ISLE OF ANGLESEY COUNTY COUNCIL	
Report to	**County Council**
Date	**10 October 2013**
Subject	**Annual Treasury Management Review for 2012/13**
Portfolio Holder(s)	**Councillor H E Jones**
Lead Officer(s)	**CLARE J WILLIAMS**
Contact Officer	**CLARE J WILLIAMS (Ext. 2601)**
Nature and reason for reporting To comply with regulations issued under the Local Government Act 2003. The Council has resolved that this report is also considered by the Audit Committee. The Audit Committee considered the content of the report at its meeting on 23 July 2013 and resolved to accept its content and to refer it to the County Council.	

Summary

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 2012/13. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

The report also includes borrowing and investment performance during the year.

Under the Prudential Code it is a requirement that all local authorities set Prudential Indicators for borrowing and investing among other factors each year. The Council confirmed its limits for 2012/13 on 5 March 2012 and outturn information is provided in this report.

During 2012/13 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year;
- a mid year (minimum) treasury update report;
- an annual review following the year describing the activity compared to the strategy (this report).

The regulatory environment places responsibility on Members for the review and scrutiny of treasury management policy and activities. This report is, therefore, 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.

This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Audit Committee before they were reported to the full Council.

Member training on treasury management issues was undertaken during October 2012 in order to support the scrutiny role of the members of the Audit Committee.

During 2012/13, the Council complied with its legistlative and regulatory requirments. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Actual prudential and treasury indicators	2011/12 Actual £000	2012/13 Original Indicator £000	2012/13 Actual £000
Capital expenditure	21,619	27,800	25,428
Total Capital Financing Requirement:			
• Non-HRA	78,849	85,300	81,347
• HRA	21,811	28,400	25,062
• Total	100,660	113,700	106,409
•			
External debt	96,103	113,717	96,097
Investments*			
• Longer than 1 year	-	-	-
• Under 1 year	16,152	25,932	13,468
• Total	16,152	25,932	13,468

** estimates and actuals, not a prudential indicator*

Other prudential and treasury indicators are to be found in the main body of this report. The s151 Officer also confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit (the authorised limit), was not breached.

The financial year 2012/13 continued the challenging investment environment of previous years, namely low investment returns and continuing heightened counterparty risk.

RECOMMENDATIONS

That the County Council notes the contents of this report, which have been scrutinised by the Audit Committee.

Appendices:

Appendix 1 – Summary Portfolio Valuation
Appendix 2 – Investment Counterparty Credit Ratings as at 31 March 2013
Appendix 3 - Equivalent Credit Ratings
Appendix 4 – The Economy and Interest Rates – A Commentary by Sector

Background papers

Treasury Strategy 2012/13
Prudential Indicators 2012/13

1. INTRODUCTION

This report summarises the following functions / activities / outcomes in financial year 2012/13:

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- The actual prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;
- Interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity.

2. THE COUNCIL'S CAPITAL EXPENDITURE AND FINANCING 2012/13

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

- Financed from borrowing; this may be through planned borrowing or otherwise. 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.

£m	2011/12 Actual (£m)	2012/13 Estimate (£m)	2012/13 Actual (£m)
Non-HRA capital expenditure	13	18	17
HRA capital expenditure	9	10	9
Total capital expenditure	**22**	**28**	**26**
Resourced by:			
• Capital receipts	1	1	1
• Capital grants	10	11	12
• Revenue	3	2	3
Unfinanced capital expenditure	**8**	**14**	**10**

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 2012/13 unfinanced capital expenditure (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 expenditure programme, the treasury service 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 Reducing the CFR

3.3.1 The Council's 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 CFR. This is effectively a repayment of the borrowing need. 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.

3.3.2 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).

3.3.3 The Council's 2012/13 MRP Policy (as required by WG Guidance) was approved as part of the Treasury Management Strategy Report for 2012/13 on 5 March 2012.

3.3.4 The Council's CFR for the year is shown below, and represents a key prudential indicator. This would include any PFI and leasing schemes on the balance sheet, which would increase the Council's borrowing need, the CFR. There were no such schemes during the year.

CFR: Council Fund	2011/ 12 Actual (£m)	2012/ 13 Budget (£m)	2012/ 13 Actual (£m)
Opening balance	79	80	79
Add unfinanced capital expenditure (as above)	4	8	6
Less MRP/VRP*	(4)	(3)	(4)
Closing balance	79	85	81

CFR: HRA	2011/ 12 Actual (£m)	2012/ 13 Budget (£m)	2012/ 13 Actual (£m)
Opening balance	19	24	22
Add unfinanced capital expenditure (as above)	4	6	4
Less MRP/VRP*	(1)	(2)	(1)
Closing balance	22	28	25

** Includes voluntary application of capital receipts*

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

3.4 Net borrowing and the CFR

In order to ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. This essentially means that the Council is not borrowing to support revenue expenditure. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2012/13 plus the expected changes to the CFR over 2013/14 and 2014/15 from financing the capital programme. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2012/13. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

3.4.1 It should be noted that this indicator is changing to compare gross borrowing to the CFR with effect from 2013/14; this is expected to provide a more appropriate indicator.

	31 March 2012 Actual (£m)	31 March 2013 Budget (£m)	31 March 2013 Actual (£m)
Gross borrowing position	96.1	113.7	96.1
Net borrowing position	79.9	87.8	82.6
CFR	100.7	113.7	106.4

3.4.2 As part of the financing of capital expenditure for 2012/13 borrowing was used to finance the gap between available resources (capital receipts, capital grants, capital contributions and revenue contributions), net of contingency, and the capital expenditure. Additionally, given the PWLB rates on offer and the market rates available for investments, it was decided, in the short term at least, to continue internalising borrowing in order to maximise net income and to minimise counterparty risk. The same strategy was adopted as for 2011/12 where the CFR switched from being £4.9m below external borrowing (31 March 2011) to being £4.6m above. As a result of continuing with this strategy, the gap between CFR and external borrowing increased during 2012/13 to £10.3m. The net current borrowing is less than the forecast CFR for the following 2 years.

3.5 The other debt related indicators are:

3.5.1 **The authorised limit** - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. The table below demonstrates that during 2012/13 the Council maintained gross borrowing within its authorised limit.

3.5.2 **The operational boundary** – 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 are acceptable subject to the authorised limit not being breached.

3.5.3 **Actual financing costs as a proportion of net revenue stream** - this 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
Authorised limit	£123.0m
Maximum gross borrowing position	£96.1m
Operational boundary	£118.0m
Average gross borrowing position	£96.1m
Financing costs as a proportion of net revenue stream - CF	5.99%
Financing costs as a proportion of net revenue stream - HRA	16.19%

On balance sheet leasing would also count against authorised limits. A second set of limits was approved, giving scope for £2m leasing. There was no requirement in the year.

4. TREASURY POSITION AS AT 31 MARCH 2013

4.1 The borrowing and investment figures for the council as at the end of the 2012/13 and 2011/12 financial years are as follows:

	31 MARCH 2012			31 MARCTH 2013		
	£'000	Average Rate (%)	Average Maturity (yrs)	£'000	Average Rate (%)	Av erage Maturity (yrs)
Debt: All Public Works Loans Board (all fixed rate)	96,102	5.53	26.5	96,096	5.53	26.5
Investments (all < 1 year, managed in house and fixed rate)	5,000	1.32		10,000	1.63	
Deposits (all no notice and managed in house)	11,151	0.77		3,468	0.79	
Net position	79,951			82,628		

These are disclosed in the Council's Statement of Accounts at "fair value": see a more detailed analysis in Appendix 1.

4.2 Borrowing is further broken down by maturity as:-

	31 MARCH 2012		31 MARCH 2013		Limits	
	£m	% of total	£m	% of total	% of total (upper)	% of total (lower)
Total borrowing	96.1	100	96.1	100		
Under 12 months	0.0	0	6.5	7	20%	0%
12 months and within 24 months	6.5	7	0.0	0	20%	0%
24 months and within 5 years	0.0	0	5.5	6	50%	0%
5 years and within 10 years	20.1	21	16.8	17	75%	0%
10 years and above	65.5	72	67.2	70%	100%	0%

4.3 The average borrowing rate of the loan portfolio remained constant during the year as there were no loan maturities, no debt rescheduling and no new borrowing. No debt rescheduling took place during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

4.4 Part of the Council's deposits are held in no notice deposit accounts which pay interest at rates near the prevailing base rate (£3.5m at 0.79% (31 March 2012: £11.2m at 0.77%). Of the remaining deposits, £10m was being held for a period of less than 1 year at an average rate of 1.63% (31 March 2012: £5m at 1.32%).

5. TREASURY STRATEGY FOR 2012/13

5.1 Our treasury strategy for 2012/13, adopted on the 5 March 2012, was based on the expectation that, in the medium term, investment rates would be short of long term borrowing rates and so value could be best obtained by postponing new external borrowing and adopting internal borrowing. Additionally, this strategy was adopted so as to minimise counterparty risks. This strategy was subject to caution, with regular monitoring of the interest rate market and a pragmatic approach to changing circumstances so as to avoid long term costs outweighing any short term gains from not externalising.

5.2 The economic position was as outlined in Appendix 4 and PWLB rates were as shown at Appendix 4. These rates favoured the internalisation strategy and so no debt rescheduling took place (no debt matured in the year).

6. INVESTMENT

6.1 The base rate remained at its historic low of 0.5% throughout the year; it has now remained unchanged for four years. Market expectations of the start of monetary tightening were pushed back during the year to early 2015 at the earliest. The Funding for Lending Scheme resulted in a sharp fall in deposit rates in the second half of the year.

6.2 Overlaying the relatively poor investment returns were the continued counterparty concerns, most evident in the Euro zone sovereign debt crisis which was an ongoing issue throughout the year.

6.3 The expected investment strategy was to keep to shorter term deposits (up to 364 days) although the ability to invest out to longer periods was retained (although not used). I expected available cash balances of £40m and ranging between £25m and £45m. The budget was set at 0.83% or £332k after adjusting for the higher rates on existing investments. As it turned out, average balances of £24.0m returned £249k (1.03%). The lower than budgeted average cash balance was the result of continuing to internalise borrowing. The higher than budgeted return was due to better than anticipated rates of return on fixed term investments.

6.4 The investment performance against the benchmark had yet to be measured at the time of reporting to the Audit Committee. We will report on the outstanding matters later in the year.

7. INVESTMENT SECURITY AND CREDIT QUALITY

7.1 No institutions in which we had made investments had any difficulty in repaying investments and interest on time and in full during the year.

7.2 During 2012/13, credit ratings remained poor across the range of our usual counterparties, including building societies. Since late 2008 it has become increasingly difficult to place deposits with appropriate counterparties. In December 2008, the Council's approval was obtained to extend flexibility with counterparties to deal with market changes; this included the ability to invest all our surplus funds with central government if necessary. The list was further widened in April 2010 to include nationalised and partly nationalised institutions (and in March 2012 this list was approved, unchanged, for 2012/13). Previous decisions had extended flexibility for investing with local authorities. Our approach of listening to expert advice, taking account of market sentiment and being cautious enabled us to improve credit quality within existing counterparty lists.

7.3 The practical effect of these policies was as follows: during the year we continued to use no notice accounts with major high street institutions (Santander, HSBC and Bank of Scotland) for day to day cash flow.

7.4 The only fixed term investment (Royal Bank of Scotland (RBS), £5.0m) at the start of the year, matured during the year. This was reinvested with RBS upon maturity for a further 6 months at a rate of 1.16%. On the same date a further £5m was invested with the same institution for 364 days, at a rate of 1.68%. The investment at 1.16% matured during the year and was re-invested for a further 6 months at a rate of 1.58%. The decision to invest with RBS was made primarily due to them being one of the few creditworthy institutions given their UK government backing. No other investments were made during the year.

7.5 During 2011/12 the credit ratings for Santander UK were downgraded bringing the institution below the thresholds in the approved lending list. Deposits continued to be made with Santander during 2012/13 consistent with the decision made by the County Council in March 2012 and endorsed by the Audit Committee. This decision was made in light of wider considerations of market conditions and taking into account the views of this Authority's appointed treasury advisors (Sector Treasury Services). The current position is the short term ratings for two of the three agencies have fallen to one category below the normal approved list level. Long term ratings continue to be below the level of the approved list. However, in line with current advice and wider market considerations, Santander continues to be used for depositing monies, on a call basis only.

CLARE J WILLIAMS
HEAD OF FUNCTION (RESOURCES) &
SECTION 151 OFFICER

5 AUGUST 2013

Appendix 1

Summary Portfolio Valutaion
As at 31 March 2013

FINANCIAL ASSETS	Nominal / Principal (£)	Fair Value (£)
Cash (interest bearing accounts) (1)	3,468,455	3,541,166
Fixed Term Desposits (2)	10,000,000	10,141,947
FINANCIAL LIABILITIES		
PWLB loan – Maturity	95,815,764	122,953,603
PWLB loan – Annuity	280,875	470,130

Counterparties

(1)	Cash (interest bearing accounts)	
	Santander	3,418,352
	Bank of Scotland	103
	HSBC	50,000
		3,468,455
(2)	Fixed Term Deposits	
	Royal Bank of Scotland	10,000,000

Appendix 2

Credit Ratings of Investment Counterparties at 31 March 2013

Institution	Fitch Long Term Rating	Fitch Short Term Rating	Moody's Long Term Rating	Moody's Short Term Rating	Standard & Poor's (S&P) Long Term Rating	Standard & Poor's (S&P) Short Term Rating	Sector Colour	Sector Suggested Duration
Santander Bank Plc	A	F1	A2	P-1	A	A-1	Green	3 months
Bank of Scotland Plc	A	F1	A2	P-1	A	A-1	Blue	12 months
HSBC Plc	AA-	F1+	Aa3	P-1	AA-	A-1+	Orange	12 months
The Royal Bank of Scotland Plc	A	F1	A3	P-2	A	A-1	Blue	12 months

- It can be seen from the above that the Bank of Scotland and the Royal Bank of Scotland were given a blue colour coding by Sector as they were part nationalised throughout 2012/13. This meant that they were eligible to have up to £10m invested, for up to 364 days, under the approved lending list (by credit rating), Section 4.1- Si (aiii). The Lending List can be found in Appendix 6 of the 2012/13 Treasury Management Strategy Statement / Annual Investment Strategy.

- It can also be seen that HSBC met the credit criteria for investment throughout the year.

- The only institution not to meet the credit criteria was Santander. This is discussed in Section 7.5.

- The equivalent credit ratings for the 3 rating agencies referred to above are foundin Appendix 3.

Appendix 3

Equivalent Credit Ratings (Fitch, Moodys, S&P)

Fitch Long Term	Moodys Long Term	S&P Long Term
AAA	Aaa	AAA
AA+	Aa1	AA+
AA	Aa2	AA
AA-	Aa3	AA-
A+	A1	A+
A	A2	A
A-	A3	A-
BBB+	Baa1	BBB+
BBB	Baa2	BBB
BBB-	Baa3	BBB-
Fitch Short Term	**Moodys Short Term**	**S&P Short Term**
F1+	n/a	A-1+
F1	P-1	A-1
F2	P-2	A-2
F3	P-3	A-3

THE ECONOMY AND INTEREST RATES

The EU sovereign debt crisis was an ongoing saga during the year. However, the ECB statement in July that it would do “whatever it takes” to support struggling Eurozone countries provided a major boost in confidence that the Eurozone was (at last) beginning to get on top of its problems. This was followed by the establishment of the Outright Monetary Transactions Scheme in September. During the summer, a €100bn package of support was given to Spanish banks. The crisis over Greece blew up again as it became apparent that the first bailout package was insufficient. An eventual very protracted agreement of a second bailout for Greece in December was then followed by a second major crisis, this time over Cyprus, towards the end of the year. In addition, the Italian general election in February resulted in the new Five Star anti-austerity party gaining a 25% blocking vote; this has the potential to make Italy almost ungovernable if the grand coalition formed in April proves unable to agree on individual policies. This could then cause a second general election – but one which could yield an equally ‘unsatisfactory’ result! This result emphasises the dangers of a Eurozone approach heavily focused on imposing austerity, rather than promoting economic growth, reducing unemployment, and addressing the need to win voter support in democracies subject to periodic general elections. This weakness leaves continuing concerns that this approach has merely postponed the ultimate debt crisis, rather than provide a conclusive solution. These problems will, in turn, also affect the financial strength of many already weakened EU banks during the expected economic downturn in the EU. There are also major questions as to whether the Greek Government will be able to deliver on its promises of cuts in expenditure and increasing tax collection rates, given the hostility of much of the population.

The UK coalition Government maintained its tight fiscal policy stance against a background of warnings from two credit rating agencies that the UK could lose its AAA credit rating. Moody’s followed up this warning by actually downgrading the rating to AA+ in February 2013 and Fitch then placed their rating on negative watch, after the Budget statement in March. Key to retaining the AAA rating from Fitch and S&P will be a return to strong economic growth in order to reduce the national debt burden to a sustainable level, within a reasonable timeframe.

2012/13 started the first quarter with negative growth of -0.4%. This was followed by an Olympics boosted +0.9% in the next quarter, then by a return to negative growth of -0.3% in the third quarter and finally a positive figure of +0.3% in the last quarter. This weak UK growth resulted in the Monetary Policy Committee increasing quantitative easing (QE) by £50bn in July to a total of £375bn on concerns of a downturn in growth and a forecast for inflation to fall below the 2% target. QE was targeted at further gilt purchases. In the March 2013 Budget, the Office of Budget Responsibility yet again slashed its previously over optimistic growth forecasts, for both calendar years 2013 and 2014, to 0.6% and 1.8% respectively.

UK 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 MPC has continued its stance of looking through temporary spikes in inflation by placing more importance on the need to promote economic growth.

Gilt yields oscillated during the year as events in the ongoing Eurozone debt crisis ebbed and flowed, causing corresponding fluctuations in safe haven flows into / out of UK gilts. This, together with a further £50bn of QE in July and widely expected further QE still to come, combined to keep PWLB rates depressed for much of the year at historically low levels.

Bank Rate was unchanged at 0.5% throughout the year, while expectations of when the first increase would occur were pushed back to quarter 1 2015 at the earliest.

The Funding for Lending Scheme, announced in July, resulted in a flood of cheap credit being made available to banks and this has resulted in money market investment rates falling sharply in the second half of the year. However, perceptions of counterparty risk have improved after the 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.

Chart 1: Borrowing Rates 2012-13

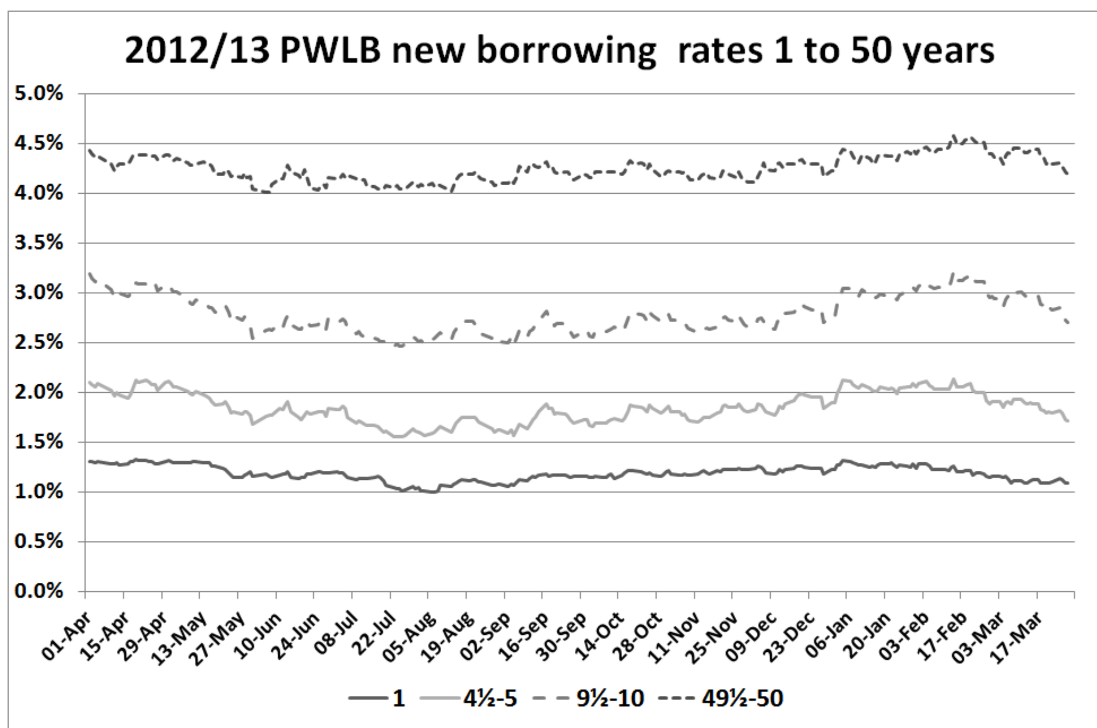
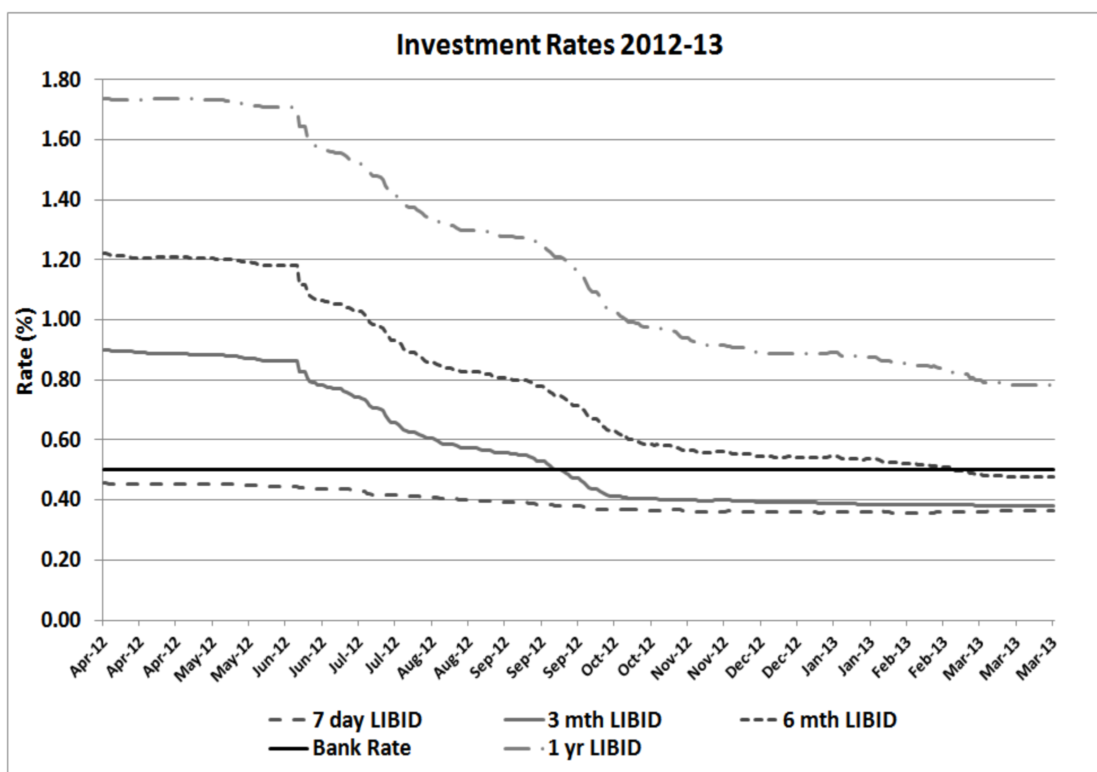


Chart 2: Investment Rates 2012-13



Extracts from report by SECTOR, Treasury Management Consultants