EAST HERTS COUNCIL

AUDIT COMMITTEE - 18 SEPTEMBER 2013

REPORT BY EXECUTIVE MEMBER FOR FINANCE

TREASURY MANAGEMENT STRATEGY STATEMENT 2012/13 AND PRUDENTIAL CODE REVIEW

WARDS AFFECTED: ALL

Purpose/Summary of Report

- This report reviews the Council's 2012/13 Treasury Management and Prudential Code arrangements and updates the current year position.

RECOMMENDATION FOR DECISION:	
(A)	**that the 2012/13 Treasury Management and Prudential Indicator Out-turn be approved; and**
(B)	**the current year position to the 31 July 2013 be noted.**

1.0 Background

1.1 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).

1.2 During 2012/13 the minimum reporting requirements were that the relevant committee should receive the following reports:

- an annual treasury strategy in advance of the year (Council 22/2/2012)
- an annual report following the year describing the activity compared to the strategy (this report)

1.3 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.

1.4 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 relevant Committee before they were reported to the full Council.

2.0 Report

2.1 This annual treasury report covers:

- Capital spending and financing 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 how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity
- The Council's current treasury positions as at 31/7/2013.

2.2. 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, internal borrowing 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.

£m	2011/12 Actual	2012/13 Estimate	2012/13 Actual
Total capital expenditure	**5.527**	**4.579**	**3.579**
Resourced by:			
• Capital receipts	4.521	1.085	1.230
• Capital grants	0.497	0.289	0.382
• Internal Borrowing	0.484	3.180	1.942
• Revenue	0.025	0.025	0.025

2.3 <u>The Council's overall borrowing need</u>

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's debt position. The CFR results from the capital activity of the Council and what resources have been used to pay for the capital spend.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

The Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are charged to revenue at a rate broadly in line with the life of the asset. To achieve this the Council is required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to reduce the CFR. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or

- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

The Council's 2012/13 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report for 2012/13 on 22/2/2012.

The borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

To ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must be for capital purposes. The Council requires specific approval by the Secretary of State to borrow for revenue purposes. 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. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2012/13. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2012 Actual	31 March 2013 Original	31 March 2013 Actual
Net borrowing position	£(58.932)m	£(55.90)m	£(60.569)m
CFR	£(47.028)m	£(41.73)m	£(43.510)m

The authorised limit - the authorised limit is the "affordable borrowing limit" required by S3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. The table below demonstrates that during 2012/13 the Council has maintained gross borrowing within its authorised limit.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - 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.

Authorised limit February 2012	£17.3m
Maximum gross borrowing position outturn	£9.6 m
Operational boundary February 2012	£10.3m
Average gross borrowing position outturn	£7.5m
Financing costs as a proportion of net revenue stream – anticipated February 2012 budget	(2.86%)
Financing costs at outturn	(3.08%)

2.4 Treasury Position as at 31 March 2013

The Council's treasury management service manages debt and investment to ensure adequate liquidity for revenue and capital activities, security of 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:

TABLE 1	31 March 2013 Principal		Rate/ Return	Average Life yrs	31 March 2012 Principal	Rate/ Return	Average Life yrs
Fixed rate funding:							
-PWLB	£1.5m				£1.5m		
-Market	£6.0m	£7.5m	8.8%		£6.0m	8.8%	
Variable rate funding:							
-PWLB	£nil				£nil		
-Market	£nil	£0.0m	0%		£nil	0%	
Total debt		***7.5m***	***8.8%***		***£7.5m***	***8.8%***	
Investments:							
- in house	£45.87m		2.95%		£17.79m	2.48%	
- with managers	£21.93m		0.67%		£48.78m	0.67%	
Total investments		***£67.8m***	***1.16%***		***£66.57m***	***1.16%***	

The maturity structure of the debt portfolio was as follows:

	31 March 2012 actual	2012/13 original limits	31 March 2013 actual
5 years and within 10 years	£6.0m	£6.0m	£6.0m
10 years and above	£1.5m	£1.5m	£1.5m

Investments - fixed deposits held as at 31st March 2013 exceeding I year is £5m with Barclays maturing Aug 2014 and £10m with Lloyds maturing April 2015.

3.0 The Strategy for 2012/13

The strategy for 2012/13 anticipated low but rising Bank Rate (starting in quarter 3 of 2013) with similar gradual rises in medium and longer term fixed borrowing rates over 2012/13. Variable or short-term rates were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

The strategy adopted in the original Treasury Management Strategy Report for 2012/13 approved by the Council on 22/02/2012 was revised during the year to permit monies from the Fund manager to be disinvested and invested directly with counterparties by in house staff to take advantage of higher fixed term deposit rates prevailing and the saving of the fund management costs.

4.0 The Economy and Interest Rates

The original expectation for 2012/13 was that Bank Rate would start gently rising from quarter 3 2013. However, economic growth (GDP) 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 it’s 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 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 increasing quantitive easing by £50bn in July to a total of £375bn. The Bank Rate therefore ended the year unchanged at 0.5% while 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 crises was an ongoing saga during the year with first Greece and then Cyprus experiencing crises which met with bailouts after difficult and fraught negotiations.

Gilt Yields oscillated during the year as events in the ongoing Eurozone debt crises ebbed and flowed causing corresponding fluctuations in safe haven flows into / 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 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 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.

5.0 Borrowing Rates in 2012/13

PWLB borrowing rates – the table for PWLB maturity rates below show a selection of maturity periods, and individual rates at the start and the end of the financial year.

5 Yr	01/04/12	2.1%	31/3/13	1.75%
10 Yr	01/04/12	3.28%	31/3/13	2.84%
25 Yr	01/04/12	4.39%	31/3/13	4.07%

The rates fell across all borrowing durations from the beginning of the financial year.

6.0 Borrowing Outturn for 2012/13

6.1 Due to the high rates of interest payable on the outstanding £1.5 million PWLB loans and the continuing low level of the corresponding discount rates for 5 year and 30 year + maturities, any potential restructuring or premature repayment of the two loans was considered to be too expensive as their repayment would attract heavy premia.

6.2 The £6 million loan stock is part of a ‘club’ deal. Any move to prematurely redeem the stock would require the consent of all members of the deal and hereto any early redemption would attract a costly premium.

6.3 No new borrowings to finance capital expenditure were undertaken. Capital receipts were applied together with internal borrowing (thereby reducing investments).

7.0 Investment Rates in 2012/13

Bank Rate remained at its historic low of 0.5% throughout the year; it has now remained unchanged for four years. Market expectations of the start of monetary tightening were pushed back during the year to early 2015 at the earliest. The Funding for Lending Scheme resulted in a sharp fall in deposit rates in the second half of the year.

8.0 Investment Outturn for 2012/13

The Council's investment policy is governed by CLG guidance, which was implemented in the annual investment strategy approved by the Council on 22/02/2012. 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 policy originally approved was amended in July 2012 to enable investments with UK banks with Credit rating of "A" for a maximum period of 2 years. The counterparty investment limits for Lloyds and Nat West were also increased to £20m .The Executive Member for Finance was given delegated authority to vary the Council's investment strategy (as a matter of urgency) in agreement with the Leader, the Chairman of the Audit Committee and the Director of Finance and Support Services and report the changes to the Council.

8.1 Funds coming available from day to day cash flow were placed with our bankers when needed immediately or placed on short term deposit with Morgan Stanley (MMF) fund. After October the limit with our bankers was increased to assist in accommodating the changes of policy with the Scottish Widows (MMF) fund.

8.2 Analysts' consideration of counterparty risks gave more weight to countries as a whole and their ability to underwrite their banks and less to individual institutions. This tightened the lending lists further because of the banks' exposure to foreign governments. The return was 0.9% on the balance held with our bank. The fixed deposits held (stated in the "current positioned" in last years report) returned 2.95% and balancing cash held with Morgan Stanley for counterparty limit 0.5%

8.3 The Council has investments managed externally by Investec and Scottish Widows (SWIP). The fund management agreements between the Council and the Fund Manager defines the limits for maximum weighting in gilts/bonds and maximum duration of the fund. Counterparty criteria and exposure limits are also pre-defined therein. The "investment board" met in June and it was agreed the funds held with SWIP would be withdrawn and placed in fixed deposits and MMF for liquidity to save fees and secure the same return or if not better.

SWIP has under performed the 7 day Libid benchmark by 0.13%. As the funds have gradually been withdrawn and the fund was on notice to close the return would fall. All funds were returned by the end of November 2012.

The Investec fund saw a varied performance over the year. Throughout the financial year 2012/13 the combination of low yields and an unsettled market background did mean there was little incentive for the manager to actively invest in the gilt market. Neverless, the manager did see some opportunities to undertake some trades and continued to see index-linked gilts more attractive than their conventional alternatives. At the beginning of the financial year the Manager underperformed against its benchmark and industry average. In the second and third quarters of the year with financial markets remaining relatively calm, Investec produced a credible performance over its respective benchmark. The final quarter of the financial year saw the Manager underperforming against its relative benchmark and industry average. Overall, the performance for the year was somewhat mixed, with two positive and two negative quarters. For the financial year 2012/13 the manager has returned 0.88% against the benchmark of 0.88%, a neutral performance. Throughout the year Investec continued to be predominantly focused on the CD market but took advantage, when they felt comfortable, of opportunities within the gilt market.

The table below sets out a summary of the investment returns achieved compared to benchmarks.

	Average Investment	**Rate of Return (gross of fees)**	**Rate of Return (net of fees)**	<u>Benchmark Return %</u>
Internally Managed	9.1m 30m Fixed	0.9% 2.95%	N/A	7 day LIBID 0.4% (not compounded)
Externally Managed SWIP Investec	 19.5m 21.8m	 0.33% 1.05%	 0.31% 0.88%	 7 day LIBID 0.46% 1-3 year Gilt Index 0.88%

9.0 <u>Current Position 2013/14</u>

9.1 Prudential Indicators

As at the end of July 2013 the data suggests that no changes are required to the current indicators that were approved by Council on 22 February 2012.

9.2 In-House Funds

As stated in the report earlier the government funding for lending scheme resulted in interest falling away compared with the previous financial year. As a result after much discussion at the Investment board meeting in June it was agreed to renew the fixed deposits for a year as they mature and keep under review our MMF to take advantage of any opportunities that are available to better these returns.

Current Fixed Deposits:
£10m Lloyds Fixed until July 2014 @ 0.92%
£5m Barclays Fixed until August 2014 @2%
£5m Barclays Fixed until April 2014 @0.90%
£5M Nat West 95 day notice @ 0.8%

Structured Deposit of £10m with Lloyds fixed until 2015. Minimum return of 3.72% and a maximum of 6.5% dependent on 3 month LIBOR rates.(This was stated in last years report).

The remaining funds are now positioned such that liquidity is maintained by using a new MMF fund, Morgan Stanley and our own bank. This saves the fees of approximately £40k by only using one fund manager. Also gives the ability to invest and diverse as new policies initiated are developed.

9.3 Fund Manager

Investec began the year with investments of £21.93m and underperformed the Merrill Lynch 1-3 benchmark by 10bps net of fees as at the end of July 13. The fund has been more active in Government stock purchasing Gilts to the value of £3.24m. The rationale for this strategic position is two-fold. First, the new governor of the Bank of England is more dovish and has communicated to the markets that UK rates are on hold for longer, thus benefitting the yield curve. The longer the period of unchanged bank rate the greater the yield to similar money market rates. If the gilt position unwinds correctly this should go a long way to reducing the under performance to date. The current projections on all funds indicate an overall return of between £875k and £896k indicating a budget Shortfall of circa - £100k. This is due to the lower rates achieved on the deposits held in house and the current position with the fund manager. Impact on performance against budgeted assumption is being reported through the monthly healthcheck report. With a recommendation that the position be managed through use of the Councils Interest Equalisation Reserve

9.4 MRP Policy

Under new regulations the Council are required to determine appropriate provisions for repayment of debt (MRP) on a prudent basis. The Regulations allow for an approach in line with previous provisions which for this Council resulted in no provision needing to be made given the Council's "negative" capital financing requirements (set aside receipts significantly in excess of outstanding debt). The Annual Treasury Management Strategy proposals will consider the ongoing position and approve any changes to this approach.

10.0 Implications/Consultations

10.1 Information on corporate issues and consultation associated with this report can be found within **Essential Reference Paper A.**

Background Papers

None

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