital grants etc, or
- If insufficient financing is available the expenditure will give rise to a borrowing need

3.2 The Council finances capital expenditure out of capital reserves and does not currently have a borrowing need.

3.3 The table below shows how capital expenditure was financed over the past two years. The decrease in actual expenditure over the estimate and subsequent financing was mainly as a result of the rephasing of affordable housing payments and various property initiatives.

	2011/12 Actual £000	2012/13 Estimate £000	2012/13 Actual £000
Total capital expenditure	**4,797**	**5,735**	**2,881**
Resourced by :			
Capital receipts	3,880	4,667	2,092
Capital grants	529	442	594
Capital reserves	388	626	195
Repairs & Renewals Fund	0	0	0
Total Resources Applied	**4,797**	**5,735**	**2,881**

4. Investment Rates in 2012/13

4.1 The market interest rates at the start and end of the year are shown below. As can be seen rates have stabilised albeit at historically low levels. The reduction in interest rates, including the effect of the introduction of the Funding for Lending Scheme by the Government, has had a significant bearing on the interest earnings of the Authority on internal investments and will do so moving forward.

Market Rates:

Notice	31/03/11	31/03/12	31/03/13
	%	%	%
Overnight	0.25	0.40	0.45
1 Week	0.30	0.40	0.48
1 Month	0.47	0.50	0.46
3 Months	0.70	0.80	0.55
6 Months	1.00	1.25	0.70
364 Day	1.50	1.70	0.84

5. Borrowing strategy for 2012/13

5.1 The major objectives to be followed in 2012/13 if there had been an underlying borrowing requirement were:

- To forecast average future interest rates and movements in future interest rates
- To secure the cheapest cost for financing capital schemes commensurate with future risk
- To ensure that, where possible, the Council’s debt free status is retained
- To manage the Council’s short-term debt, if any so arises, ensuring prompt payment of interest and principal on the due dates

6. **Borrowing outturn for 2012/13**

6.1 The Council did not raise any funds through the money market or through the Public Works Loans Board (PWLB), either in the short or long term, during 2012/13. This has been the case since 1987. The Council's last external loan was repaid in February 1997 and Mole Valley became debt free on 1st April 1997.

7. **Compliance with Treasury Limits and Prudential Indicators**

7.1 During the financial year the Council operated within the Prudential Indicators 2012/13 – 2014/15 and Treasury Management Strategy and Plan 2012-13 as agreed by Council on 21st February 2012. The outturn for the Treasury and Prudential Indicators is detailed in Appendix A of this report.

8. **Investment Strategy for 2012/13**

8.1 The Investment Strategy's primary objectives are safeguarding the re-payment of the principal and interest of its investments on a timely basis first and ensuring adequate liquidity second, with the investment return being the third objective.

8.2 The Council manages its investments in-house and invests with the institutions listed in the Council's approved lending list. The Council primarily invests for a range of periods less than one year dependent on the Council's cash flows, its interest rate view and the rates of interest on offer. The Base Rate remained at 0.50% for the duration of the financial year.

8.3 In light of continuing stresses on the world banking system, enhanced priority was given to security and liquidity in order to reduce counterparty risk. Sector, our treasury management advisors, view is that investments, with the exception of part government owned institutions, should be kept short during the ongoing market uncertainties. This would enable advantage to be taken quickly of an upturn in the money markets if rates increased.

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

9. **Investment outturn for 2012/13**

9.1 The Council's investment policy is governed by Communities and Local Government (CLG) guidance, which has been implemented in the annual investment strategy approved by the Council on 21st February 2012. This policy sets out the approach for selecting investment counterparties, and is based on credit ratings provided by the three main credit rating agencies. The rating criteria use the lowest common denominator method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria. This is in compliance with the CIPFA Treasury Management Code of Practice. Credit rating information is supplied by our treasury management advisor.

9.2 Detailed below is the result of the investment strategy undertaken by the Council.

Internally Managed Funds

9.3 The Council maintained its investment activities during the year, as agreed by Council on 21st February 2012.

9.4 During the year all investments were made in full compliance with the Council's treasury management policies and practices and the Council had no liquidity difficulties.

9.5 The limit to be placed with each counterparty remained at £7.5 million. The Council also operated a 'group limit', whereby the collective investment exposure to individual banks within the same banking group was restricted to a group total set also at £7.5 million.

9.6 The analysis below shows the activity undertaken on internally managed funds during 2012/13.

	£
Balance outstanding 01/04/12	20,655,000
Investments made during the year	120,861,000
	141,516,000
Less: Investments maturing during the year	117,064,000
Balance outstanding 31/03/13	24,452,000

9.7 These investments generated interest of approximately £342,000 in the year (£378,000 in 2011/12), gross of all associated charges against a budget of £307,000. Some good returns were made on a number of short-term investments (investments that mature in, or are held for, 12 months or less) in the early part of the year but the increase over the budget has been achieved by investing some funds longer-term (investments that are placed for a period longer than 12 months), in particular attractive yields are still being achieved on two 'cap and collar' investments. There has been no movement in the Base Rate since the 0.50% reduction on 5th March 2009 to the current level of 0.50%.

2012/2013	Original Estimate £	Actual Outturn £	Variance £
Internally Managed Funds	307,000	341,877	34,877

9.8 Mole Valley achieved a rate of return of 1.06% on its internally managed funds during the year, this was based on an average fund value of approximately

£32,390,000. The formal method used to compare performance is to contrast the rate of return against the average uncompounded 7-day LIBID rate (0.394% for 2012/13). The long-term ‘cap and collar’ deals previously alluded to have in part enhanced the return on internally managed funds when compared to the benchmark.

9.9 Detailed below is the result of the investment strategy undertaken by the Council.

	Average Fund Value	Rate of Return	Benchmark Return *
Internally Managed	£32,390,000	1.06%	0.394%

* 7-day LIBID uncompounded 0.394%

The uncompounded rates are for internally managed funds and exclude the roll-up of principal and interest. Upon maturity of the investment, interest is paid over with the original principal sum.

Externally Managed Funds (Investec Asset Management)

9.10 This Fund was closed on 29th September 2010 and the balance was reinvested in higher yielding, but less liquid, alternative financial instruments. An average fee saving of £29,000 was also achieved by not using the services of the external fund manager.

10. Debt rescheduling

10.1 The Council did not raise any funds through the money market or through the Public Works Loans Board (PWLB) during the year. The last external loan was repaid in February 1997 and Mole Valley became debt free on 1st April 1997. Therefore, debt rescheduling was not an issue.

11. Other issues

11.1 The Treasury Management Strategy Report for 2014/15 to 2016/17 will be coming to the November Audit Committee and will include plans for exploring alternative investment options.

12. Corporate Implications

12.1 Legal Implications

The Council’s treasury management activities are regulated by a variety of professional codes, statutes and guidance:

- The Local Government Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity.
- The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (no restrictions were made in 2012/13).
- Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act.
- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities. The Prudential Code required indicators to be set, some of which are limits, for a minimum of three forthcoming years.
- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services.
- Under the Act the DCLG has issued Investment Guidance to structure and regulate the Council's investment activities. Updated guidance became available on 1st April 2010. The emphasis of the Guidance is on the security and liquidity of investments.

The Council has complied with all of the above relevant statutory and regulatory requirements that limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means both that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

12.2 **Financial and Risk Implications**

The Council considers security, liquidity and yield, in that order, when making investment decisions:

Security – counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swaps, gross domestic product (GDP) of the country in which the institution operates, the country's net debt as a percentage of GDP, any potential support mechanisms and share price. The minimum long-term counterparty credit rating determined for 2012/13 was A (Fitch).

Liquidity – the Council maintained a sufficient, though not excessive, level of liquidity during the year using various call accounts and short-term, fixed-rate, deposits.

Yield – the Council sought to optimise returns commensurate with its objectives of security and liquidity. Short-term money market rates remained at very low levels throughout the year which had a significant impact on investment income.

A high reliance on investment income can place the Council at significant risk of budget variation as interest rates rise and fall, which has an impact upon future Council Tax levels. The Council's Medium Term Financial Strategy addresses this risk and seeks to reduce this reliance over time.

Locking significant investments into long-term fixed-rate deals means the Council has a potential disadvantage in a rising interest market, especially if the interest rate rises above the assumption made when the long-term deal was placed.

To mitigate this, the Council's in-house team predominantly invest up to periods of three months only, hence advantage can be taken of prevailing interest rates upon the investments maturity. This minimises the disadvantage whilst maintaining certainty over the level of future return and stability in planned future Council Tax levels. With interest rates remaining at historically low levels the Authority has made some longer term investments that are higher yielding, although less liquid. This has proved to be a good decision as interest rates have remained at low levels throughout the year.

The Council is looking to diversify its investment portfolio and the 2013/14 Treasury Management Strategy provides for alternative investment funds should the opportunity arise.

12.3 **Equalities Implications**

None within the report

12.4 **Employment Issues**

None within the report

12.5 **Sustainability Issues**

None within the report

12.6 **Consultation**

A number of meetings were convened during the year involving Sector, Members and Officers.

13. BACKGROUND PAPERS

CIPFA Treasury Management in the Public Services – Code of Practice and Cross-Sectoral Guidance Notes (2011 edition).

CIPFA Treasury Management in the Public Services – Guidance Notes for Local Authorities including Police Authorities and Fire Authorities (2011 edition).

CIPFA the Prudential Code for Capital Finance in Local Authorities (2011 edition).

Treasury Management Annual Strategy Report 2012-13 and Prudential Indicators 2012-13 to 2014-15.

Performance management information from Sector.

2012/13 final accounts working papers.

APPENDIX A

1. PRUDENTIAL INDICATORS AND COMPLIANCE ISSUES

1.1 The treasury management service is an important part of the overall financial management of the Council's affairs. Whilst the Prudential Indicators consider the affordability and impact of capital expenditure decisions, the treasury management service covers the effective funding of these decisions.

1.2 The 2003 Prudential Code for Capital Finance in Local Authorities requires that actual prudential indicators be reported after the year-end. The table below summarises the key prudential indicator performance for 2012/13.

1.3 The Council at its meeting on 21st February 2012 adopted the prudential indicators for 2012/13.

2011/12 Actual	Prudential Indicator	2012/13 Actual
	CAPITAL EXPENDITURE / AFFORDABILITY	
£000's	**Capital Expenditure**	**£000's**
4,797	General Fund	2,881
4,797	**Total**	**2,881**
£000's	**Capital Financing Requirement**	**£000's**
3,762	General Fund	3,392
3,762	**Total**	**3,392**
%	**Ratio of Financing Costs to Net Revenue Stream**	**%**
2	General Fund	2
2	**Total**	**2**
	TREASURY MANAGEMENT	
£000's	**External Debt**	**£000's**
0	General Fund	0

Capital Financing Requirement (CFR)

1.4 The CFR is derived from the Authority's balance sheet and measures its underlying need to borrow for a capital purpose. This Authority fully finances its capital expenditure (including the value of assets acquired under finance leases) without borrowing. Where capital expenditure is to be financed in future years by charges to revenue as assets are used by the Authority, the expenditure results in an increase in the Capital Financing Requirement, a measure of the capital expenditure incurred historically by the Authority that has yet to be finalised.

1.5 In accordance with best practice this Authority does not associate borrowing with particular items or types of expenditure, in day-to-day cash management no distinction can be made between capital cash and revenue cash. Any external borrowing would arise as a consequence on all financial transactions whereas this measure reflects the Authority's underlying need to borrow for a capital purpose only.

Net Borrowing and the CFR

1.6 In order to ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2012/13 plus the expected changes to the CFR over 2013/14 and 2014/15. The Council has complied with this prudential indicator.

The Authorised Limit

1.7 The Authorised Limit is the "Affordable Borrowing Limit" required by S3 of the Local Government Act 2003 irrespective of the Authority's indebted status. The limit is the maximum amount of external debt that can be outstanding at any one time during the financial year. The Authorised Limit also provides some headroom for unexpected cash movements. The introduction of International Financial Reporting Standards (IFRS) required finance leases to be included under other long-term liabilities on the balance sheet. A limit of £5.5m was used for the Authorised Limit. The actual outturn was £3.5m (£3.9m in 2011/12) for finance lease liabilities. There was no borrowing during 2012/13.

The Operational Boundary

1.8 The Operational Boundary is the expected borrowing position of the Council during the year, and periods where the actual position is either below or over the Operational Boundary is acceptable subject to the Authorised Limit not being exceeded. The Operational Boundary does not allow for additional headroom as is the case with the Authorised Limit. A limit of £4m was used for the Operational Boundary. The actual outturn was £3.5m (£3.9m in 2011/12) for finance lease liabilities. There was no borrowing during 2012/13.

Actual financing costs as a proportion of net revenue stream

1.9 This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream. Since the Council is a debt free authority this indicator is not relevant.

1.10 A "debt free" Authority does not incur financing costs because it does not have any long-term debt. Instead, this indicator measures the investment income earned by the Council as a percentage of the Council Tax budget requirement, so as to show the level by which investment income is being used to underpin the Council's operational budget. See table at paragraph 1.3.

Adoption of the CIPFA Treasury Management Code

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

1.12 The Council approved the adoption of the CIPFA Treasury Management Code at its full Council meeting on 20th January 2004.

1.13 The Council has incorporated the changes from the revised CIPFA Treasury Management Code of Practice into its treasury policies, procedures and practices. Council approved the revised Treasury Management Policy on 21st February 2012.

Investment Activity

1.14 The purpose of the following indicators is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates.

1.15 **Interest rate exposure**

Interest rate exposures			
	2011/12 Actual	2012/13 Original	2012/13 Actual
	Upper	Upper	Upper
Limits on fixed interest rates : (investments only)	83.40%	100%	86.52%
Limits on variable interest rates : (investments only)	16.60%	17%	13.48%

1.16 **Maturity structure of fixed interest rate borrowing 2012/13**

Maturity structure of fixed interest rate borrowing 2012/13		
	Lower	Upper
Under 12 months	0%	0%
12 months to 2 years	0%	0%
2 years to 5 years	0%	0%
5 years to 10 years	0%	0%
10 years and above	0%	0%

1.17 The Council has been debt free since 1st April 1997. These indicators have therefore not moved from 0% in the estimate or the actual outturn.

1.18 **Maximum principal sums invested > 364 days**

Maximum principal sums invested > 364 days			
	2011/12 Actual	2012/13 Original	2012/13 Actual
Principal sums invested > 364 days	£4m	£5m	£2m