

## **AUDIT COMMITTEE**

**11 JULY 2013**

### **TREASURY MANAGEMENT OUTTURN ANNUAL REPORT**

Report from: Mick Hayward, Chief Finance Officer

Author: Andy Larkin, Finance Support Manager

#### **Summary**

This report gives an overview of treasury management activity during 2012/13.

#### **1. Budget and Policy Framework**

- 1.1 The council's treasury management strategy and policy are approved by Full Council following consideration by Business Support Overview and Scrutiny and Cabinet. However, Full Council approved that reporting of the Treasury Management Annual Outturn is to Cabinet followed by Audit Committee. This year the Business Support Overview and Scrutiny Committee also requested to see this report.

#### **2. Background**

- 2.1 This Council is required by 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).
- 2.2 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 23 February 2012)
  - A mid-year (minimum) treasury update report (Council 24 January 2013)
  - An annual report following the year describing the activity compared to the strategy (this report).
- 2.3 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.

2.4 This Council also promotes prior scrutiny of the Treasury Strategy and mid-year review with both being submitted to the Business Support Overview and Scrutiny Committee before reporting to Cabinet and the full Council. The revised Code of Practice introduced by CIPFA (following the Icelandic banking collapse) and adopted as part of the Council's Treasury Strategy for 2009/10 prompted training for Members which has taken place periodically.

2.5 This annual treasury outturn report covers:

- The Council's treasury position as at 31 March 2013;
- Borrowing activity 2012/13;
- Performance measurement
- The strategy for 2012/13
- The economy and interest rates in 2012/13
- Borrowing rates in 2012/13
- The borrowing outturn for 2012/13
- Debt rescheduling;
- Compliance with treasury limits and Prudential Indicators;
- Investment rates in 2012/13
- Investment outturn for 2012/13

### 3. The Economy and Interest Rates

3.1 The financial year 2012/13 continued the challenging investment environment of recent years, namely low investment returns and continuing heightened levels of counterparty risk. The original expectation for 2012/13 was that 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 and downgraded the rating to AA+ in April. Key to regaining the AAA rating 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 quantitative easing (QE) by £50bn in July to a total of £375bn. 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 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.

3.2 **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 / 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.

3.3 **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 European Central Bank (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.

**4. Overall Treasury Position as at 31 March 2013**

4.1 The Council’s debt and investment position at the beginning and end of the year was as follows.

**Table 1 – borrowing and investment levels**

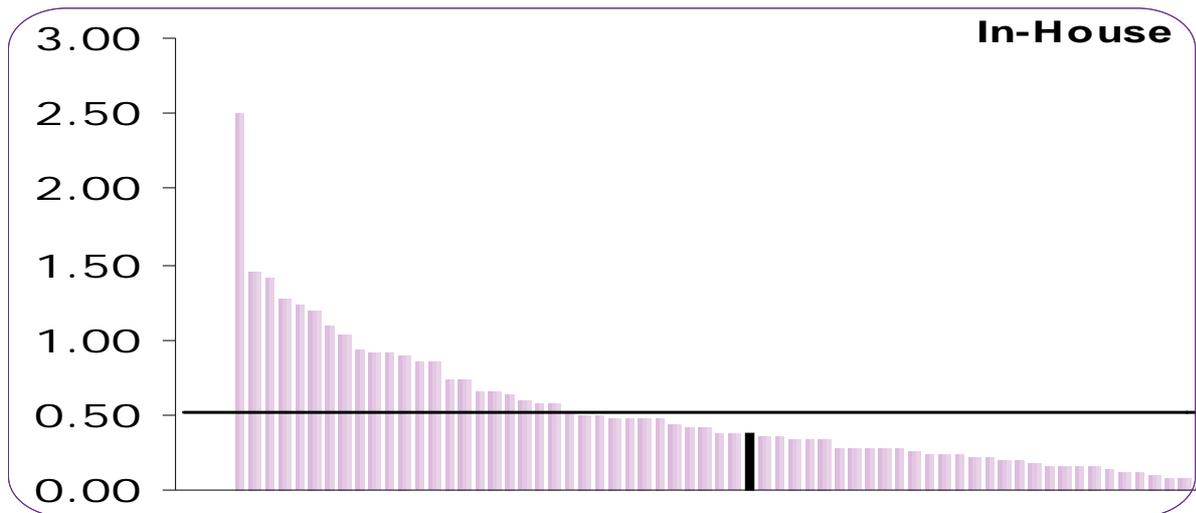
	<b>31/03/12 £m</b>	<b>Rate</b>	<b>31/03/13 £m</b>	<b>Rate</b>
<b>Gross borrowing</b>	182.4	4.16%	172.4	4.15%
<b>Plus other long term liabilities*</b>	3.1		2.5	
<b>Total Debt</b>	185.5		174.9	
<b>CFR</b>	254.6		252.5	
<b>(Under)/Over Borrowing</b>	(69.1)		(77.6)	
<b>Less investments</b>	65.3	1.51%	55.7	1.46%
<b>Net borrowing</b>	120.2		119.2	

\* Embedded Leases (on balance sheet)

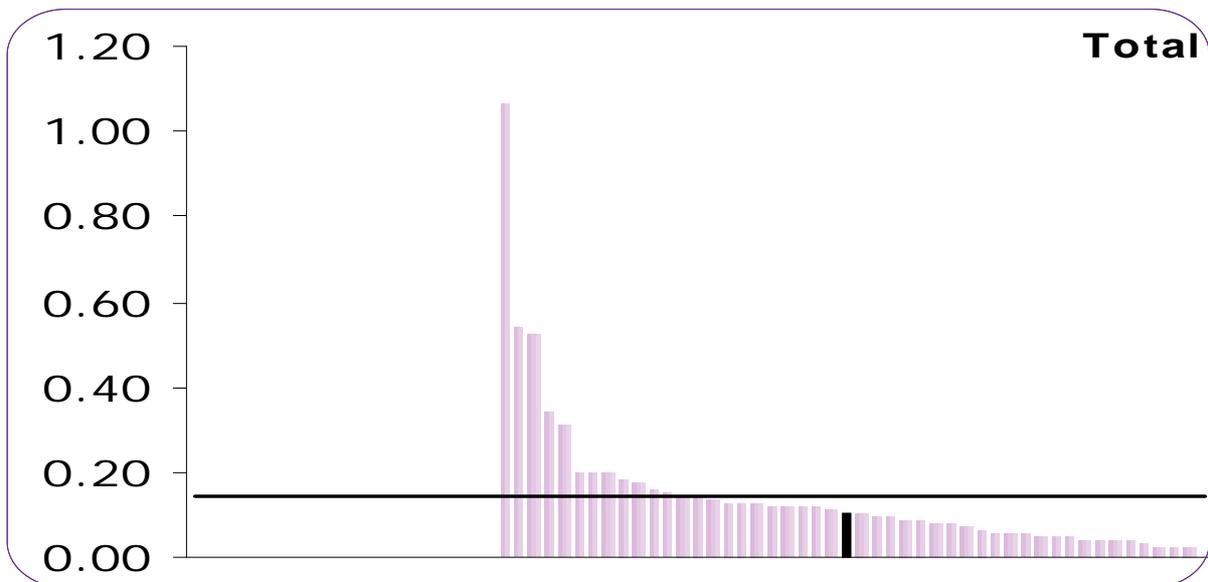
4.2 The three graphs below show the overall in-house cost (£000s) per £m invested and borrowed, additionally the third graph shows our Fund Managers cost (£000s) per £m invested, compared to 68 other authorities participating in the CIPFA Treasury benchmarking. The highlighted bar shows the Medway position as compared to others, the horizontal black line shows the average cost.

4.3 The graphs demonstrate that both the In-House and Fund Manager do provide value for money albeit a reducing number of authorities are utilising the services of Fund Managers.

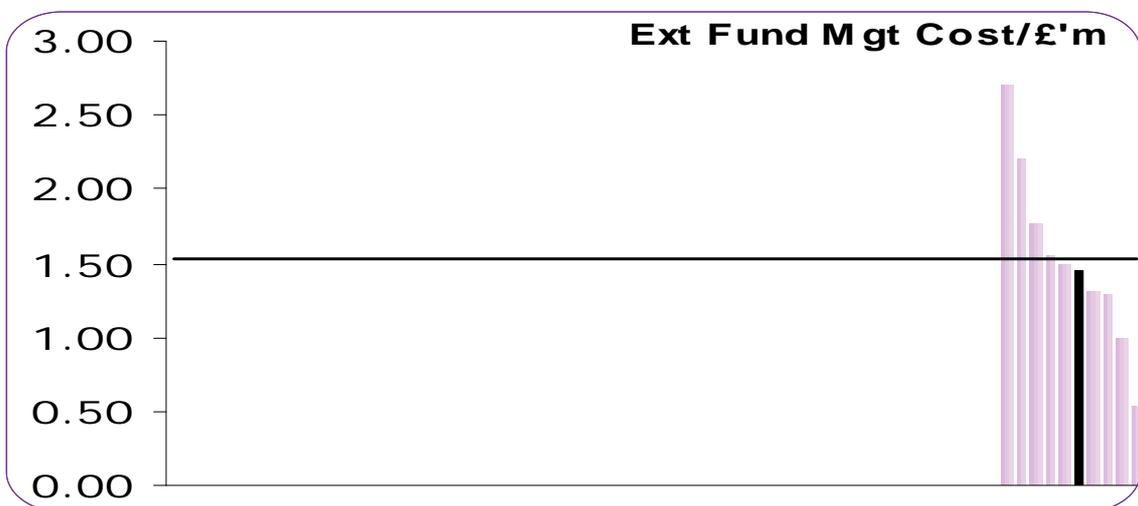
**Graph 1 – In-House Cost £k per £m invested**



**Graph 2 – In-House Cost £k per £m average borrowed**



**Graph 3 – Fund Manager Cost £k per £m invested**



## 5. The Strategy for 2012/13

- 5.1 The expectation for interest rates within the strategy for 2012/13 anticipated low but rising Bank Rate (starting in quarter 4 of 2014) 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 counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.
- 5.2 In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.
- 5.3 The actual movement in gilt yields meant that PWLB rates fell during the first quarter of the year to historically low levels. This was caused by a flight to quality into UK gilts from EU sovereign debt, and from shares, as investors became concerned about the potential for a Lehman's type crisis of financial markets if the Greek debt crisis were to develop into a precipitous default and exit from the Euro. During the second and third quarters, rates rose gradually and agreement of a second bail out for Greece in December saw the flight to quality into gilts reverse somewhat, as confidence rose that the Eurozone crisis was finally subsiding. However, gilt yields then fell back again during February and March as Eurozone concerns returned, with the focus now shifting to Cyprus, and flight to quality flows into gilts resumed. This was a volatile year for PWLB rates, driven by events in the Eurozone which oscillated between crises and remedies.

## 6 The Borrowing Requirement and Debt

- 6.1 The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR).

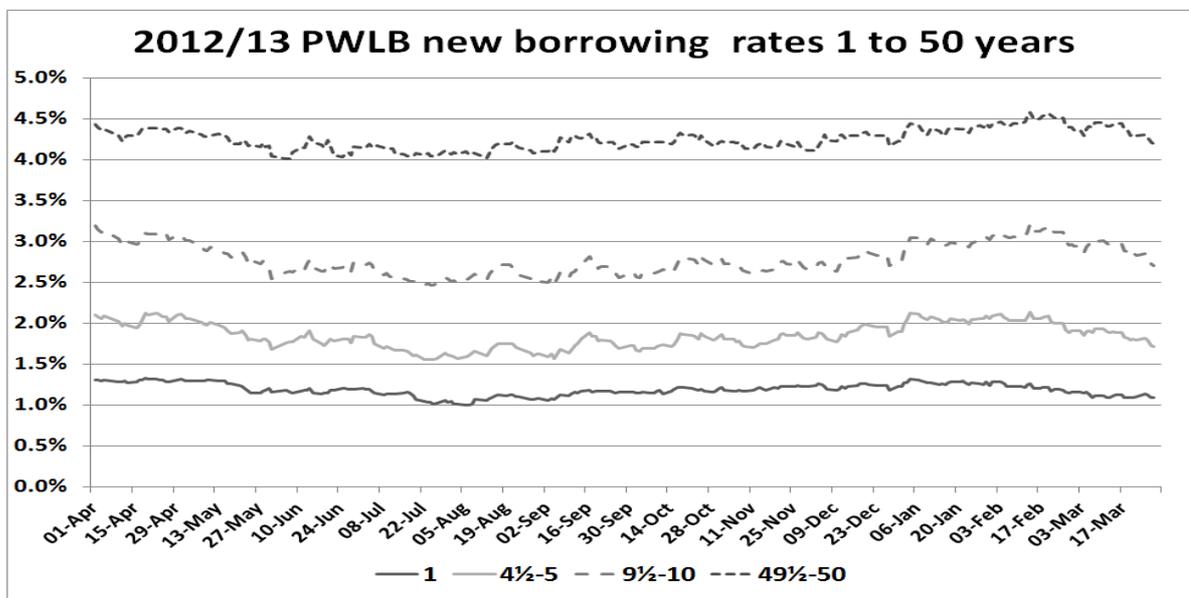
**Table 2 Capital Financing Requirement**

	31 March 2012 Actual £m	31 March 2013 Budget £m	31 March 2013 Actual £m
CFR General Fund (£m)	213,422	.212.971	212,164
CFR HRA (£m)	41,146	41,487	40,323
Total CFR	254,568	254.458	252.,487

## 7. Borrowing rates in 2012/2013

7.1 PWLB borrowing rates - the graph below shows how PWLB rates remained at historically very low levels during the year.

**Graph 4 - PWLB new Borrowing rates 2012-13**



## 8. Borrowing Outturn for 2012/13

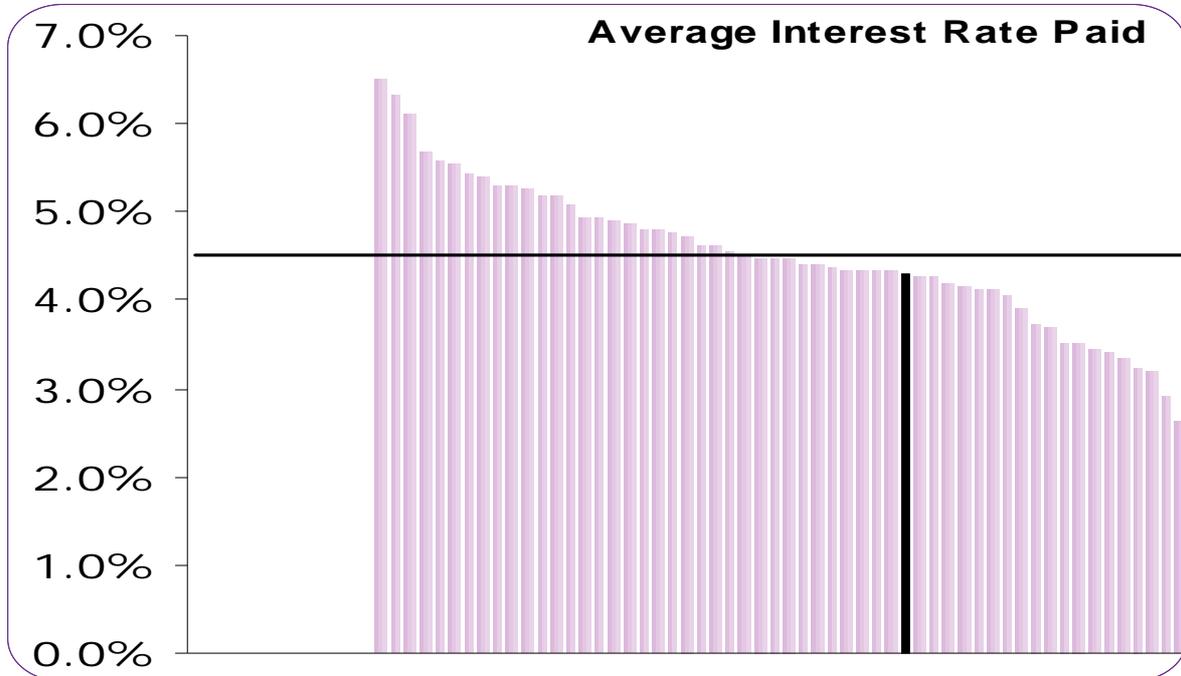
8.1 The borrowing strategy for the council confirmed the holding of £101.8 million in Lenders Options, Borrowers Options (LOBO) debt. These are debts that are subject to immediate repayment or variation of interest chargeable and the option to repay, on request from the lender on the review dates. However, the lender can only apply this clause once within the lifetime of the LOBO. This type of borrowing has therefore been classed as fixed rate.

8.2 Due to the very low interest rates being earned on investments and restrictions to mitigate counterparty risk, officers have been repaying existing and deferring taking out new debt. The Council repaid a £10m loan to the PWLB that fell due in 2012/13.

8.3 As highlighted in section 4 above the average debt portfolio interest rate has moved very marginally over the course of the year from 4.16% to 4.15% and the total debt decreased by the £10m debt referred to in paragraph 8.2, that fell due for repayment and was not replaced. The approach during the year was to use cash balances to finance new capital expenditure or maturing debt so as to run down cash balances and minimise counterparty risk incurred on investments. This also maximised treasury management budget savings, as investment rates were much lower than most new borrowing rates.

8.4 Graph 5 below demonstrates the overall interest rate being paid for our debt is marginally below the average being paid by contributors to the CIPFA benchmarking club.

**Graph 5 Average interest paid on Debt (2012/13)**



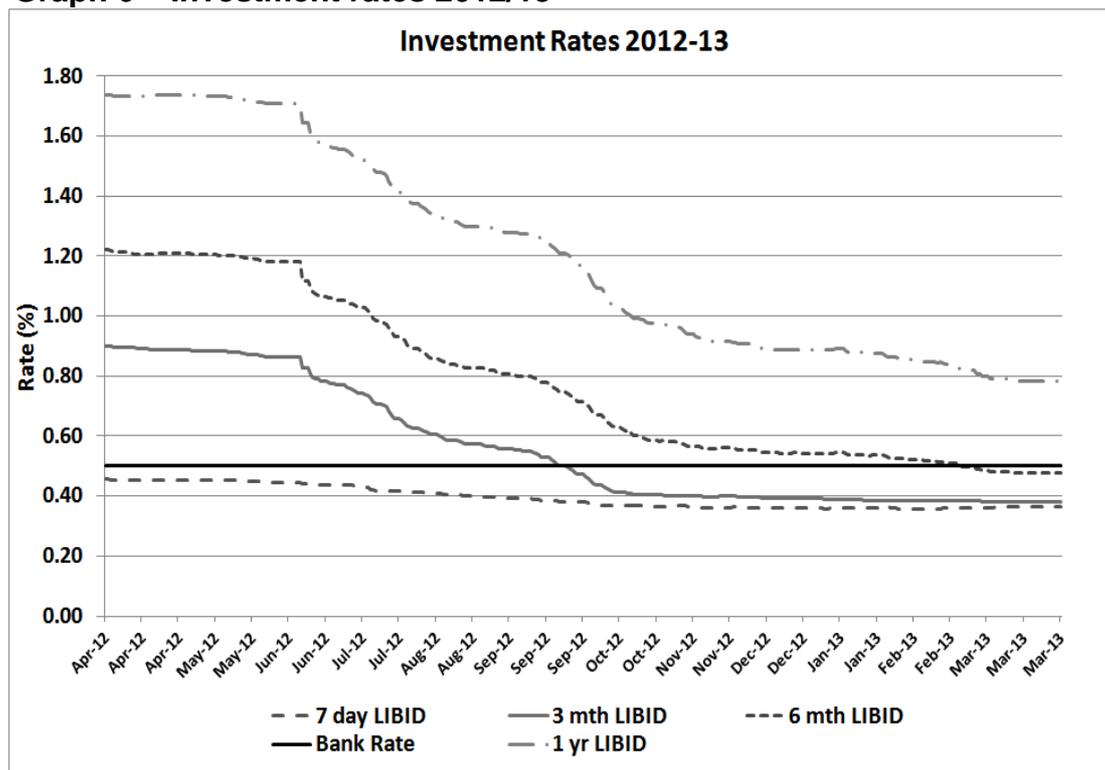
## 9. Debt Rescheduling

9.1 No debt restructuring was undertaken during 2012/13 and it is not envisaged that that there will be any opportunities where the debt restructuring would be economically viable in 2013/14.

## 10 Investment Rates in 2012/13

10.1 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.

**Graph 6 – Investment rates 2012/13**



## 11 Investment Outturn for 2012/2013

11.1 **Investment Policy** - The Council's investment policy is governed by CLG guidance, which was implemented in the Annual Investment Strategy (which is incorporated within The Treasury Management Strategy Statement) that was approved by Council on 23 February 2012. This policy sets out the approach for choosing investment counterparties for the in-house team, 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 etc.). The Council also employs an external fund manager Investec and they have their own policy setting out their approach for choosing investment counterparties which also was approved at Council on the 23 February 2012.

11.2 **Internally Managed Investments** – The Council manages the major part of its investments in-house using the institutions listed in the Council's approved lending list. These funds are identified as 'core funds' where the investment can be for an extended time period and usually fixed prepayment date, or 'cash flow' where the investment is required to be available for immediate liquidity. The council can invest for a range of periods from overnight to 5 years dependent on forecast of the Council's cash flows, the duration and counterparty limits set out in the approved investment strategy, its interest rate view and the interest rates on offer. During the year all investments were made in full compliance with the Council's treasury management policies and practices. The Annual Investment Strategy, outlines the Council's investment priorities as:

- (1) Security of capital and liquidity; and
- (2) The achievement of optimum return (yield) on investments.

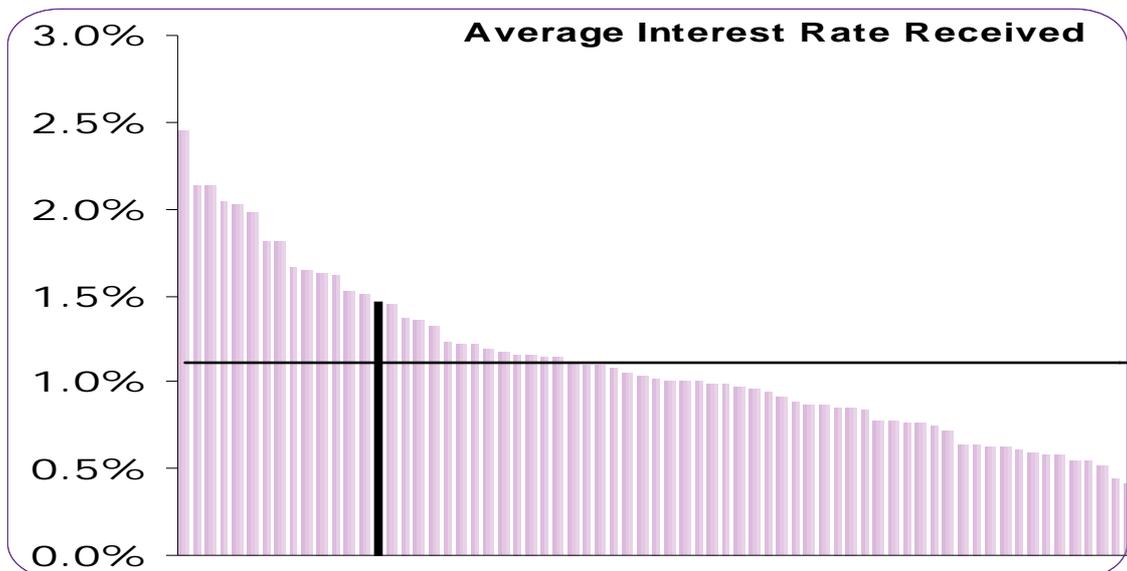
- 11.3 **Externally Managed Investments** – The Council also has investments managed externally by Investec. The fund management agreement between the Council and the Fund Manager defines the limits for maximum weighting in gilts/bonds and maximum duration of the fund. Counterparty criteria and exposure limits are also pre-defined therein.
- 11.4 **Investment performance for 2012/13** – Detailed below is the result of the investment strategy undertaken by the Council.

**Table 3 Investment Performance 2012/13**

	Average Investment	Rate of Return (gross of fees)
<b>Internally Managed – Core Funds</b>	£26.247m	2.27%
<b>Internally Managed – Cash Flow Funds</b>	£23.416m	0.95%
<b>Overall Internally Managed Funds</b>	£49.663m	1.66%
<b>Externally Managed</b>	£22.820m	1.06%

- 11.5 No institutions in which investments were made during 2012/2013 had any difficulty in repaying investments and interest in full during the year.
- 11.6 Graph 7 demonstrates that the average interest rate being earned on investments is above average for those authorities participating in the CIPFA Treasury benchmarking club.

**Graph 7 Average Interest Rate Received**



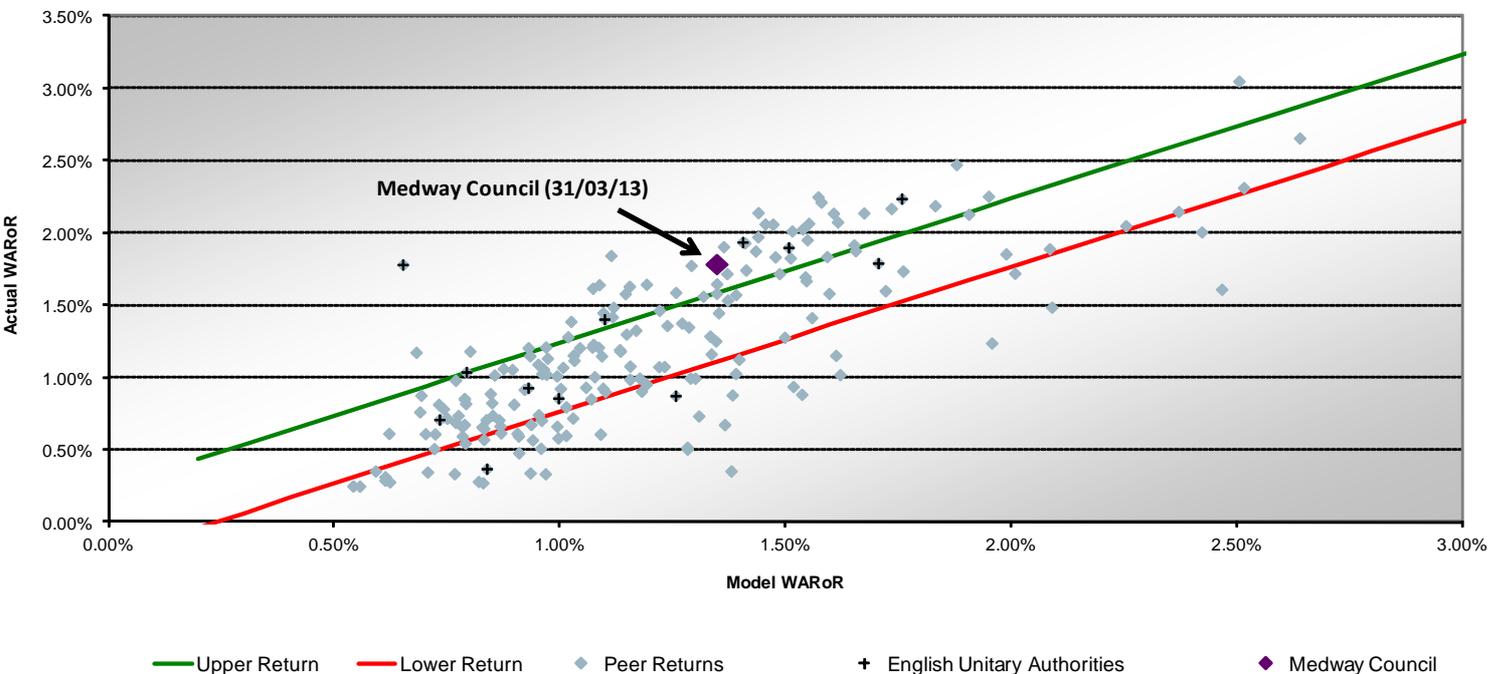
- 11.7 Although graph 7 does compare our return against the return achieved by other authorities it does not take account of the level of risk undertaken for each investment. Graph 8 below is produced by Sector (our external adviser) in its own benchmarking exercises which are built to compare return vs risk.

11.8 The aim of the Sector benchmarking model is to compare portfolio weighted average rate of returns (WARoR) by adjusting for risks inherent in the portfolio. The main risks in cash portfolios are, maturity risk and credit risk. As such the model must normalise WARoRs by adjusting for these risks so as to calculate risk adjusted returns, or “Model WARoR”. The risks the model looks at include; maturity risk, credit risk and any change in the shape of the yield curve. This will account for the majority of all risk in the portfolio, however, there will still be some “model uncertainty” as no model can fully explain each WARoR. The difference in model WARoR and actual WARoR may be due to the following reasons; timing differences, higher diversification and or a tilt towards a particular asset type or institution type that is extraordinarily paying an above market rate.

11.9 As a result, the model builds in “Standard Error Bands” around the model WARoR calculated so as to adjust for this model uncertainty. This gives a range for where the actual WARoR should fall. If the actual WARoR is above this upper band, then the actual performance of the portfolio is above on a risk adjusted basis given the inherent risks within the portfolio.

11.10 Graph 8 demonstrates that the performance of the Medway in-house portfolio did perform above on a risk-adjusted basis. The Sector benchmarking is run on a monthly basis, graph 8 shows the performance for March 2013 and not the performance for the whole of 2012-13 financial year, however this should be representative of the year as a whole.

**Graph 8 Actual Returns against Model Returns**



	Actual WARoR	Model WARoR	Variance	Lower Band	Upper Band	Performance
Medway	1.78%	1.35%	0.44%	1.11%	1.59%	Above

## 12 Compliance with Treasury Limits

- 12.1 During the financial year the Council operated within the Treasury Limits and Prudential Indicators set out in the Council's annual Treasury Strategy Statement. The outturn for the Prudential Indicators is shown in appendix 1.

## 13 Risk Management

- 13.1 As stated within the Treasury Strategy, a key driver for the review of the CIPFA code has been the exposure to risk evidenced by the Icelandic investments and more generally by the financial crisis. Risk and the management thereof is a key feature throughout the strategy and in detail within the treasury management practices (TMP1) within the Treasury Strategy.

## 14 Business Support Overview and Scrutiny Committee

- 14.1 The Business Support Overview and Scrutiny Committee considered this report on 20 June 2013. The Committee suggested that future reports include information on debt maturity analysis and requested that the mid-year review report includes information on the quantum of local authorities that use just in-house and a mixture of in-house and external fund manager services.

## 15 Cabinet

- 15.1 The Cabinet will consider this report on 9 July 2013 and the outcome of that discussion will be reported verbally to the Audit Committee.

## 16 Financial and Legal Implications

- 16.1 Overall the Interest and Financing budget made a surplus over its targeted budget of £1.068m. In light of the continued historically low bank rate which continued at 0.5% throughout 2012/13, the overall rate achieved for investments averaged 1.46%.
- 16.2 A breakdown of the Interest and Financing budget is shown below:

**Table 4 Interest and Finance Budget against spend**

	Budget 2012/13 £000's	Actual 2012/13 £'000s	(Under)/ Overspend £'000s	Forecast 2013/14 £000's
Treasury Expenses	234	218	(16)	243
Interest Earned	(2,505)	(3,681)	(1,176)	(3,059)
Interest Paid	9,999	9,665	(334)	9,182
KCC Principle	1,965	1,811	(154)	1,739
MRP	7,792	8,331	539	8,317
Invest to Save recharges	(2,043)	(1,971)	72	(1,528)
<b>Total</b>	<b>15,442</b>	<b>14,374</b>	<b>(1,068)</b>	<b>14,894</b>

- 16.3 As part of the 2013/14 budget setting the general Fund used £550,000 of the surplus towards achieving a balance on the overall budget and further agreed to cease the debt recharge for the highways investment of £480,000 per annum with the equivalent amount returned to the highway maintenance budget. The budget for

Interest and Financing for 2013/14 is now set at £14.892 million (the reduction in recharged debt costs being managed elsewhere in the interest and Financing budget).

- 16.4 The body of the report and the appendices outline the significant financial implications. Any transactions undertaken on either investments or borrowings are governed by the London Code of Conduct, the council's treasury policy statement, and the CIPFA Code of Practice on Treasury Management in Local Authorities.
- 16.5 Legal implications – For the financial year 2012/13 our investments were managed in compliance with the Codes of Practices, guidance and regulations made under the Local Government Act 2003

## **17. Recommendations**

- 17.1 In accordance with the CIPFA Code of Practice, Audit Committee is recommended to approve the Treasury Management Outturn Annual Report.

## **Appendices**

Appendix 1 Prudential Indicators

## **Background papers**

Sector Template Report

## **Lead officer contact**

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**PRUDENTIAL and TREASURY INDICATORS (DRAFT)**

	2011/12	2012/13	2012/13
	£'000	£'000	£'000
	Actual	Estimate	Actual
<b>Capital Expenditure</b>			
Non - HRA	69,312	81,710	72,445
HRA	5,855	5,111	5,077
TOTAL	75,167	86,821	77,522
<b>Ratio of financing costs to net revenue stream</b>			
Non - HRA	4.73%	3.41%	3.76%
HRA	9.95%	25.20%	18.23%
<b>Net borrowing requirement</b>			
brought forward 1 April	108,176	123,322	122,635
carried forward 31 March	122,635	119,599	117,013
in year borrowing requirement	14,459	-3,724	-5,622
<b>Net Debt</b>	120.20	119.60	119.20
<b>Actual Debt</b>	182,338	172,416	175,681
<b>Capital Financing Requirement as at 31 March</b>			
Non – HRA	213,422	212,971	212,164
HRA	41,146	41,487	40,323
TOTAL	254,568	254,458	252,487
<b>HRA Limit on Indebtedness</b>	45,846	45,846	45,846
<b>Annual change in Cap. Financing Requirement</b>			
Non – HRA	-4,569	-165	-1,258
HRA	19,133	735	-823
TOTAL	14,564	570	-2,081

	2011/12	2012/13	2012/13
	Limit	Limit	Breach?
	£'000	£'000	
<b>Authorised Limit for external debt -</b>			
borrowing	433,356	440,537	No Breach
other long term liabilities	8	4,400	No Breach
TOTAL	433,364	444,937	No Breach
<b>Operational Boundary for external debt -</b>			
borrowing	395,708	400,488	No Breach
other long term liabilities	8	4,000	No Breach
TOTAL	395,716	404,488	No Breach
<b>HRA Limit on Debt</b>	45,846	45,846	No Breach
<b>Upper limit for fixed interest rate exposure</b>			
Net principal re fixed rate borrowing / investments	100%	No Change	No Breach
<b>Upper limit for variable rate exposure</b>			
Net principal re variable rate borrowing / investments	40%	No Change	No Breach
<b>Upper limit for total principal sums invested for over 364 days</b> (per maturity date)	£150,000	No Change	No Breach

<b>Maturity structure of fixed rate borrowing during 2012/13</b>	upper limit	lower limit	Breach ?
under 12 months	50%	0%	No Breach
12 months and within 24 months	50%	0%	No Breach
24 months and within 5 years	50%	0%	No Breach
5 years and within 10 years	50%	0%	No Breach
10 years and above	100%	25%	No Breach