CABINET

15 JULY 2014

TREASURY MANAGEMENT OUTTURN ANNUAL REPORT

Portfolio Holder: Councillor Alan Jarrett, Finance and Deputy Leader

Report from: Mick Hayward, Chief Finance Officer

Author: Andy Larkin Finance Support Manager

Summary

This report gives an overview of treasury management activity during 2013/14.

1. Budget and Policy Framework

1.1 The council's treasury management strategy and policy are approved by Full Council following consideration by Cabinet. However, Full Council approved that reporting of the Treasury Management Annual Outturn is to Cabinet followed by Audit Committee.

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 2013/14. 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 2013/14 the minimum reporting requirements were that the full Council should receive the following reports:

- An annual treasury strategy in advance of the year (Council 21 February 2013)
- A mid-year treasury update report (Council 26 November 2013)
- An annual report following the year describing the activity compared to the strategy (this report).

2.3 The regulatory environment places responsibility 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 the former being submitted to the Business Support Overview and Scrutiny Committee, with the latter to Audit Committee before reporting to Cabinet and Full Council. For the year 2014/15 onwards, Full Council (20 February 2014) agreed that scrutiny of all Treasury Management reports will be via Audit Committee.

2.5 This annual treasury outturn report covers:

- The Council's treasury position as at 31 March 2014;
- Borrowing activity 2013/14;
- Performance measurement
- The strategy for 2013/14
- The economy and interest rates in 2013/14
- Borrowing rates in 2013/14
- The borrowing outturn for 2013/14
- Debt rescheduling;
- Compliance with treasury limits and Prudential Indicators;
- Investment rates in 2013/14
- Investment outturn for 2013/14

3. The Economy and Interest Rates

3.1 The financial year 2013/14 continued the challenging investment environment of previous years, namely low investment returns, although levels of counterparty risk had subsided somewhat. The original expectation for 2013/14 was that Bank Rate would not rise during the year and for it only to start gently rising from quarter 1 2015. This forecast rise has now been pushed back to a start in quarter 3 2015. Economic growth (GDP) in the UK was virtually flat during 2012/13 but surged strongly during 2013/14. Consequently there was no additional quantitative easing during 2013/14 and Bank Rate ended the year unchanged at 0.5% for the fifth successive year. While CPI inflation had remained stubbornly high and substantially above the 2% target during 2013, by January 2014 it had, at last, fallen below the target rate to 1.9% and then fell further to 1.7% in February. It is also expected to remain slightly below the target rate for most of the two years ahead.

3.2 Gilt yields were on a sharply rising trend during 2013 but volatility returned in the first quarter of 2014 as various fears sparked a flight to quality (see paragraph 4.) The Funding for Lending Scheme, announced in July 2012, resulted in a flood of cheap credit being made available to banks which then resulted in money market investment rates falling drastically in the second half of that year and continuing into 2013/14. That part of the Scheme which supported the provision of credit for mortgages was terminated in the first quarter of 2014 as concerns rose over resurging house prices.

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

3.4 The EU sovereign debt crisis subsided during the year and confidence in the ability of the Eurozone to remain intact increased substantially. Perceptions of counterparty risk improved after the ECB statement in July 2012 that it would do “whatever it takes” to support struggling Eurozone countries; this led to a return of confidence in its banking system which has continued into 2013/14 and led to a move away from only very short term investing. However, this is not to say that the problems of the Eurozone, or its banks, have ended as the zone faces the likelihood of weak growth over the next few years at a time when the total size of government debt for some nations is likely to continue rising. Upcoming stress tests of Eurozone banks could also reveal some areas of concern.

4. Overall Treasury Position as at 31 March 2014

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

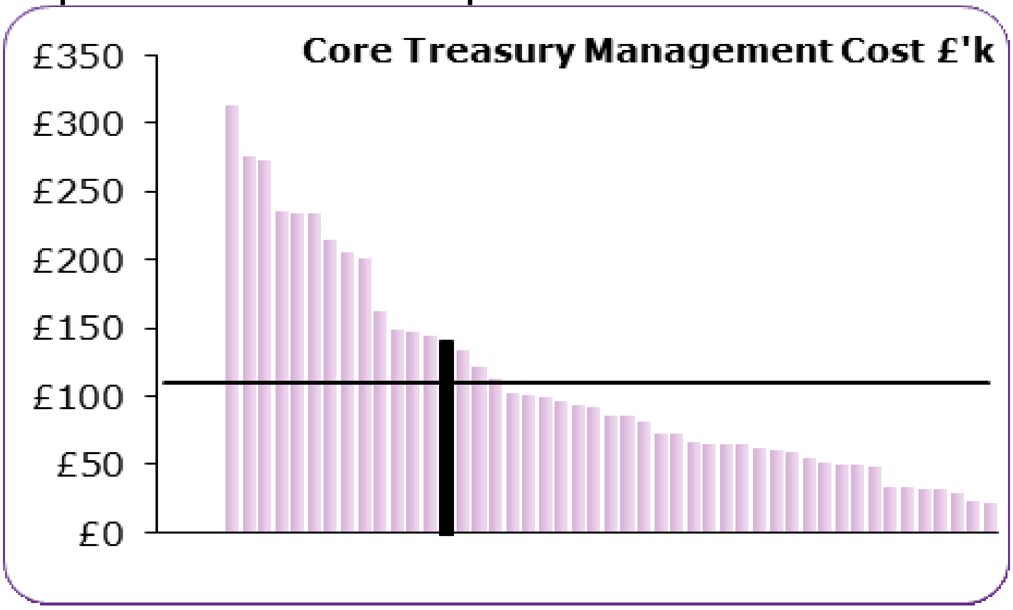
Table 1 – borrowing and investment levels

	31/03/13 £m	Rate	31/03/14 £m	Rate
Gross borrowing	172.4	4.15%	162.3	4.20%
Plus other long term liabilities*	2.5		2.0	
Total Debt	174.9		164.3	
Capital Financing Requirement (CFR)	252.5		248.4	
(Under)/Over Borrowing	(77.6)		(84.1)	
Less investments	55.7	1.46%	39.3	0.675%
Net borrowing	119.2		125.0	

*Embedded Leases (on balance sheet)

4.2 The graph below show the overall Medway Treasury Management cost of £142,100, compared to 50 other authorities participating in the CIPFA Treasury benchmarking. This graph demonstrates that Medway’s Treasury costs are current above the average cost of the costs incurred by the benchmarking group which stands at £110,400. Members will be aware that within the 2013/14 costs Medway Council had £30,100 of costs from the former fund manager, these costs will not be incurred in the future and if excluded from 2013/14 would have reduced our total costs down to £112,000.

Graph 1 – In-House Cost £000 per £m invested



5. The Strategy for 2013/14

5.1 The expectation for interest rates within the strategy for 2013/14 anticipated low but rising Bank Rate (starting in quarter 1 of 2015), and gradual rises in medium and longer term fixed borrowing rates during 2013/14. 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.

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 were on a rising trend during 2013 as markets anticipated the start of tapering of asset purchases by the US Fed. This duly started in December 2013 and the US FOMC (the Fed.), adopted a future course of monthly reductions of $10bn (from a starting position of $85bn), meaning that asset purchases were likely to stop by the end of 2014. However, volatility set in during the first quarter of 2014 as fears around emerging markets, various vulnerabilities in the Chinese economy, the increasing danger for the Eurozone to drop into a deflationary spiral, and the situation in the Ukraine, caused rates to dip down, reflecting a flight to quality into UK gilts.

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).

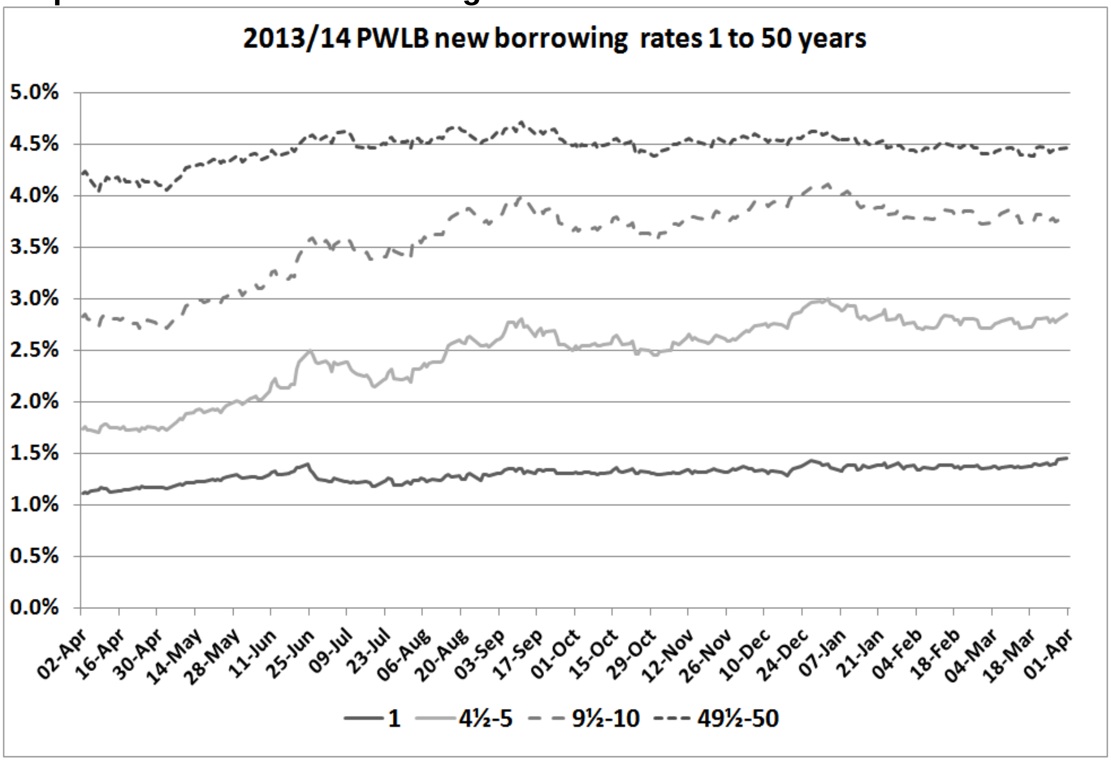
Table 2 Capital Financing Requirement

	31 March 2013 Actual £m	31 March 2014 Budget £m	31 March 2014 Actual £m
CFR General Fund (£m)	212,166	.209,770	209,021
CFR HRA (£m)	40.323	39,516	39,516
Total CFR	252,489	249,286	248,537

7. Borrowing rates in 2013/2014

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

Graph 2 - PWLB new Borrowing rates 2013-14



8. Borrowing Outturn for 2013/14

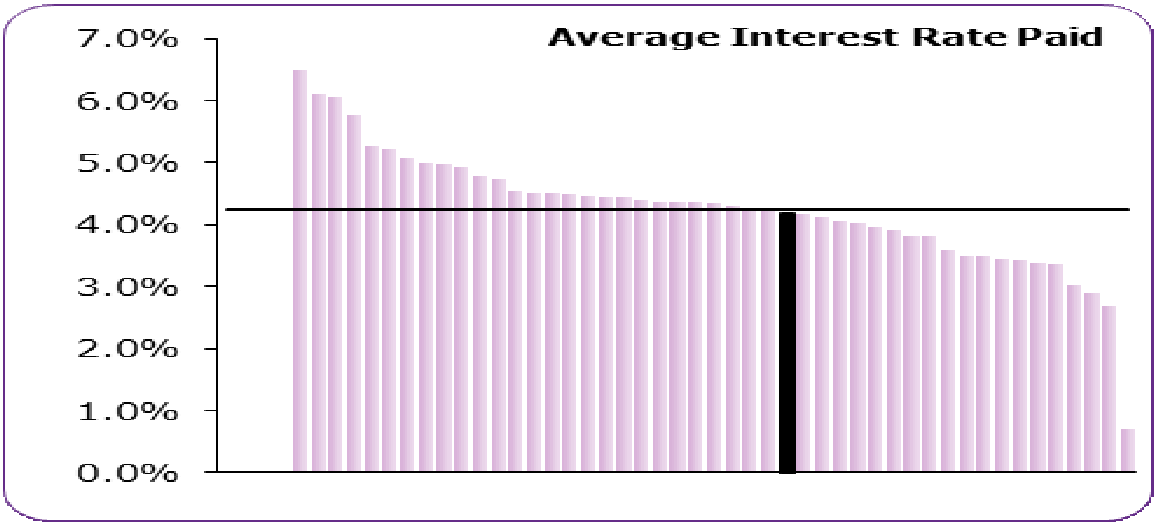
8.1 The borrowing strategy for the council confirmed the holding of £101.8 million in Lenders Options, Borrowers Options (LOBO) debt. These are debts that are subject to immediate repayment or variation of interest chargeable and the option to repay, on request from the lender on the review dates. However, 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 2013/14.

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 4.15% to 4.20% 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 3 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 3 Average interest paid on Debt (2013/14)



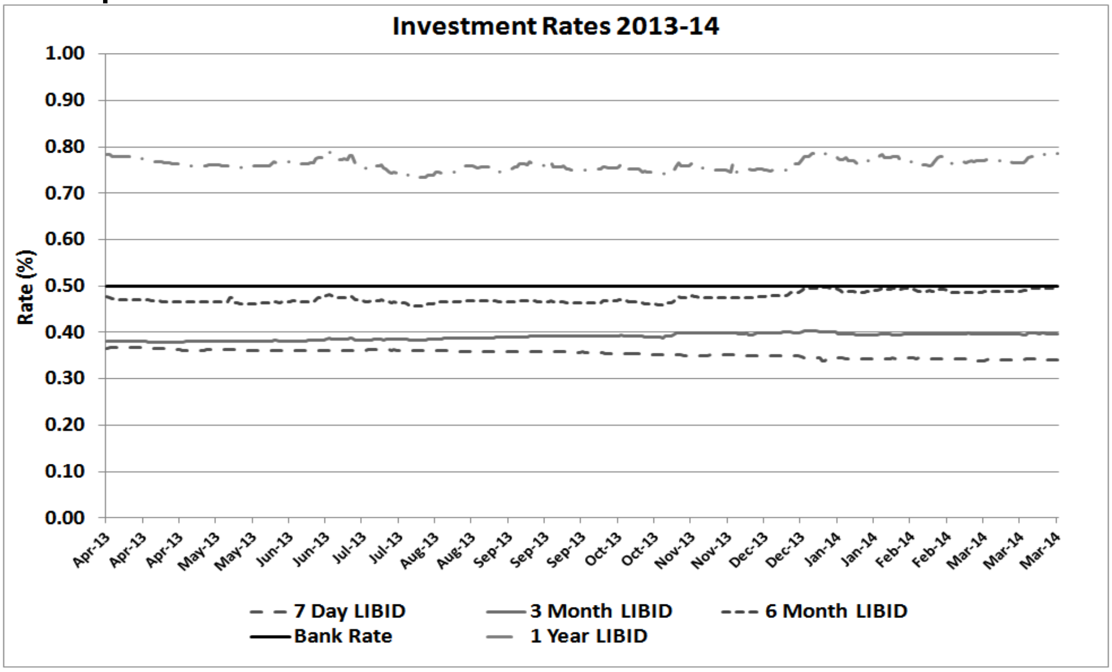
9. Debt Rescheduling

9.1 No debt restructuring was undertaken during 2013/14 and it is not envisaged that that there will be any opportunities where the debt restructuring would be economically viable in 2014/15.

10 Investment Rates in 2013/14

10.1 Bank Rate remained at its historic low of 0.5% throughout the year; it has now remained unchanged for five years. Market expectations as to the timing of the start of monetary tightening ended up unchanged at early 2015. The Funding for Lending Scheme resulted in deposit rates remaining depressed during the whole of the year, although the part of the scheme supporting provision of credit for mortgages came to an end in the first quarter of 2014.

Graph 4 – Investment rates 2013/14



11 Investment Outturn for 2013/2014

11.1 **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 21 February 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 Council also employed an external fund manager Investec and they had their own policy setting out their approach for choosing investment counterparties which was also approved at Council on the 21 February 2013. The 2013/14 Mid-Year Treasury review considered the performance of the external fund manager and agreed to remove all funds from them. As at 31 March 2014 no Council funds are being held by Investec.

11.2 **Internally Managed Investments** – The Council historically 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 historically also had investments managed externally by Investec, and the fund management agreement between the Council and the Fund Manager defined the limits for maximum weighting in gilts/bonds and maximum duration of the fund. Counterparty criteria and exposure limits are also pre-defined therein. As at the 31 March 2014 all funds have been removed from the external fund manager and are now being managed in-house.

11.4 **Investment performance for 2013/14 –** Detailed below is the result of the investment strategy undertaken by the Council.

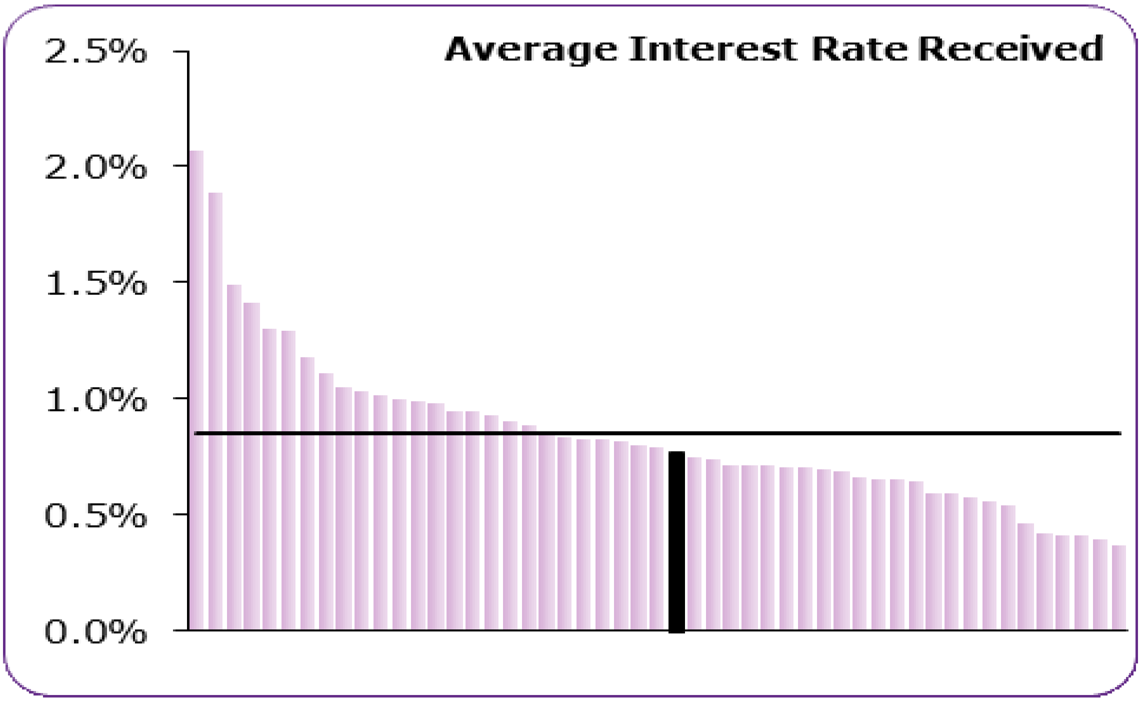
Table 3 Investment Performance 2013/14

	Average Investment	Rate of Return (gross of fees)
Internally Managed – Core Funds	£16.658m	1.65%
Internally Managed – Cash Flow Funds	£30.700m	0.68%
Overall Internally Managed Funds	£49.358m	1.02%
Externally Managed	£23.024m	0.22%

11.5 No institutions in which investments were made during 2013/2014 had any difficulty in repaying investments and interest in full during the year.

11.6 Graph 5 demonstrates that the average interest rate being earned on investments is marginally below the average at 0.78% with the average at 0.85%, however, it can be seen from table 3 above that the in-house team achieved 1.02% yield in 2013/14, whilst our then fund managers achieved an average yield of 0.22%, which pulled the whole average down to 0.78%. As members are aware we have withdrawn the investment portfolio from our fund managers resulting in all our funds now being managed by the in-house team.

Graph 5 Average Interest Rate Received

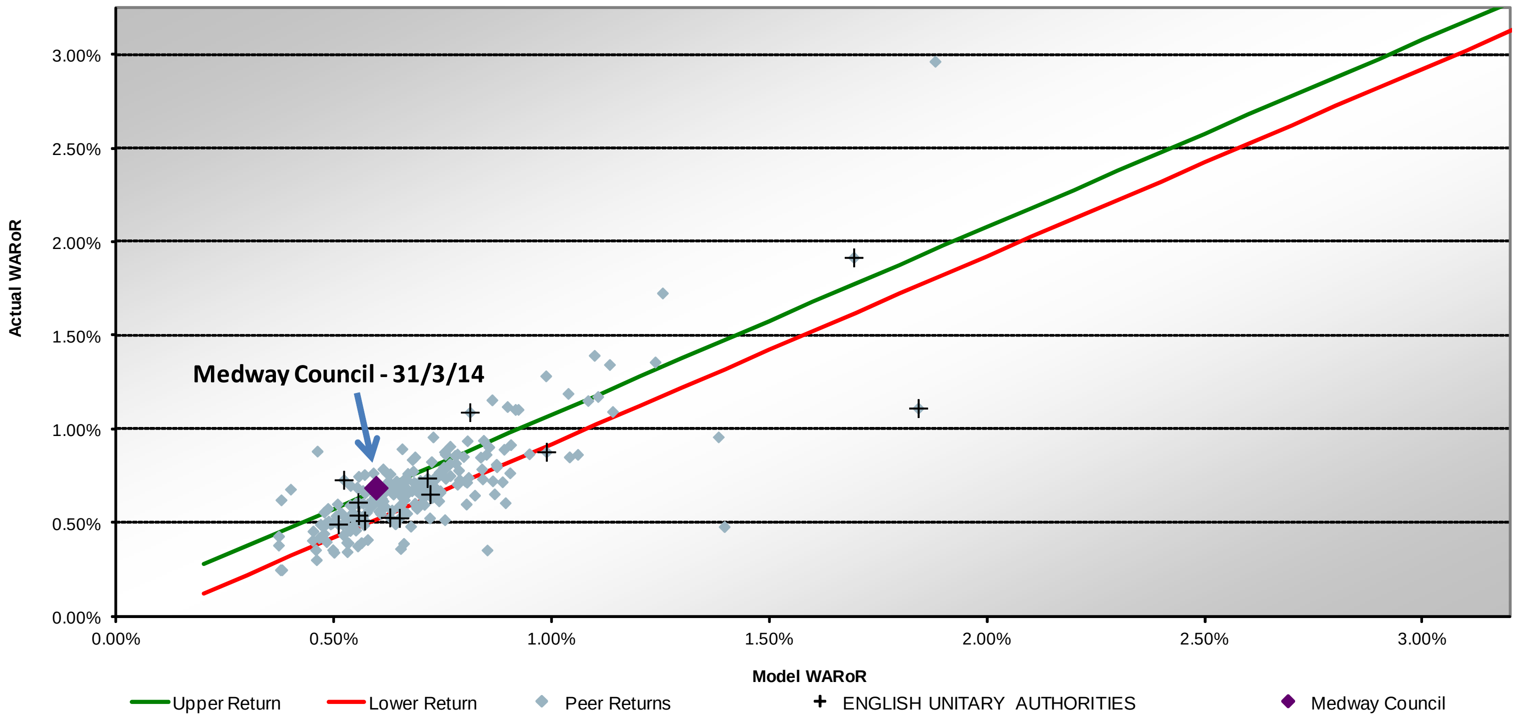


11.7 Although graph 5 does compare our return against the return achieved by other authorities it does not take account of the level of risk undertaken for each investment. Graph 6 below is produced by Capita Asset services (our external adviser) in its own benchmarking exercises which are built to compare return vs risk.

11.8 The "x" axis of the graph shows the "Model Weighted Average Rate of Return" (WARoR), this is easiest interpreted as the level of return we should expect for the level of risk that we are taking with our investment portfolio. This is then plotted against the "Actual Weighted Average Rate of Return" on the "y" scale, running diagonally upwards across the graph are two parallel lines, if a Council performance falls between these lines then they are deemed to be receiving a return as would be expected for their level of risk, below these two lines and performance is considered below that expected and above then the return being received is above that expected. As can be seen Medway's return is marginally "above" that expected for our level of risk.

11.9 The Capita benchmarking is run as a snap shot as at 31 March 2014 and not the performance for the whole of 2013-14 financial year.

Graph 6 Actual Returns against Model Returns



	Actual WARoR	Model WARoR	Variance	Lower Band	Upper Band	Performance
Medway	0.69%	0.60%	0.09%	0.52%	0.67%	Above

11.10 Although Medway is currently earning a yield "above" the level anticipated for the level of risk, it is anticipated that the yield will grow throughout 2014/15 as we have commenced lending to other Local Authorities for periods of up to 5 years. This will increase the yield whist not increasing the risk inherent within portfolio.

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, with the exception of one breach, where investments made in a counterparty exceeded the approved limit by £1.1m and was rectified the following day. Full details were reported to this committee as part of the Treasury mid-year review in November 2013. 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 Financial and Legal Implications

14.1 Overall the Interest and Financing budget made a surplus over its targeted budget of £0.043m. In light of the continued historically low bank rate which continued at 0.5% throughout 2013/14, the overall rate achieved for investments averaged 0.75% composed of 1.02% from the In-house team and 0.22% from the external fund manager Investec.

14.2 A breakdown of the Interest and Financing budget is shown below

Table 4 Interest and Finance Budget against spend

	Budget 2013/14 £000's	Actual 2013/14 £'000s	(Under)/ Overspend £'000s
Treasury Expenses	243	209	(34)
Interest Earned	(3,059)	(2,981)	78
Interest Paid	9,182	9,286	104
KCC Principle	1,739	1,739	0
MRP	8,317	8,246	(71)
Invest to Save recharges	(1,529)	(1,649)	(120)
Total	**14,893**	**14,850**	**(43)**

14.3 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.

14.3 Legal implications – For the financial year 2013/14 our investments were managed in compliance with the Codes of Practices, guidance and regulations made under the Local Government Act 2003

15 Recommendations

16.1 In accordance with the CIPFA Code of Practice, Cabinet is asked to note the content and recommend this report to the Audit Committee.

17. Suggested Reasons for Decision

17.1 In line with CIPFA's Code of Treasury Management Practice an annual report must be taken to Cabinet detailing the council's treasury management outturn within six months of the close of each financial year.

Appendices
Appendix 1 Prudential Indicators

Background papers
Capita Asset Services Template Report.

Lead officer contact

Mick Hayward, Chief Finance Officer, Gun Wharf, Tel (01634) 332220, e-mail mick.hayward@medway.gov.uk

Appendix 1

PRUDENTIAL and TREASURY INDICATORS

	2012/13	2013/14	2013/14
	£'000	£'000	£'000
	Actual	Estimate	Actual
Capital Expenditure			
Non - HRA	72,445	27,566	40,015
HRA	5,077	5,000	5,214
TOTAL	77,522	32,566	45,229
Ratio of financing costs to net revenue stream			
Non - HRA	3.76%	2.99%	4.41%
HRA	18.23%	17.94%	23.14%
Gross borrowing requirement			
brought forward 1 April	185,852	172,325	175,881
carried forward 31 March	175,881	162,224	166,132
in year borrowing requirement	-9,971	-10,101	-9,749
Actual External Debt	178,427	164,724	168,087
Capital Financing Requirement as at 31 March			
Non – HRA	212,164	209,770	209,021
HRA	40,323	39,516	39,516
TOTAL	252,487	249,286	248,537
HRA Limit on Indebtedness	45,846	45,846	45,846
Annual change in Cap. Financing Requirement			
Non – HRA	-1,258	-2,394	-3,143
HRA	-823	-807	-807
TOTAL	-2081	-3,201	-3,950

	2012/13 Limit £'000	2013/14 Limit £'000	2013/14 Breach?
Authorised Limit for external debt -			
borrowing	440,537	431,515	No Breach
other long term liabilities	4,400	4,400	No Breach
TOTAL	444,937	435,915	No Breach
Operational Boundary for external debt -			
borrowing	400,488	392,286	No Breach
other long term liabilities	4,000	4,000	No Breach
TOTAL	404,488	396,286	No Breach
HRA Limit on Debt	45,846	45,846	No Breach
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing / investments	100%	100%	No Breach
Upper limit for variable rate exposure			
Net principal re variable rate borrowing / investments	40%	40%	No Breach
Upper limit for total principal sums invested for over 364 days	£150,000	£150,000	No Breach
(per maturity date)			

Maturity structure of fixed rate borrowing during 2012/13	upper limit	lower limit	Breach ?
under 12 months	75%	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%	0%	No Breach