Annual Treasury Management Review 2013/14

1 *Introduction*

1.1 The Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of 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).

1.2 During 2013/14 the minimum reporting requirements were as follows:

- an annual treasury strategy in advance of the year (Council 20 February 2013)
- a mid year treasury update report (Scrutiny Panel 10 December 2013)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

1.3 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.

1.4 The Council confirms that it has complied with the requirement under the Code to give prior scrutiny to the annual treasury strategy by the Scrutiny Panel before it was reported to the full Council.

1.5 This report summarises:

- Capital financing activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- The actual prudential and treasury indicators;
- The overall treasury position;
- The Treasury Management Strategy for 2013/14;
- The economy and interest rates;
- Borrowing activity; and
- Investment activity.

2 *Capital expenditure and financing 2013/14*

2.1 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 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.

2.2 The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

	2012/13 Actual £'000	2013/14 Estimate £'000	2013/14 Actual £'000
Non-HRA capital expenditure	8,735	7,940	12,797
HRA capital expenditure	7,112	11,360	10,076
Total capital expenditure	15,847	19,300	22,873
Resourced by:			
· Capital receipts	875	5,196	6,836
· Capital grants	3,836	3,101	5,045
· Capital reserves	6,268	7,723	5,737
· Finance Leases	2,359	0	1,057
· Revenue	1,540	3,216	3,185
New borrowing requirement	969	64	1,013

3 The Council's overall borrowing need

3.1 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. It represents the 2013/14 new borrowing requirement (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

3.2 Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the Capital Programme, the Accountancy team 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.

3.3 The Council's (non HRA) underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision (MRP), to reduce the opening balance of the CFR. This is effectively a repayment of the non-Housing Revenue Account (HRA) borrowing need (there is no statutory requirement to reduce the HRA 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).

3.4 The Council's 2013/14 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report for 2013/14 on 20 February 2013.

3.5 The Council's CFR for the year is shown below, and represents a key prudential indicator. It includes leasing schemes on the balance sheet, which increase the Council's borrowing need. No borrowing is actually required against these schemes as a borrowing facility is included in the contract.

	31-Mar-13	31-Mar-14	31-Mar-14
	Actual	Budget	Actual
CFR	£'000	£'000	£'000
Opening balance	148,714	154,368	151,269
Add unfinanced capital expenditure (as above)	969	64	1,013
Add on-balance sheet leasing schemes	2,359	0	1,057
Less MRP/VRP	657	708	658
Less finance lease repayments	116	0	451
Closing balance	151,269	153,724	152,230

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

3.7 In order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2013/14. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31-Mar-13	31-Mar-14	31-Mar-14
	Actual	Budget	Actual
	£'000	£'000	£'000
Gross borrowing position	136,094	136,094	136,094
CFR	151,269	153,724	152,230

3.8 The **Authorised Limit** is the 'affordable borrowing limit' required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2013/14 the Council has maintained gross borrowing within its authorised limit.

3.9 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.

3.10 The **actual financing costs as a proportion of net revenue stream** 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.

	2012/13	2013/14
	£'000	£'000
Authorised limit	169,350	169,124
Maximum gross borrowing position	136,094	136,094
Operational boundary	141,390	142,740
Average gross borrowing position	136,094	136,094
Financing costs as a proportion of net revenue stream	6.77%	9.11%

4 *Treasury position as at 31 March 2014*

4.1 The Council's debt and investment position is organised to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting (as detailed in the introduction), and through officer activity detailed in the Council's Treasury Management Practices. At the beginning and the end of 2013/14 the Council's treasury position (excluding borrowing by finance leases) was as follows:

	31 March 2013 Principal	Rate/ Return	31 March 2014 Principal	Rate/ Return
	£'000	%	£'000	%
Fixed rate funding:				
PWLB	101,594	3.80%	101,594	3.80%
LOBO	14,500	4.04%	14,500	4.04%
Stock Issue	20,000	8.79%	20,000	8.79%
Total debt	**136,094**	**4.56%**	**136,094**	**4.56%**
CFR	151,269		152,230	
Over/ (under) borrowing	(15,175)		(16,136)	
Investments:				
- In house (excl. impaired)	21,676	0.63%	34,744	0.49%
Total investments	**21,676**	**0.63%**	**34,744**	**0.49%**

4.2 The maturity structure of the debt portfolio was as follows:

	31-Mar-13	31-Mar-14
	Actual	Actual
	£'000	£'000
Under 12 months	10,500	10,500
12 months and within 24 months	0	4,000
24 months and within 5 years	4,000	0
5 years and within 10 years	20,000	20,000
10 years and within 20 years	7,200	9,200
20 years and within 30 years	23,000	28,600
30 years and within 40 years	41,000	34,994
40 years and within 50 years	30,394	28,800
	136,094	**136,094**

4.3 All investments were for a period of less than one year, and there was not any exposure to variable rates of interest.

4.4 The outturn position for the Central Loans and Investment Account (CLIA) is shown below. This shows a favourable variance of £223k.

CLIA		Budget £'000	Actual £'000	Variance £'000
Total Interest Paid		6,616	6,534	(82)
	Less: HRA recharge	(5,606)	(5,606)	(0)
Total less HRA		**1,010**	**928**	**(82)**
Total Investments		(109)	(258)	(149)
	Less: Item 8 credit	20	28	8
Total less HRA		**(89)**	**(230)**	**(141)**
Total CLIA		**921**	**698**	**(223)**

4.5 The CLIA comprises the Council's borrowing costs and investment income. It is difficult to predict and can be affected by several factors. The majority of the Council's debt is on fixed rates reflecting the longer-term nature of the borrowing decisions. Investments are generally made for shorter periods, making returns more variable. This mix is generally more beneficial when interest rates are high or increasing. It is important to add that the exposure to interest rate movements is regularly monitored to minimise risks to changes in returns. There are a number of reasons that have contributed to the above variances:

- The Annual Treasury Strategy attempts to minimise the impact of reduced investment income through deferral of new borrowing in favour of disinvestment, which is known as 'internal borrowing'. This has resulted in budgeted interest costs for new borrowing being avoided during the year.
- The variance against interest income is as a result of a higher level of funds than was envisaged being available for investment, and the rates against some investments being higher than the recommended budgeted figure.

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) with similar 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 continue to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk, by 'borrowing internally'.

5.3 The investment policy reflected the Council's low appetite for risk, emphasising the priorities of security and liquidity over that of yield. The main features of the policy were that the Council will only invest with institutions with the highest credit ratings, taking into account the views of all credit rating agencies, and always using the lowest rating from all the agencies (i.e. the lowest common denominator). Investment decisions also took into account other market data including Capita Asset Services' creditworthiness service, which combines data from credit rating agencies with credit default swaps, sovereign ratings, rating outlooks and bank share prices.

5.4 The Council would only use approved counterparties from countries with the highest credit rating of 'AAA', together with those from the UK, including the institutions that have been nationalised or part-nationalised, or those that are covered by the UK Government's support package. The Council would also continue to avoid longer term deals while investment rates are at such low levels.

6 The economy and interest rates

6.1 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 was later 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 the year. 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 2012, 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.

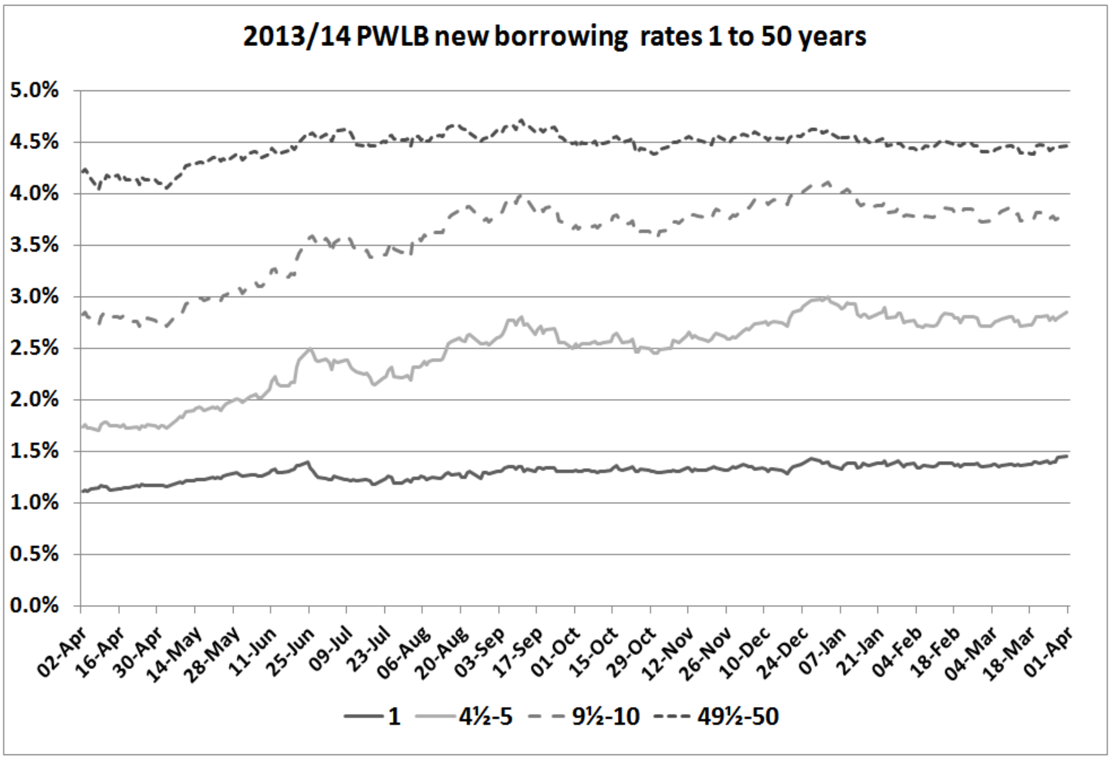
6.2 Gilt yields were on a sharply rising trend during 2013 but volatility returned in the first quarter of 2014 as various fears sparked a flight to quality. The Funding for Lending Scheme, announced in July 2012, resulted in a flood of cheap credit being made available to banks which then resulted in 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.

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

6.4 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.

7 Borrowing

7.1 The table for PWLB borrowing rates below shows, for a selection of maturity periods, the movement in rates during the course of the financial year.



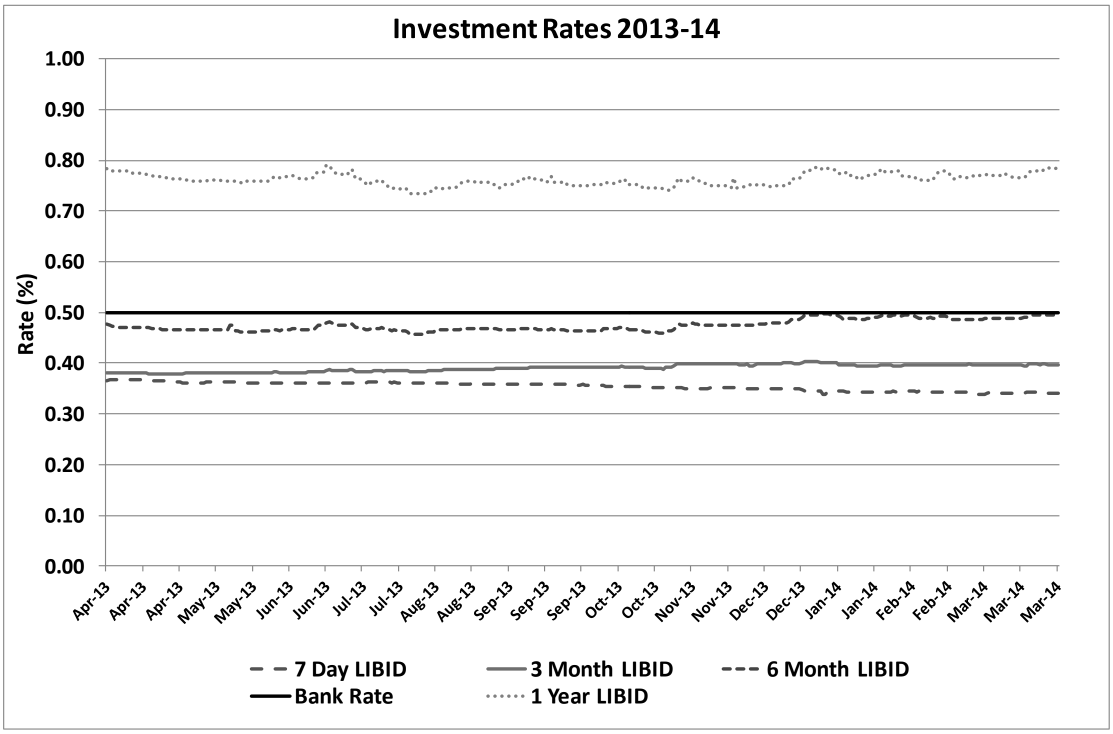
7.2 The Council's total debt outstanding at 31 March 2014 was £136.1m, which was unchanged from the figure at the end of the previous financial year. This means that the average interest rate on the Council's debt at the end of the year has remained at 4.56%.

7.3 The Council's approach during the year was to use cash balances to finance new capital expenditure 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. No new short-term borrowing for cash flow purposes was undertaken during 2013/14.

7.4 No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

8 Investments

8.1 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 almost unchanged at around the end of 2014 / start of 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.



8.2 The Council manages its investments in-house, and its cash balances comprise revenue and capital resources and cash flow monies. The Council's investment policy is governed by CLG guidance, which was implemented in the annual investment strategy approved by the Council on 20 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.)

8.3 The investment activity during the year conformed to the approved strategy, the Council had no liquidity difficulties, and no institutions in which investments were made during 2013/14 had any difficulty in repaying investments and interest in full.

8.4 The Council's internally managed funds earned an average rate of return of 0.49%. The comparable performance indicator is the average 7-day LIBID rate (London Interbank Bid Rate – the rate charged by one bank to another for a deposit) (uncompounded), which was 0.354%.

	2012/13	2013/14
Details	%	%
Temporary Investments	0.71	0.56
Overnight and Deposit Account	0.64	0.43
Total	**0.68**	**0.49**
Benchmark (7 day LIBID)	0.39	0.35
Return as a % of the Benchmark	172.6%	138.4%

8.5 The Council had temporary investments totalling £34.7m outstanding as at 31 March 2014. Of this, £22.5m relates to fixed-term deposits that are due to mature during 2014/15, £9.7m is held in a 'AAA' rated money market fund, and the remaining £2.5m is held in a 35 day notice account. All of the deposits are with counterparties within 'AAA' sovereign rated countries or those from the UK, and there is no direct exposure to the Eurozone.

9 Icelandic bank defaults

9.1 In October 2008, a number of Icelandic banks collapsed. The Council had £4 million deposited with one of these institutions, with maturity dates and interest rates as follows:

Bank	Date Invested	Maturity Date	Principal £'000	Interest Rate %	Impairment £'000	Distributions £'000	Carrying Amount £'000
Landsbanki Islands	02/09/2008	02/12/2008	3,000	5.82	(260)	(1,592)	1,148
Landsbanki Islands	10/09/2008	10/12/2008	1,000	5.80	(87)	(530)	383
			4,000		(347)	(2,122)	1,531

9.2 The Council charged a net impairment of £872k to the General Fund in 2010/11. This figure was calculated by discounting the assumed cash flows at the effective interest rate of the original deposits in order to recognise the anticipated loss of interest to the Council until monies were recovered. Based on revised guidance this was reduced to £347k in the 2012/13 accounts.

9.3 Following the Icelandic Supreme Court decision to grant UK local authorities priority status, the winding up board made distributions to creditors in a basket of currencies in February, May and October 2012, and September 2013.

9.4 In February 2014 the Council sold its claims against the insolvent estate of Icelandic Bank LBI through a competitive auction process, with the proceeds of the sale being paid in Pounds Sterling. This means that Colchester Borough Council is no longer a creditor of LBI.

Bank	Carrying Amount £'000	Proceeds of Sale £'000	Surplus to Revenue £'000
Landsbanki Islands	1,148	(1,185)	(37)
Landsbanki Islands	383	(395)	(12)
	1,531	(1,580)	(49)