AGENDA ITEM 10

REPORT OF:	**DIRECTOR OF FINANCE**
TO:	**COUNCIL**
ON:	**7th November 2013**

TREASURY MANAGEMENT ANNUAL REPORT 2012-13 AND MID-YEAR REVIEW FOR 2013-14

1. PURPOSE OF THE REPORT

1.1 To advise Members of Treasury Management performance for 2012-13, and update Members with regard to the position to date in 2013-14.

2. RECOMMENDATIONS

2.1 The Council is recommended to note the Outturn position for 2012-13 and confirm that the current Treasury Management Strategy for 2013-14 remain unchanged.

3. BACKGROUND

3.1 In March 2012 the Council agreed a Treasury Management Strategy for 2012-13, and adopted CIPFA's 2011 Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes, and an updated Treasury Management Policy Statement.

3.2 In March 2013 the Council, and agreed a Treasury Management Strategy for 2013-14.

4. RATIONALE

4.1 The CIPFA Treasury Management Code requires the Council to approve a Treasury Management Strategy (including various Treasury Management indicators) before the start of each financial year, and to consider both the outturn after each year end, and the mid-year position in each current year. The Council has determined to combine the outturn and mid-year review into a single report.

5. KEY ISSUES

5.1 Treasury Priorities

The Council has operated within CIPFA and statutory guidance and requirements in respect of Treasury Management practice. The approved Treasury Management Policy Statement, and more detailed Treasury Management Practices, and each year's Annual Strategy, have all emphasised the importance of Security and Liquidity over Yield.

5.2 2012-13 Outturn

5.2.1 Strategy for the Year

The Treasury Management Strategy for 2012-13 was approved by Council on 5th March 2012.

With short-term interest rates expected to continue to be lower than long-term rates, it was, for another year, acknowledged that it may continue to be more cost effective to not borrow and reduce the level of investments instead. However it was recognised that long-term interest rates were expected to rise in the future, so the short- term savings would need to be balanced against potential longer term costs.

Long-term borrowing would be taken, therefore, if it became apparent that there was a risk of significantly increased interest rates, or if required to maintain cash flow balances.

Any balances over and above that required to maintain basic liquidity could be invested either in the medium term (out to a year) or in the longer term (over a year). Throughout, priority to be given to security of funds and liquidity (accessibility) over yield (or return).

The limits to investment by reference to amount, duration and credit rating were largely unchanged from those applying in previous years, with the addition of closer controls on foreign and any longer term investments.

5.2.2 Economic Review 2012-13

The overall global outlook stabilised, mainly due to central banks maintaining low interest rates and expansionary monetary policy for an extended period. Equity market assets recovered sharply, despite economic growth in G-7 nations being either muted or disappointing.

The **UK economy** alternated between shrinkage and growth, moving into an overall pattern of growth by the end of the financial year, particularly fuelled by a recovery in the services sector. A fall in sterling did not lead to significant export in exports, given demand weakness across the global economy, and did raise the price of imports, especially low margin goods such as food and energy. Inflationary pressures, though reducing, also contributed to a squeeze on household purchasing power as wage growth remained subdued.

The lack of growth and limited inflation persuaded the Bank of England to maintain the Bank Rate at 0.5% and continue its asset purchases ("Quantitative Easing"). The possibility of a rate cut was discussed, but was not implemented as the potential drawbacks outweighed the benefits. In the March Budget the Bank's policy was revised to include a 2% CPI inflation remit alongside the flexibility to commit to intermediate targets.

The resilience of the labour market, with the unemployment rate falling, was the main surprise given the challenging economic backdrop. Many of the gains in employment were through an increase in self-employment and part time working.
The Chancellor largely stuck to his fiscal plans with the austerity drive extending into 2018. The limited growth resulted in lower tax revenues, an increase in the

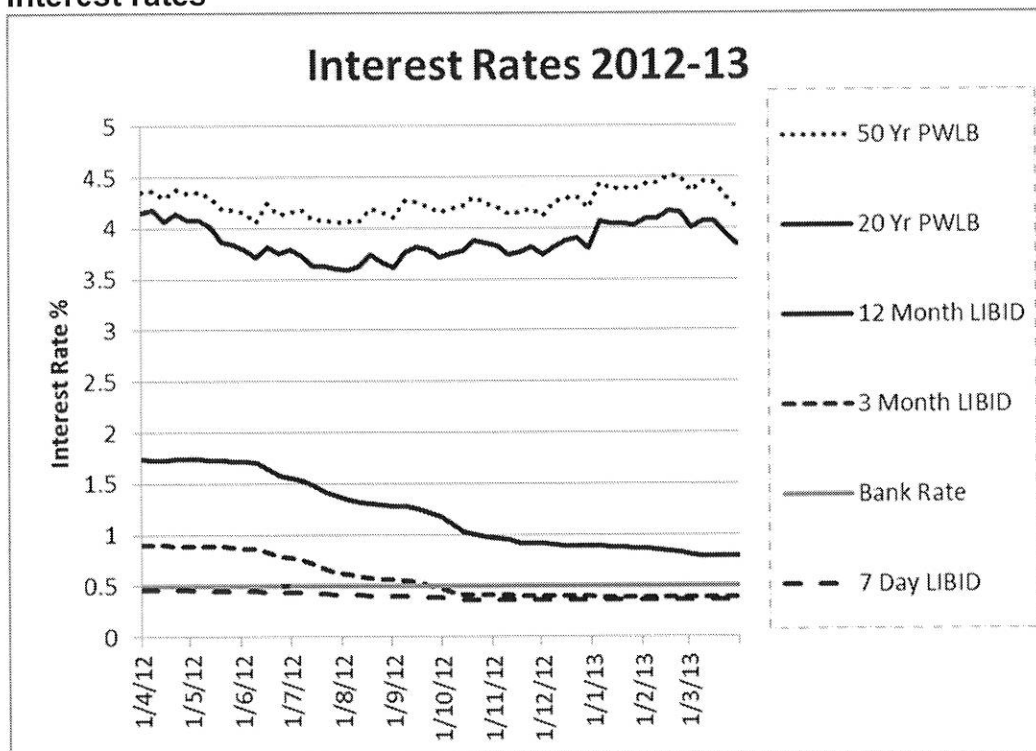
budget deficit, and an increase in projected borrowing. The coalition's target of a fall in debt as a percentage of GDP by 2015-16, was pushed into the future. It was not surprising that the UK's sovereign rating was downgraded by Moody's.

The Government's Funding for Lending (FLS) initiative began in August which gave banks access to cheaper funding on the basis that it would then result in them passing this advantage to the wider economy. There was an increased flow of credit to mortgagees, but lending to business did not improve as hoped for.

The **Eurozone** suffered further uncertainty after Italian and Spanish government borrowing costs rose sharply, Spain was forced to seek a bailout for its domestic banks, inconclusive Italian election results, and the Cyprus bailout (with its impact on many depositors). The ECB's declaration that it would do whatever it takes to stabilise the Eurozone and the proposals for the Outright Monetary Transactions (OMT) facility, bought time for further fiscal adjustments, so while growth was hindered in most economies, there was not a full blown market downturn

In the **United States** the Federal Reserve extended quantitative easing and shifted policy to focus on the jobless rate with a pledge to keep rates low until unemployment falls below 6.5%. The country's extended fiscal and debt ceiling negotiations remained unresolved.

Interest rates



Borrowing costs in respect of local authorities' capital financing are largely determined by PWLB rates, in turn set by reference to the cost of Government borrowing through gilts (government debt financing instruments). Gilt yields ended the year lower than the start in April, particularly at the short dated end, reflecting a range of factors: the Bank of England's continued purchases of gilts under QE; purchases by banks, insurance companies and pension funds driven by capital

requirements and the preference for safe harbour government bonds.

The Government's Funding for Lending Scheme impacted on potential investment returns, as there was a sharp drop in LIBID (London Interbank Bid Rate) over the year. This tracks the rates at which banks would be prepared to borrow from local government more effectively than LIBOR (London Interbank Offer Rate), though these also fell over the period.

5.2.3 Summary of Treasury Management transactions / performance

Debt and investment positions at the start and end of the year were as follows:

	31st Mar 2013 Principal	Rate/ Return	*Av Life yrs*	31st Mar 2012 Principal	Rate/ Return	*Av Life Yrs*
Fixed Rate Funding:						
- PWLB	£116.8m	4.53%	*23.6*	£99.6m	4.83%	*27.9*
- Market	£10.4m	4.50%	*41.7*	£10.4m	4.50%	*42.7*
	£127.2m			£110.0m		
Variable Rate Funding						
- PWLB	£0.0m			£0.0m		
- Market	£13.5m	6.28%	*18.2*	£13.5m	6.28%	*19.2*
	£13.5m			£13.5m		
Funds borrowed by BwDBC	**£140.7m**	**4.69%**	***24.3***	**£123.5m**	**4.96%**	***28.1***
Debt from PFI Arrangements	£74.5m			£27.1m		
Other Long Term Liabilities – Debt managed by LCC	£18.8m	Actual LCC 12-13 rate 2.4%		£19.6m	Actual LCC 11-12 rate 2.1%	
Total Debt	**£234.0m**			**£170.2m**		
Total Investments	**£31.6m**	0.49%		**£22.3m**	0.76%	

Borrowing Rates are NOT weighted for duration
Average Lives for PWLB/Money Market Loans only (excludes £0.4m irredeemable stock)
Investment Rates show return across the year

Other than the movements on that part of the Council's debt managed by LCC, the key changes to the Council's overall debt position across the year were:

(a) taking out four new PWLB loans, to a total value of £18m - of these loans,

£4m (@3.56%) and £5m (@3.06) were as maturity loans, and £4m (@ 1.94%) and £5m (@2.5%) as EIP (Equal Instalment of Principal) loans – this was partly offset by principal repayments of approaching £1m, and

(b) the recognition on the balance sheet of the impact of the new Witton and Blackburn Central High Schools (financed through Building Schools for the Future), which added around £47m to the Council's total nominal debt

The accounting adjustments recognising PFI assets and liabilities on the balance sheet are designed to show our effective long term control over the assets concerned, and the parallel "indebtedness" arising from financing the cost of them, but do not add to the "bottom line" met by the Council Tax payer.

No debt restructuring was undertaken in the year, as no opportunities for achieving material benefits from doing so were identified.

The take on of new PWLB loans still left the Council's debt more than £29 m less than its Capital Financing Requirement (outstanding indebtedness arising from the Capital Programme). Investment balances were, therefore, significantly lower than they would otherwise have been. This, combined with the still lower interest rates available, and the operation of cautious and short-term approach to investment, reduced the amount of interest earned on balances.

In summary, the outturn position in respect of interest costs and income is as follows:

Outturn 2011-12		Original Budget 2012-13	Outturn 2012-13
£000		£000	£000
6,346	Interest paid on borrowing	8,567	6,628
1,681	PFI Interest Paid	-	5,013
- 219	Interest receipts	- 236	- 161
6,666	Provision for debt repayment	7,324	7,129
125	Provision for debt repayment - PFI	-	722

Interest paid on borrowing in 2012-13 was around £1.9 m less than the Original Estimate, which had allowed for significant borrowing both late in 2011-12 and across 2012-13. As already noted, there was only limited new long term borrowing, with only part-year effect interest costs.

As with the required balance sheet adjustments, PFI interest charges did not add to the "bottom line" faced by the Council Taxpayer, as grants covered their cost.

The average investment balance across the year was around £38.2 m (£31.1 m in 2011-12). Balances tend to fall to their lowest point at the start and end of each year. The interest earned on balances in 2012-13 fell below £0.2 m (over £0.2 m in 2011-12) at an average rate of 0.49% (0.70% in 2011-12).

Interest rates have been low for several years, and the rates available from the limited range of institutions the Council can invest with have continued to fall, so overall investment income fell further in 2012-13. Funds have also been invested for shorter periods, and more often with the government's Debt Management Office, to lessen risk, also contributing to lower returns.

The position with regard to performance against Treasury and Prudential Indicators is summarised in the Appendix. There were no breaches of the Borrowing Limits, and the main element to highlight is that the outturn capital spend was £93.9 m (including PFI elements of £48.2 m), lower than the £115.6 m forecast. This in turn meant that the Capital Financing Requirement was, at £263.2 m, lower than the original 2012/13 forecast (£285.6 m).

5.2.4 Treasury Management consultancy

The Council contracted with Sterling Consultancy Services, under a new contract (after tendering) running from April 2012 to 31st March 2016. Sterling Consultancy Services was acquired by Arlingclose Limited in October 2012. Arlingclose continues to provide advice and information on the Council's investment and borrowing activities, although responsibility for final decision making remains with the Council and its officers

Sterling, and now Arlingclose, have, over the duration of their support to the Council, reviewed the Council's Treasury management procedures and activities. They have provided member training; ongoing officer training; support for and review of treasury decisions, reports and strategies; feedback on accounting for treasury activities; benchmarking with other authorities; guidance on borrowing and investment opportunities; forecasts of interest rates, and regular updates on credit ratings and other information on credit quality. The quality of the support provided has been of a high standard.

5.3 2013-14 Strategy Review

5.3.1 Original Strategy

The Treasury Management Strategy for 2013-14 was approved by Council on 4th March 2013. The Council adopted the latest (2011) edition of the CIPFA Code of Practice on Treasury Management in March 2012.

With continuing uncertainty as to future trends in interest rates, and over when it would become necessary to start borrowing, the Original Strategy for 2013/14 was again similar to that for previous years. Short-term interest rates were still expected to continue to be lower than long-term rates, so it was recognised that it may again be beneficial to limit the levels of borrowing taken. However the need to monitor long-term interest rates against the risks of future increases was also recognised.

Cash balances would need to be maintained for managing short-term Council cashflow, with any balances over and above that being invested either in the medium term (out to a year) or in the longer term (over a year). Throughout, priority was to be given to security of funds and liquidity (accessibility) over yield (or return).

The limits to investment by reference to amount, duration and credit rating remained cautious, though a wider range of investment vehicles was approved, to increase the scope for spreading risk, along with some relaxation of investment duration at the shorter end, again to increase flexibility.

5.3.2 Mid-year review for 2013-14

Update on the Economy

Growth: The UK economy showed some improvement, with consumer spending boosting growth across the first two quarters. Revisions by the Office of National Statistics to GDP back-data showed the UK avoided a double-dip recession in 2012, but that the downturn in 2008-09 was deeper than previously estimated.

Some positive signs for consumer confidence and household spending emerged. The deterioration in real earnings growth (i.e. earnings less inflation) slowed, which implied a slower erosion of purchasing power. Household savings rates remained high, which is unsurprising given the uncertain economic outlook, but appear to be on a downward track, suggesting spending was being driven by borrowing or lower savings. This raises questions about the sustainability of the recovery at these rates of growth.

Inflation: Latest Annual CPI was 2.8% (to July). Inflation has risen in line with expectations and is expected to remain close to this level throughout the autumn. Further out, inflation should fall back towards the 2% target as external price pressures fade and a revival in productivity growth curbs domestic cost pressures. Oil prices have climbed above $100/barrel on the back of political unrest in Egypt and the unresolved crisis in Syria.

Monetary Policy: There was no change to **UK monetary policy** stance with Bank Rate and asset purchase levels maintained. The main development came with Mark Carney's appointment as Governor and the implementation of forward guidance, the main element of which is to indicate that monetary tightening will be deferred until specified improvements in Unemployment Rates occur, though with a raft of caveats. The Bank projected that the probability of this happening would remain below 50% until 2016. The forward guidance and projections have recently had to be defended in the face of rising financial market expectations on the back of more encouraging economic data.

In the **USA**, the Federal Reserve indicated that, if the nascent economic recovery became established, there would be a reduction in its asset purchase programme (QE). This prompted extreme asset price volatility in bonds and equities, as investors sought to lock in gains, and, as a consequence, government bond yields spiked. Nonetheless, there is a growing expectation that the Federal Reserve will seek to taper asset purchases before the end of this calendar year.

Global: Whilst the outlook for the global economy appeared to have improved over the first half of calendar 2013/14, significant economic risks remain, particularly in China and the Eurozone. The Chinese banking system is facing tighter liquidity conditions as officials seek to slow down rampant credit growth, and, despite the time gained by the ECB to allow individual members and the Eurozone as a whole to reform their economies, the Eurozone debt crisis has not gone away. The region appears to be dragging itself out of recession, but up-coming events, such as the German general election, could limit progress towards a more balanced and stable regional economy. The US recovery appears to be in train, but political risks remain regarding the debt ceiling and the federal budget.

Current Outlook for Interest Rates

At the time of writing this report, the UK economic outlook appears to have improved. The projected path for growth has risen, but remains relatively subdued, with a distinct reliance on household consumption, which itself remains under pressure given the deterioration in real earnings growth, high unemployment and general low confidence. Other factors will continue to weigh on a domestic recovery, including on-going fiscal consolidation, muted business confidence and subdued foreign demand. While the economic recovery may pick up steam, forward guidance from the Bank of England suggests that monetary policy is unlikely to be tightened soon.

The Council's current projections for interest rates, based on the latest central forecast from our advisors Arlingclose is below:

Projected Interest Rates (%)	Bank Rate	3 month LIBID	1 Year LIBID	PWLB Certainty Rates		
				10 Yrs	20 Yrs	50 Yrs
Sept 13	0.50	0.40	0.85	3.30	4.00	4.20
Dec 13	0.50	0.45	0.90	3.35	4.05	4.25
Mar 14	0.50	0.45	0.95	3.40	4.10	4.30
June 14	0.50	0.50	0.95	3.45	4.15	4.35
Sept 14	0.50	0.55	0.95	3.50	4.20	4.40
Dec 14	0.50	0.55	1.00	3.55	4.25	4.45
Mar 15	0.50	0.55	1.05	3.60	4.30	4.50
June 15	0.50	0.55	1.10	3.65	4.35	4.55
Sept 15	0.50	0.60	1.15	3.70	4.45	4.60
Dec 15	0.50	0.65	1.20	3.80	4.55	4.65
Mar 16	0.50	0.70	1.25	3.90	4.65	4.75
June 16	0.50	0.80	1.30	4.10	4.85	4.85

Treasury Performance to Date

Thus far, cash balances have continued to hold up, and no new borrowing has been undertaken.

Investments have continued to be made with a limited range of banks, building societies and Money Market Funds, along with the Government's Debt Management Office, earning interest at low levels (on average below 0.4%).

Savings of around £0.3 m on the £7.6 m Original Estimate for external interest payments have already been reported through Corporate Monitoring, reflecting lower borrowing last year, and this year to date - a result of continuing with the policy of deferring borrowing while cash balances permit, along with some savings on LCC's transferred debt costs. Investment returns continue to be low, as initially projected (Original Estimate was under £0.15 m). Further savings may arise, depending upon market conditions and the resilience of the Council's cash flow.

It is anticipated that at least £20 m borrowing will be undertaken later in this year, as revenue cash balances reduce and there is a risk of increases to longer term interest rates. Though other borrowing options are under consideration, it is likely that most of any borrowing will be from the PWLB.

2013-14 Changes in debt outstanding

	End of March 2013		End of August 2013	
	£' 000	£ ' 000	£' 000	£ ' 000
TEMPORARY DEBT				
Less than 3 months	0		0	
Greater than 3 months	0		0	
		0		0
LONGER TERM DEBT				
Bonds	23,503		23,503	
Mortgages	17		17	
PWLB	116,746		115,965	
Stock & Annuities	404		404	
		140,670		139,889
Lancs County Council transferred debt		18,828		18,640
Recognition of Debt re PFI Arrangements		74,528		74,528
TOTAL DEBT		234,026		233,057
Less: Temporary Lending		31,650		42,000
		202,376		191,057

5.3.3 Updated Investment and Borrowing Strategy

There is no need, at this stage, to reframe the overall strategy set at the start of the year. It is proposed that criteria for investments and Treasury and Prudential Limits and Indicators also remain unchanged.

The Borrowing Strategy will also remain unchanged, with the Council looking to take new borrowing as determined by cash flow requirements and by reference to movements in long term interest rates.

The Council will again be able to take advantage of the Public Works Loan Board (PWLB) Certainty Rate, which is set 0.2 percentage points below standard PWLB rates (currently 1.0% above the UK government bond yield). The Council will seek to take borrowing across the remainder of the financial year, looking to balance the short term risks of carrying excessive cash against the longer term risks of PWLB rates continuing to move upwards.

5.4 Risk Management

The Council's primary objectives for the management of its investments are to give priority to the security and liquidity of its funds before seeking the best rate of return. The majority of its surplus cash is therefore held as short-term investments with the UK Government, highly rated banks and pooled funds. In addition, the Council holds some investments that entail a slightly higher level of risk, including callable deposits (where there is a risk that changing interest rates may mean that the loan does not run to full term) and unrated building society deposits (where risks have been mitigated by limiting the amount and duration of exposure).

The Council's primary objective for the management of its debt is to ensure its long-term affordability. The majority of its loans (£116 m) have been borrowed from the Public Works Loan Board at long-term fixed rates of interest.

The other significant element of the Council's debt is £23.5 m of "lender's option, borrower's option" (LOBO) loans with initially fixed (and initially low) rates of interest. Under these instruments the Lender can, at certain times, exercise an option to increase the rate payable on the debt, and the Borrower has the choice then to either accept the proposed increase or repay the whole loan (which would mean, effectively, having to live with whatever the market conditions for interest rates were at that point.) This exposes the Council to some risk of rising long-term interest rates, but that is mitigated by the fact that £10 m of this debt (forming a large part of the lowest interest rate elements) can only be "called" once in every five years. Recent estimates based on the current projected future interest rates, suggest LOBOs are unlikely to be called in the next 5 years (assuming no extraneous influences).

The combination of short duration investments and long duration debt exposes the Council to the risk of falling investment income during periods of low interest rates. Both longer-term investments and any variable rate instruments would hedge against that risk, though the Council currently holds neither of these. However this risk is viewed as of lower priority compared to the requirements of optimising the security and liquidity of investments.

6. POLICY IMPLICATIONS

None

7. FINANCIAL IMPLICATIONS

The financial implications arising from the 2012-13 Treasury Outturn and latest position for 2013-14 have been incorporated into Corporate Budget Monitoring Reports in 2013-14.

8. LEGAL IMPLICATIONS

Under the Local Government Act 2003, local authorities determine locally their levels of capital investment and associated borrowing. The Prudential Code has been developed to support local authorities in taking these decisions, and the Council is required by Regulation to have regard to the Code when carrying out its duties under Part 1 of the Local Government Act 2003.

The Department for Communities and Local Government has issued Guidance on Local Government Investments, under the Local Government Act 2003, effective from 1st April 2010. Under this, authorities should manage their investments within an approved strategy, setting out what categories of investment they will use and how they assess and manage the risk of loss of investments.

9. RESOURCE IMPLICATIONS

None as a direct consequence of this report.

10. EQUALITY IMPLICATIONS

None as a direct consequence of this report.

11. CONSULTATIONS

None.

Chief Officer/Member	Elizabeth Hall, Director of Finance – Ext 5482
Contact Officer:	Jeanette Moister, Finance Manager – Ext. 5702 Ron Turvey, Deputy Finance Manager – Ext. 5303
Date:	9th September 2013
Background Papers:	Treasury Management strategies for 2012-13 and 2013-14 approved at Council 5th March 2012 and 4th March 2013 respectively

Performance against Treasury and Prudential Indicators 2012-13 (as approved by Council 5th March 2012) **Appendix 1**

No.	Indicator	As approved March 12	Current Monitoring up to March	Commentary
1	Local Authority has adopted CIPFA Treasury Management Code of Practice	latest edition of CIPFA TM Code of Practice adopted March 2012		
	PRUDENTIAL INDICATORS			
2	Estimated Capital Expenditure 2012/13	£115.6 million (includes projected impact of recognition of new PFI/Lease assets)	**£93,936,468** 81% of original programme	**Including incl £48.164 M for Witton/Bbn Central High BSF PFI schemes**
3	Estimated total Capital Financing Requirement at end of 2012/13	£285.6 million (incl. LCC element £18.8 M and accumulated PFI / Lease element £76.7 M)		
4	Estimated incremental impact of capital investment decisions on Council Tax 2012/13	£1.03		
5	Estimated ratio of financing costs to net revenue stream 2012/13	11.55%		

6 Outturn External Debt Prudential Indicators 2012/13

As approved March 12	£M	Current Monitoring (**limits unchanged**) actual borrowing to date	£M	Commentary
LCC Debt	18.8	LCC Debt	**18.8**	**LCC debt falls during year**
PFI elements (no lease)	76.7	PFI elements	**74.5**	**incl prov'nl BSF Schools, less MRP**
remaining elements	196.1	Blackburn with Darwen	**140.7**	
Operational Borrowing Limit	291.6 }	total	**234.0**	
Authorised Borrowing Limit	301.6 }			

TREASURY

No.	Indicator	As approved March 12	Current Monitoring up to March	Commentary
7	Variable Interest Rate Exposure 2012/13	£36.5 million	**limits unchanged**; actual exposure to date £M **-18**	**limit not breached during year**
8	Fixed Interest Rate Exposure 2012/13	£192.7 million	**limits unchanged**; actual exposure to date £M **154**	**limit not breached during year**

9 Prudential limits for maturity structure of borrowing 2012/13 — **limits not breached in year**

Lower Limit	Upper Limit	Period (Years)	Actual Maturity structure to date:	£M	%	Commentary
0	30%	under 12 months	under 12 months	14.0	10.0%	short term borrowing
0	15%	1-2 years	1-2 years	0.9	0.6%	
0	30%	2-5 years	2-5 years	22.9	16.3%	
0	30%	5-10 years	5-10 years	3.4	2.4%	
		additional	*10-20 years*	*37.7*	*26.8%*	
		breakdown of	*20-30 years*	*14.0*	*10.0%*	
		age of debt	*30-40 years*	*0.0*	*0.0%*	
		(not a formal	*40-50 years*	*47.4*	*33.7%*	
		Prud. Indicator)	*over 50 years*	*0.4*	*0.3%*	
25%	95%	over 10 years	over 10 years	99.5	70.7%	
				140.7	100.0%	

No.	Indicator	As approved March 12	Current Monitoring up to March
10	Total Investments for Longer than 364 days	£7 million	**no long term investments made**