**The Highland Council**

**The Highland Council – 24 October 2013**

| | |
|---|---|
| Agenda Item | 11 |
| Report No | HC/44/13 |

# Annual Treasury Management Report – 2012/13

**Report by Director of Finance**


**Summary**

The attached Annual Treasury Management Report for 2012/13 is prepared in compliance with the Chartered Institute of Public Finance and Accountancy's (CIPFA) revised Code of Practice on Treasury Management in Local Authorities. The revised Code was adopted by the Council on 3 March 2010.

The report highlights the Council's treasury management activities undertaken, provides a commentary on the year, and compares activity to the expected activities contained in the annual Treasury Strategy Statement and Investment Statement which was approved by the Council on 1 March 2012.

In compliance with the Code, the attached Annual Treasury Management Report - 2012/13 was submitted to the Finance, Housing and Resources Committee on 9 October 2013 for scrutiny, and is now submitted to the Council for approval.

In addition, the Prudential Code requires the Council to report the actual prudential indicators after the financial year end and these are contained in this report.


## 1. Background

1.1 In December 2001, CIPFA published a Revised Code of Practice on Treasury Management (the Code) with a suggested implementation date of 1 April 2002. The Council adopted the revised Code in February 2002 and fully complies with its requirements.

1.2 The primary requirements of the Code are the:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the Council of an Annual Strategy Report for the year ahead, a mid–year report and an **Annual Review Report** of the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management policies to a specific named body, which in this Council is the Finance,

Housing and Resources Committee.

1.3 Treasury Management is defined as:

"*The management of the local authority's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities and the pursuit of optimum performance consistent with those risks*".

1.4 This report sets out:

- An overview of the Strategy agreed for 2012/13 (section 2)
- A recap on the economy and interest rates position for the year (section 3)
- Performance measurement for the year (section 4 and 5)
- The Council's treasury position at 31 March 2013 compared to the previous financial year (section 5)
- A summary of treasury decisions taken and effects on the revenue budget (section 6)
- A commentary on performance and risk (section 7)
- A review of compliance with the Council's procedures and Prudential Indicators (section 8)

## 2. The Strategy Agreed for 2012/13

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

2.2 In this scenario, the treasury strategy was to avoid locking into longer term deals while investment rates are down at historically low levels unless attractive rates are available with counterparties of particularly high creditworthiness.

2.3 In respect of borrowing, the advantages of short term savings achieved by avoiding external borrowing were to be balanced against the potential for incurring additional long term extra costs by delaying unavoidable new external borrowing costs until later years when Public Works Loans Board (PWLB) long term rates are forecast to be significantly higher. The general approach was that the interest rate market would be monitored and a pragmatic approach taken to changing circumstances with any decision being reported to the Finance, Housing and Resources Committee at the next available opportunity.

2.4 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.

2.5 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 and into gilts resumed. This was a volatile year for PWLB rates, driven by events in the Eurozone which oscillated between crises and remedies.

## 3. The economy and interest rates during the year

3.1 As noted above, the original expectation for 2012/13 was that Bank Base Rate would not rise in 2012/13 and for it to start gently rising from quarter 4 of 2013/14. This forecast rise has now been pushed back, with the most recent Bank of England Governor's statement resulting in a market view that rate rises may not be likely before 2015 - 2016. Economic growth (GDP) in the UK was virtually flat during 2012/13, due to the UK austerity programme, subdued domestic consumer expenditure, a lack of rebalancing of the UK economy to exporting, and weak growth in our biggest export market – the European Union (EU). This weak UK growth resulted in the Monetary Policy Committee increasing quantitative easing by £50bn in July to a total of £375bn. The Bank Base Rate, therefore, ended the year unchanged at 0.5%, while CPI inflation has remained stubbornly high and above the 2% target, starting the year at 3.0% and still being at 2.8% in March; however, it is forecast to fall to 2% in three years time. The EU sovereign debt crisis was an on-going saga during the year, with an eventual very protracted agreement of a second bailout for Greece in December followed by a second major crisis, this time over Cyprus, towards the end of the year.

3.2 Gilt yields oscillated during the year as events in the on-going 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 low levels.

3.3 The Funding for Lending Scheme, announced in July, has resulted in a flood of cheap credit being made available to banks and this has resulted in money market investment rates falling drastically 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.

3.4 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 in March.

3.5 A summary of the interest rate movements throughout 2012/13 is provided in the Table below. Bank rate remained at its historic low of 0.5% throughout the year; it has now remained unchanged for four years.

| | Bank rate (%) | LIBOR (%)* | | | PWLB (%) | | |
|---|---|---|---|---|---|---|---|
| | | 3 mth | 6 mth | 12 mth | 5 yr | 12.5 yr | 22.5 yr |
| Mar 2012 | 0.50 | 1.03 | 1.35 | 1.86 | 2.18 | 3.65 | 4.27 |
| Jun 2012 | 0.50 | 0.90 | 1.18 | 1.68 | 1.95 | 3.23 | 3.93 |
| Sep 2012 | 0.50 | 0.60 | 0.84 | 1.30 | 1.77 | 3.06 | 3.89 |
| Dec 2012 | 0.50 | 0.52 | 0.67 | 1.01 | 1.99 | 3.23 | 3.97 |
| Mar 2013 | 0.50 | 0.51 | 0.60 | 0.91 | 1.87 | 3.29 | 4.00 |

* LIBOR – London Inter-bank Offered Rate

## 4. Performance measurement

4.1 Whilst investment performance criteria have been well developed, the traditional average portfolio rate of interest remains the principal debt performance indicator (as incorporated in the Table at Section 5.1 below).

## 5. The Council's treasury position at the year end

5.1 The treasury position at the 31 March 2013 compared with the previous year is detailed in the table below.

| | 31 March 2013 | | 31 March 2012 | | Year on Year | |
|---|---|---|---|---|---|---|
| | Balance £m | Avg. Rate (%) | Balance £m | Avg. Rate (%) | Balance £m | Avg. Rate (%) |
| **Debt** | | | | | | |
| - Fixed Interest Rate | 592.8 | 4.91 | 557.5 | 4.90 | +35.3 | +0.01 |
| - Variable Interest Rate | 92.3 | 5.01 | 101.1 | 5.01 | -8.8 | - |
| **Total Debt** | **685.1** | **4.93** | **658.6** | **4.91** | **+26.5** | +0.02 |
| **Investments** | | | | | | |
| - Fixed Interest Rate | 19.2 | 0.58 | 18.7 | 1.20 | +0.5 | -0.62 |
| - Variable Interest Rate | 56.6 | 0.51 | 51.2 | 0.63 | +5.4 | -0.12 |
| **Total Investments** | **75.8** | **0.53** | **69.9** | **0.78** | **+5.9** | **-0.25** |
| **Debt net of investments** | **609.3** | | **588.7** | | | |

The figures highlight a marginal increase in the average interest rate on external debt borrowings from 4.91% at March 2012 to 4.93% at March 2013. This was due to the Council replacing low rate short/medium maturities with longer term borrowing due to PWLB rates being at historically low levels. The investment return for 2012/13 was down on the previous year as a result of a fall in rates including those for fixed term longer duration deposits; this fall in deposit rates in the second half of the year was largely as a result of the Funding for Lending Scheme, whereby banks had access to relatively cheap finance through quantitative easing, and therefore the rates on offer to depositers dropped.

## 6. Treasury decisions taken and revenue effects

### 6.1 Borrowing

6.1.1 The actual net capital expenditure compared to the net capital expenditure in the Treasury Strategy 2012/13 is below. Reasons for variations in Service and project capital expenditure for the year have already been reported to Strategic Committees as part of the 2012/13 out-turn capital monitoring reports.

| **Net capital expenditure** | **Per Treasury Strategy 2012/13** | **Actual 2012/13** | **Variance** |
|---|---|---|---|
| | **£m** | **£m** | **£m** |
| General Fund | 53.2 | 32.8 | -20.4 |
| HRA | 18.9 | 21.7 | +2.8 |

The reason for the variance in General Fund net capital expenditure, was a combination of some capital programme slippage, plus additional unplanned Scottish Government grant funding of £11m which reduced the borrowing requirement in year, this was a one off adjustment which will be rebalanced in 2013/14

The reason for the variance in HRA net capital expenditure was primarily due to acceleration of elements of the core Scottish Housing Quality Standard (SHQS) and New Build Housing programmes.

Details of gross capital for the year, against the estimated position, is summarised in the table at **appendix A**.

After accounting for capital grant income, the estimated borrowing requirement (net of instalments) to fund net capital expenditure per the Treasury Management Strategy Statement for 2012/13 was £37.9m.

6.1.2 Some long term borrowing was undertaken to finance net capital expenditure in the year, replace debt maturing in the year and to reduce the Capital Financing Requirement (CFR) gap (see section 6). A total of £40m was borrowed from the PWLB at an average rate of 3.64% and an average repayment term of 16.8 years, taking the opportunity to access attractive borrowing rates for this maturity period, while at the same time aiming to balance the maturity profile of the overall debt portfolio.

6.1.3 In addition to the above borrowing, £3.86m was borrowed for on-lending as part of the National Housing Trust programme for which the Council has specific borrowing consents and guarantees from the Scottish Government.

6.1.4 The remainder of the funding for the year came from short-term borrowing and movement in internal balances.

6.1.5 In November 2012, the PWLB introduced a certainty rate, whereby if local authorities applied for the certainty rate scheme and gave HM Treasury forward borrowing plans, they would be guaranteed a reduced PWLB rate (0.2% discount). The Council benefitted from the discounted rate on new borrowings from that date onwards.

6.1.6 Although the expected trend in long term rates is upwards, as referred to at paragraph 3.1, any rise in interest rates is now later than had been expected at the start of the year.

6.2 **Rescheduling**

6.2.1 There was no rescheduling completed during 2012/13. While refinancing rates were closely monitored throughout the year no significant opportunities arose to make savings due to breakage costs.

6.2.2 A summary of Outstanding Deferred Revenue Costs attributable to debt rescheduling exercises undertaken in years to date, is provided in the table below. These represent early debt repayment costs (premiums) and discounts, associated with debt rescheduling. It is accounting practice for these to be written off over the periods of the new loans taken as part of the rescheduling. The approach being that these costs are spread over the same period the saving from the new lower rate loans will be realised.

| | **Outstanding 31 March 2012 £000** | **Incurred 2012/13 £000** | **Written off 2012/13 £000** | **Outstanding 31 March 2013 £000** |
|---|---|---|---|---|
| Premiums | 41,486 | - | (1,992) | 39,494 |
| Discounts | (7,121) | - | (40) | (7,081) |
| Net Deferred Revenue Costs | 34,365 | - | (1,952) | 32,413 |

6.2.3 The Council's average loans fund interest rate for the year was 4.84% against a budgeted rate of 5.2%, the budget having been predicated on the assumption that there would be an upwards trend in borrowing rates, which did not materialise during the year.

6.2.4 Revenue effect: The final position shows a budget saving of £3.4m (General Fund) and £1.0m (HRA) in loan charges compared to budget for the year. This is partly a result of the Council having been able to take advantage of sustained and historically low long term borrowing rates and favourable cash flow.

6.3 **Investments held by the Council**

6.3.1 The Council's investment policy is governed by the Scottish Government Investment Regulations, which were adopted in the Annual Investment Strategy 2010/11, approved by the Council on 24th June 2010. This policy sets out the approach for choosing investment categories and 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.).

6.3.2 The Council's policy states the maximum investment period is 2 years. However during 2012/13 deposits were placed for periods of less than 1 year to reflect credit risk.

6.3.3 The Council maintained an average end of month balance of £67.5m of internally managed funds. These internally managed funds earned an average rate of return of 0.76%. The comparable performance indicator is the average 7-day LIBID rate, and this was 0.52%.

6.3.4 No institutions in which investments were made showed any difficulty in repaying the investment and interest in full during the year.

## 7. Performance and risk

7.1 The Council's debt portfolio has been proactively managed over the year and Officers have continued to take advantage of the relatively low interest rates on offer to favourably position the debt portfolio against potential adverse interest rate movements.

7.2 As a consequence, there is limited risk of volatility of costs in the current debt portfolio as the interest rates are predominantly at attractive, fixed long-term levels (£584.1m representing 85% of the total gross debt portfolio).

7.3 All major borrowing and CFR financing decisions taken by officers were undertaken following discussion with the Council's treasury management advisors. Current indications are that assumptions made on future long term interest rate movements are still in line with subsequent market movements, and it is now expected that the trend in low long term rates over all periods will continue for some time (see paragraph 3.1)

7.4 Returns on the Council's investments are predominantly determined by short-term variable rates. Whilst this can introduce an element of volatility to returns, it is minimal in terms of the total debt portfolio. Risk, in relation to the potential loss of principal, is minimised through the Council's restricted lending list (using a diversified list of counter-parties and based on credit risk assessment).

7.5 The Council uses three firms of money market brokers to facilitate short-term borrowing and investment deals. This ensures competitive market rates are obtained. All brokers charged the same level of commission per transaction and performed satisfactorily. In addition, the Council's treasury management staff has direct lines to some major banks to facilitate investment business.

## 8. Compliance with the Council's procedures and Prudential Indicators

8.1 The Council has complied with its internal procedures and the requirements of the CIPFA Code of Practice on Treasury Management. The Council is bound by best practice requirements, which involve limits to be set and adhered to in relation to short-term borrowing and exposure to variable interest rates.

8.2 The following tables detail the Council's limits that apply to these requirements and it should be noted that the Council complied with these limits throughout the year.

**Maximum the Council may have outstanding by way of short term borrowing (net of investments)**

| | Maximum During 2012/13 £m | Position At 31/03/13 £m |
|---|---|---|
| Short term borrowing (net of investments) as a % of outstanding long term debt | (3.35%)* | (9.99%)* |
| **Council limit** | **25.00%** | **25.00%** |

* Short term investments exceeded short term borrowing in these instances, shown in (brackets) above.

**Total amount of exposure to variable interest rates (net of investments)**

| | Maximum During 2012/13 £m | Position At 31/03/13 £m |
|---|---|---|
| Variable interest debt (net of investments) as a % of outstanding long term debt | 10.60% | 5.28% |
| **Council limit** | **35.00%** | **35.00%** |

## 9. The Prudential Code - Indicators

9.1 The Council is required by the Prudential Code to report the actual prudential indicators compared with actual treasury positions at the year-end. **Appendix A** provides details of all the mandatory, estimated and actual prudential indicators for the year 2012/13.

9.2 <u>Capital Financial Requirement</u>

The capital financing requirement (CFR) represents the accumulated net capital expenditure which the Council requires to fund by way of long term borrowing and other capital financing, until the capital projects, comprising the CFR, are fully written off to revenue (mainly by way of annual loan charges).

9.3 In recent years the Council has been in a position whereby its CFR is greater than its long-term borrowing. This results from the Council using internal cash sources, as well as long-term borrowing to finance the CFR. The use of internal cash sources can represent a more effective and low cost option for financing, compared to long-term borrowing, given the low returns available on short-term deposits when compared to PWLB rates, even in the current low borrowing rate environment. However, the Council must keep the CFR and long-term borrowing position under regular review, as the use of internal cash sources can result in increased re-financing risk i.e. if internal cash sources unexpectedly reduce, and the Council has no choice but to borrow, and not necessarily at a time of its choosing, borrowing costs could be impacted.

| | 31 March 2013 Estimated Indicator | 31 March 2013 Actual |
|---|---:|---:|
| Net borrowing position | £671.0m | £601.6m |
| Long term borrowing position | £706.0m | £677.2m |
| **Capital Financing Requirement** | | |
| General Fund excluding PPP | £541.1m | £513.8m |
| Housing Revenue Account | £161.4m | £161.4m |
| Joint Boards | £25.8m | £25.8m |
| **Sub total excluding PPP** | **£728.3m** | **£701.0m** |
| PPP | £133.0m | £133.0m |
| **Total CFR including PPP** | **£861.3m** | **£834.0m** |

9.4 The CFR is kept under regular review, and in recent years part of the annual treasury strategy has been to take steps to manage the CFR versus long-term borrowing position to an acceptable level. Paragraph 6.1.24 describes the net additional long-term PWLB borrowing undertaken in the year. As shown in the table below the difference between CFR and long-term borrowing stood at £23.8m as at 31/3/13 (down from £47.4m at 31/3/12). This position will be kept under regular review as part of on-going treasury management arrangements.

In order to ensure that over the medium term borrowing net of investments will only be for a capital purpose, net borrowing should not, except in the short term, exceed the CFR for 2012/13. The table below highlights that the Council has complied with this requirement.

9.5

| | 31/03/13 |
|---|---:|
| Long term borrowing position | £677.2m |
| CFR excl PPP | £701.0m |
| CFR not yet funded by long-term borrowing | £23.8m |

9.6 <u>Borrowing Limits</u>

The Council is required to agree an Authorised Limit for borrowing for the year. This figure provides for estimated contingencies which may require to be funded in the year in addition to planned capital expenditure. The table below demonstrates that during 2012/13 the Council maintained its gross borrowing within its Authorised Limit.

| | 2012/13 |
|---|---:|
| Indicator - Authorised Limit for borrowing | £877.6m |
| Indicator - Operational Boundary for borrowing | £848.8m |
| Maximum borrowing position during the year | £692.2m |
| Minimum borrowing position during the year | £652.2m |

9.7 The Operational Boundary, also approved by the Council in compliance with the Code, is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the Boundary are acceptable subject to the Authorised Limit not being breached.

## 10. Implications

10.1 Resource, Legal, Equalities, Risk, Climate Change and Carbon Clever Implications – there are no specific implications to highlight, as the report represents a retrospective review of 2012/13 treasury management performance.

**Recommendation**

In compliance with the Code of Practice on Treasury Management in Local Authorities, Members are asked to approve the Annual Treasury Report 2012/13.

Designation: Director of Finance

Date: 10 October 2013

Author: Brian Porter, Finance Manager
Catriona Stachan, Accountant

Background Papers:

Logotech Treasury Management System reports

Sector Treasury reports

Treasury Strategy Statement and Investment Strategy 2012/13

*This Treasury Management Report is a document impacting on the whole of the Highland population and therefore all aspects of equalities have to be cross referenced against all duties which apply. This Treasury Management Report has been screened for its impact on equalities groups and does not require a full equalities impact assessment.*

**Appendix A**
**Estimated and Actual Treasury Position and Prudential Indicators**

| | Figures are for financial year unless otherwise titled in italics | 2012/13 Indicator | 2012/13 Actual |
|---|---|---|---|
| 1 | **Capital Expenditure (Gross)** | | |
| | General Fund including PPP | £77.8m | £77.2m |
| | Housing Revenue Account (variance due to accelerated spend) | £27.6m | £32.9m |
| 2 | **Capital Financing Requirement (CFR) at 31 March** | | |
| | General Fund excluding PPP | £541.1m | £513.8m |
| | Housing Revenue Account | £161.4m | £161.4m |
| | Joint Boards | £25.8m | £25.8m |
| | Sub total excluding PPP | £728.0m | £701.0m |
| | PPP | £133.0m | £133.0m |
| | **Total** | **£861.3m** | **£834.0m** |
| | General Fund including PPP | £674.1m | £646.8m |
| | | | |
| 3 | **Treasury Position at 31 March** | | |
| | Borrowing | £706.0m | £685.1m |
| | Other Long Term Liabilities | - | - |
| | Total Debt | £706.0m | £685.1m |
| | | | |
| | Investments | £35.0m | £75.8m |
| | Net Borrowing | £671.0m | £609.3m |
| 4 | **Authorised Limit for Borrowing** (against maximum position) | £877.6m | £692.2m |
| 5 | **Operational Boundary for Borrowing** | £848.8m | £692.2m |
| 6 | **Ratio of financing costs to net revenue stream** | | |
| | General Fund including PPP | 11.4% | 11.4% |
| | Housing Revenue Account | 32.1% | 30.4% |
| 7 | **Incremental impact of capital investment** decisions on the Band D council tax | £Nil | £Nil |
| 8 | **Incremental impact of capital investment** decisions on the housing rent levels (Weekly figures based on a 48 week year are shown in brackets).<br>There is zero incremental impact on Council Tax and Rents shown as Council Tax and Housing Rents have already been already set for these years. | £Nil | £Nil |
| 9 | **Interest rate exposures of debt net of investments** | | |
| | Upper Limit (Fixed) | £728.3m | £573.6m |
| | Upper Limit ( Variable) | £254.9m | £67.6m |
| 10 | **Maturity structure of fixed rate borrowing (against maximum position)** | | |
| | Under 12 months | 30% | 7.6% |
| | 12 months to 2 years | 30% | 4.8% |
| | 2 years to 5 years | 30% | 12.5% |
| | 5 years to 10 years | 50% | 20.5% |
| | 10years and above | 100% | 66.6% |
| 11 | **Upper limit for the maturing of investments made for periods longer than 364 days(against maximum position)** | 0 | £5m |

In addition to the above the Council is required as a Prudential Indicator to:

- Adopt the CIPFA Code of Practice.
- Ensure that over the medium term borrowing will only be for a capital purpose (i.e. net external borrowing is less than the CFR).

The compliance for these indicators is highlighted in the body of the report.