Treasury Management Annual Report 2012/13

1.1 Introduction

1.1.1 This 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 **[Appendix 1]**. 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).

1.1.2 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 treasury update report; and
- an annual review following the end of the year describing the activity compared to the strategy (this report).

In addition, treasury management update reports have been presented to each meeting of the Audit Committee throughout the 2012/13 financial year.

1.1.3 Recent changes in the regulatory environment place a much greater onus 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.

1.1.4 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 full Council. Training on treasury management issues was undertaken in October 2011 to support Members' scrutiny role.

1.2 The Economy and Interest Rates

1.2.1 The original expectation for 2012/13 was that Bank Rate would not rise in 2012/13 or 2013/14 and for it to start gently rising from quarter 4 of 2014. This forecast rise has now been pushed back to start in quarter 1 of 2015 at the earliest. Economic growth (GDP) in the UK was virtually flat during 2012/13 due to the government's 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 (QE) by £50bn in July to a total of £375bn. The Bank Rate ended the year unchanged at 0.5%. CPI inflation has remained stubbornly high and above the 2% target, starting the year at 3.0% with only a modest fall to 2.8% in March. CPI is forecast to fall to 2% in three years time. The EU sovereign debt crisis was an ongoing 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 financial year.

1.2.2 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 and 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.

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

1.2.4 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 placed their rating on negative watch, after the Budget in March. Fitch followed this with an actual rating downgrade to AA+ with stable outlook in April.

1.3 Treasury Position at 31 March 2013

1.3.1 At the beginning and the end of 2012/13 the Council‘s debt and investment position was as follows:

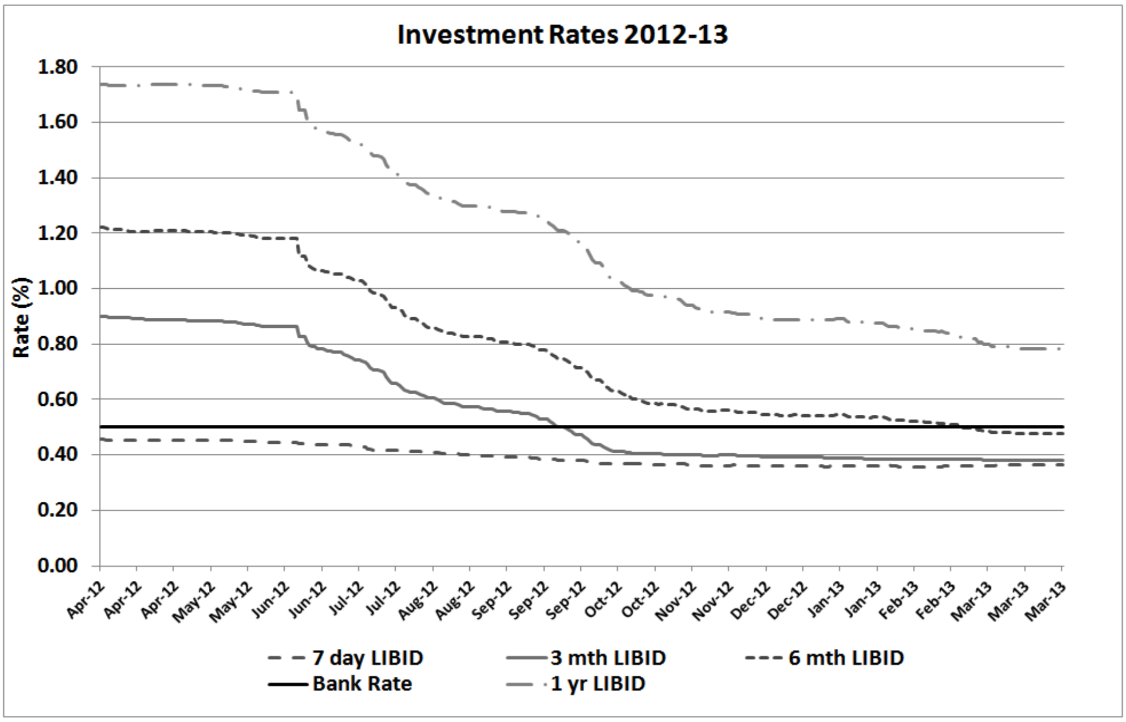
	31 March 2012 £m	Rate / Return %	Average duration Years	31 March 2013 £m	Rate / Return %	Average duration Years
Variable rate debt:						
Overdraft	0.00	-	-	0.00	-	-
Total debt	**0.00**	-	-	**0.00**	-	-
Fixed rate investments:						
In-house cash flow	-	-	-	2.00	3.00	0.03
In-house cash flow Landsbanki	1.00	-	-	0.51	-	-
Externally managed core fund	-	-	-	2.06	0.32	0.01
Variable rate investments:						
In-house cash flow	4.20	0.82	0.01	3.44	0.54	0.01
Externally managed core fund	21.02	1.24	0.54	13.33	0.53	0.18
Total Investments	**26.22**	**1.17**	**0.45**	**21.34**	**0.75**	**0.12**

1.4 The Strategy for 2012/13

1.4.1 The expectation for interest rates within the strategy for 2012/13 anticipated low but rising Bank Rate starting in quarter 4 of 2014. 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.

1.5 Investment Rates in 2012/13

1.5.1 The Bank 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 2015 at the earliest. The Funding for Lending Scheme resulted in a sharp fall in deposit rates in the second half of the year.



1.6 Investment Outturn for 2012/13

1.6.1 The Council's investment policy sets out the approach for choosing investment counterparties and is based on credit ratings provided by the three main credit rating agencies. This is supplemented by additional market information including rating outlooks and credit default swap data. The 2012/13 Annual Investment Strategy was approved by the Council on 23 February 2012.

1.6.2 All investment activity during the financial year complied with the requirements of the approved strategy. No liquidity issues were experienced resulting in nil borrowing throughout 2012/13.

1.6.3 **Cash Flow Investments held by the Council** - the Council maintained an average balance of £10.9m of internally managed cash flow funds. These funds earned an average rate of return of 1.08%. The comparable performance indicator is the average 7- day LIBID rate which was 0.46%. This compares with a revised budget assumption of £9.0m investment balances earning an average rate of 1.06%.

1.6.4 The majority of cash flow funds are required to meet our regular payment obligations and as a consequence are invested overnight in bank deposit accounts and money market funds allowing next day access. However, the opportunity to invest for longer durations and generate additional yield is taken when cash flow surpluses permit.

1.6.5 **Core Fund Investments held by the Fund Manager** - the Council uses Investec Asset Management to invest its core fund cash balances. The manager earned an average rate of return of 1.10% on an average balance of £18.2m against a benchmark return of 0.46%. This compares with a budget assumption of an average investment balance of £18.1m at a return of 1.25%.

1.6.6 Unlike cash flow, core fund balances are not required to meet our regular payment obligations and are, therefore, available to invest for durations exceeding one year. This added flexibility is generally reflected in a better return on core funds relative to cash flow investments.

1.6.7 Performance for the financial year as a whole, excluding the Landsbanki investment, is summarised in the table below:

	2012/13 Average Balance £m	Return %	2012/13 Interest Earned £	2012/13 Revised Estimate £	Variance Better (worse) £
In-house Cash Flow	10.9	1.08	117,100	95,500	21,600
Externally Managed Core Fund	18.2	1.10	202,800	227,000	(24,200)
Total	29.1	1.09	319,900	322,500	(2,600)

1.6.8 The performance of both internally and externally managed funds fell short of our revised estimate predictions by £2,600 (£26,500 better than expected when measured against our original 2012/13 estimates).

1.6.9 However, these figures are adjusted at year end to account for unrealised gains and losses on our externally managed portfolio and to incorporate notional interest on the defaulted Landsbanki investment. In addition, our revised estimates assumed that the Council would participate in the Housing Mortgage Assistance Scheme (LAMS) part way through 2012/13. As a consequence our revised estimates included £7,200 in interest on our contribution to the scheme (£1m from mid-December at 2.5% per annum). Taking these adjustments into account, investment income for year-end reporting purposes is calculated at £368,150 against a revised estimate including LAMS of £329,700 which is £38,450 better than expected.

1.7 Icelandic Bank Defaults

1.7.1 The Council invested £1m in a three-month fixed term deposit with the Icelandic bank, Landsbanki. The bank went into administration a few days prior to the investments intended maturity in October 2008. The Council has participated in a joint action, coordinated by the Local Government Association, to recover the investment and associated interest. In April 2011 the Icelandic District Court ruled that such deposits have **priority status**. Following an appeal, this ruling was upheld by the Icelandic Supreme Court in September 2011. Agreement to the Council's settlement was approved by the Icelandic District Court in May 2012 and payment of our first distribution of funds received in June 2012. A further distribution of funds was made in October 2012 bringing the total recovery to date to just under £491,000.

1.7.2 Subject to exchange rates, we anticipate that we will recover all of the £1m we had on deposit with Landsbanki, together with the interest that was due had the deposit been repaid on time. In addition, this Council was one of a limited number of authorities who submitted a demand for repayment. The validity of our demand has been recognised by the award of additional interest (gap interest for the period October 2008 to April 2009). The way in which the LGA and our legal advisors have coordinated the legal action with other local authorities has minimised legal costs whilst enabling us to advance the strongest possible arguments to secure this excellent result. The cost of the litigation to date amounts to less than 1 per cent of the amount we expect to recover.

Financial Services
May 2013