Part I – Release to Press

Meeting: **Audit Committee / Executive / Council** **Agenda Item: 6**

Portfolio Area: Resources

Date: **3 September 2014 / 30 September 2014 / 8 October**

ANNUAL TREASURY MANAGEMENT REVIEW OF 2013/14 AND MID YEAR REVIEW REPORT FOR 2014/15

NON-KEY DECISION

Author – Anita Thomas Ext No. 2430

Contributors – Crystal Leader Ext No. 2351

Lee Busby Ext No. 2730

Lead Officer – Scott Crudgington Ext No. 2185

Contact Officer – Clare Fletcher Ext No. 2933

1. PURPOSE

1.1 To review the operation of the 2013/14 Treasury Management and Investment Strategy and to approve updates to the 2014/15 Treasury Management and Investment Strategy.

2. RECOMMENDATIONS

2.1 That subject to any comments from Executive and the Audit Committee these committees recommends to Council the approval of the 2013/14 Annual Treasury Management Review and 2014/15 Mid Year Review and the prudential and treasury indicators in this report.

2.2 That changes to the treasury limits (as detailed in paragraph 4.8.2) are recommended for approval by Executive/Council.

2.3 That the change to the operational borrowing limit for the General Fund and hence the change to the authorised limit (as detailed in paragraph 4.8.5) are recommended for approval by Executive/Council.

3. BACKGROUND

3.1 The Council is required under the Local Government Act 2003 to produce an Annual Treasury Report reviewing treasury management activities including the 2013/14 prudential and treasury indicators. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management ((revised 2013) (the

Code)) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

3.2. This report covers two of three reporting requirements under the code of practice, the other report being;

- Annual Treasury Strategy in advance of the year (last reported 26/02/2014)

3.3 This report summarises:

- Capital expenditure for 2013/14;
- Impact of the expenditure on the Council's underlying indebtedness, (the Capital Financing Requirement);
- Reporting of the required prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity.

4 REASONS FOR RECOMMENDED COURSE OF ACTION AND OTHER OPTIONS

4.1 The Council's Capital Expenditure and Financing 2013/14

4.1.1 Council expenditure can be classified as capital when it is used to purchase assets with a life of more than one year and meets the guidelines laid out in CIPFA accounting practises.

4.1.2 These costs can be financed either by capital resources the Council has on its Balance Sheet for example capital receipts, capital grants or by making a revenue contribution to capital. If sufficient capital resources are not available to fund the expenditure incurred it would give rise to a need to borrow.

4.1.3 The Treasury Management outturn for 2013/14 has resulted in Prudential Indicator variances to the Treasury Strategy approved 4th December 2013 due to 2013/14 scheme slippage and underspends (as reported to Executive 22 July 2014). The actual 2013/14 capital expenditure was £1,322,826 lower than budgeted, of which £100,215 related to schemes funded from prudential borrowing.

4.1.4 It is the actual capital expenditure for the year that is used to calculate the prudential indicators included in this report. Table One (shown below) summarises the actual capital expenditure and how this was financed.

Table One: 2013/14 Capital Expenditure and Financing			
	2012/13 Actual £'000	**2013/14 Estimate £'000**	**2013/14 Actual £'000**
Capital Expenditure:			
General Fund Capital Expenditure	10,901	3,317	3,006
HRA Capital Expenditure	16,264	21,808	20,796
Total Capital Expenditure	**27,165**	**25,125**	**23,802**
Resources Available for Capital Expenditure:			
• Capital Receipts	(917)	(2,225)	(1,688)
• Capital Grants /Contributions	(6,681)	(7,870)	(7,860)
• Capital Reserves	(8,222)	(8,351)	(7,402)
• Revenue contributions	(2,746)	(4,748)	(5,021)
Total Resources Available	**(18,566)**	**(23,194)**	**(21,971)**
Capital Expenditure Requiring Borrowing	**8,599**	**1,931**	**1,831**

4.2 The Council's overall need to borrow

4.2.1 The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). It represents the amount of debt the Council needs to/has taken to fund the capital programme after repayments and Minimum Revenue Provision (MRP) are taken into account.

4.2.2 Based on the Capital Strategy and Treasury Management Strategy, the treasury service manages the Council's cash position to ensure sufficient cash is available to meet the capital payments. This may be through borrowing from external bodies (such as the Government, through the Public Works Loan Board (PWLB) or the money markets), or utilising cash balances held by the Council in the short to medium term.

4.3 Cash balances and cash flow management

4.3.1 Currently cash projections are estimated to be £32Million by 31 March 2015, which means the Council will not need to take any external borrowing in 2014/15 until such time as either:

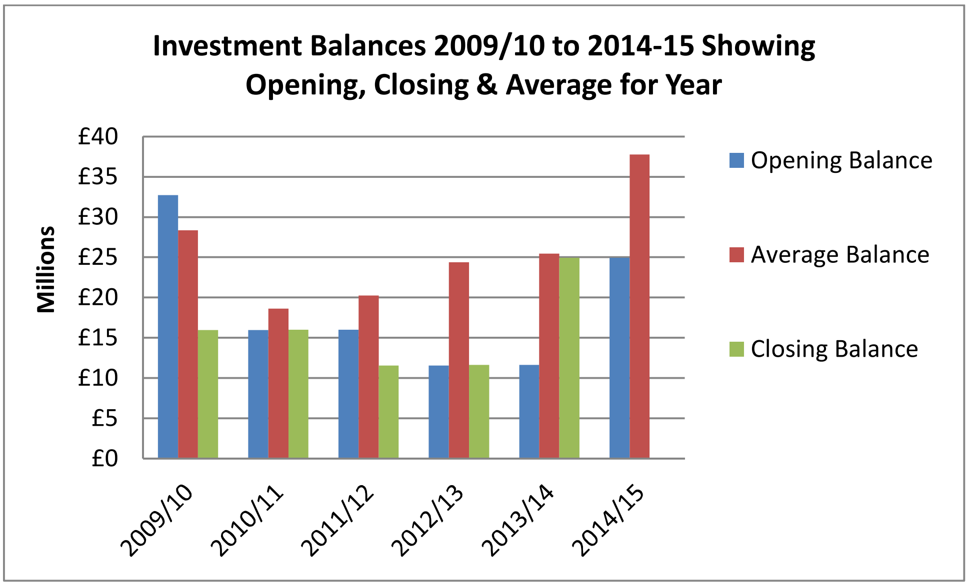
(i) interest rates look as if they will rise significantly
or (ii) cash balances fall below £10Million.

4.3.2 The Council's cash balances are significantly higher in 2014/15 compared to other years (as shown in Chart One paragraph 4.4.5). Cash balances held by the Council have increased over the last eight months partially due to increased right to buy receipts, increased HRA balances (needed to fund future debt repayments) and the requirement to hold specific provisions for NDR appeals following the localisation of business rates.

4.3.3 The level of cash balances held by the Council is not indicative to its overall financial health as these balances arise due to the timing difference between when income is received (for example council tax and business rates) and when payments are made (for example debt repayments and NDR refunds).

4.3.4 The following chart shows the closing and average cash balances held by the Council over the last five years demonstrating that average balances held during the year have increased over the last two years and significantly in 2014/15.

Chart One: Cash Balances



4.4 Borrowing and the 2013/14 Capital Financing Requirement (CFR)

4.4.1 In 2013/14 the Council did take some borrowing totalling £4Million (£1.5Million July 2013, £2.5Million August 2013) which related to a regeneration asset purchased in the prior year, anticipating that the cash balances held would fall at year end as in 2012/13.

4.4.2 In 2013/14 no further external borrowing was taken despite an in year CFR of £1,830,774 being identified as the Council's cash holdings remained high during and at the year end. On average, balances were £25.4 Million in 2013/14 and much higher than the minimum £10Million required for the delivery of day to day services and in 2014 the average cash holding between April and July was £37.7Million. While investment returns are low the "internal" borrowing rate is significantly cheaper than the cost of external borrowing and is a prudent use of the Council's cash balances.

4.4.3 As at the 31 March 2014 the Council had HRA external borrowing with the PWLB of £211,915,000. The majority of this debt (£194,911,000) was taken out in March 2012 to finance the payment required to central government for self-financing. This debt was arranged over a number of loans with fixed rates and with varying maturities with one loan of £2million repaid in 2013/14. As at 31 March 2014, the HRA also had £739,922 of internal borrowing.

4.4.4 The HRA borrowing includes £17,004,000 used to fund the pre 2012 decent homes programme. This debt was called 'supported borrowing' under the former HRA subsidy system but now forms part of the HRA debt portfolio.

4.4.5 HRA borrowing is constrained by legislation (unlike the General Fund) and is capped at £217,685,000. As at the 31 March 2014 the "head room" available for new HRA borrowing was £5,030,078.

4.4.6 The Council's CFR for the year is shown below, and is a key prudential indicator.

Table Two: Capital Financing Requirement 2012/13 and 2013/14			
CFR Calculation	**31 March 2013 (£'000)**	**31 March 2014 (£'000)**	**Movement in Year**
Opening Balance	**224,647**	**230,096**	
Closing Capital Financing Requirement (General Fund)	15,440	15,624	184
Closing Capital Financing Requirement (Housing Revenue Account)	214,656	213,642	(1,014)
Closing Balance	**230,096**	**229,266**	
Increase/ (Decrease)	**5,448**	**(830)**	**(830)**

4.4.7 The HRA CFR has decreased by £1,014,000 in year as a result of the £2million debt repayment on the 28 March 2014 (reducing the CFR) and an appropriation of land at Archer Road and two General Fund properties (increasing the CFR).

4.4.8 The General Fund CFR has increased by £184,000 in year as a result of the appropriation of land at Archer Road and the two General Fund properties to the HRA (reducing the CFR), the Minimum Revenue Provision (MRP) made in year (reducing the CFR) and the additional prudential borrowing needed to fund the capital scheme for 2013/14 (increasing the CFR) .

4.4.9 The Council could reduce its CFR by:

- the application of additional capital financing resources (such as unapplied capital receipts) if available; or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP) which would impact on revenue budgets.

4.5 Minimum Revenue Requirement (MRP)

4.5.1 The Council must base its borrowing decisions in accordance with the Prudential Code which requires the Council to demonstrate a need to borrow and to show the cost of that borrowing for the General Fund is affordable. The Council's MRP policy, as required by CIPFA (Chartered Institute of Public Finance and Accountancy) guidance, is approved annually by Council as part of the Treasury Management Strategy. The calculation of MRP is based upon prior years' borrowing requirement and the life of the assets for which borrowing was required.

4.5.2 An MRP will need to be made regardless of whether actual external borrowing has been taken and hence differs from the treasury management arrangements, the latter considers utilising cash balances when borrowing rates are relatively high compared to investment interest earned (as in paragraph 4.4.2).

4.5.3 In 2013/14 the MRP charged to the General Fund was £528,883.

4.6 Other indicators

4.6.1 The treasury management indicators have been calculated based on the updated Capital Strategy reported to Executive (22 July 2014) and for further known adjustments. The 2015/16 Capital Strategy will be rebased as part of the Integrated Financial Planning process, to be approved at the February 2015 Council and as such the data relating to future years is indicative only and will be subject to change.

4.6.2 The **net borrowing position** of the Council as at 31 March 2014 was £188,797,457 of borrowing (total borrowings/loans of £213,717,457 less total investments held of £24,920,000).

4.6.3 The **operational boundary and authorised limit** refer to the borrowing limits within which the treasury team operate. A temporary breach of the operational boundary is permissible for short term cash flow purposes however a breach of the authorised limit would require a report to Council. There were no breaches of either limit in 2013/14.

4.6.4 The **ratio of financing costs to net revenue stream** (General Fund interest costs divided by the General Fund net budget requirement). The 2013/14 indicator is 5.14%. lower than the estimated 5.65% as the Council used investment balances to support borrowing. In addition slippage on the capital programme meant that some forecasted borrowing was not required in year again reducing the ratio.

4.6.5 The full list of Treasury Prudential Indicators is shown on Appendix A updated for the 2013/14 out-turn position and revised 2014/15 estimates.

4.7 Treasury Position 31 March 2014

4.7.1 The Council's debt and investment position is managed by the Treasury Management section to ensure adequate liquidity for revenue and capital activities. In addition investment decisions are based on the security of the investments and spread over a number of counter parties to manage the Council's exposure to risk.

4.7.2 The Council's investment returns are low reflecting the 0.5% Bank of England Base Rate. In 2013/14 the average rate of interest earned was 0.56%

compared to 0.78% earned in 2012/13. However this still exceeded the 7 day LIBOR benchmark rate of 0.48% (source: CAPITA).

4.7.3 The rates earned have also been low as much of the investments have been held in short-term variable instruments rather than putting monies out for more than one year which would attract higher investments yields. Investments have been held for less than 12 months anticipating the year end reduction in cash balances and to keep investments liquid (readily available) for day to day service delivery.

4.7.4 Table three illustrates the rates available to the Council over different terms as at 1st August 2014.

Table three: Fixed Term Investment Rates Quoted as at 1st August 2014					
Term	**HSBC**	**DMO**	**Barclays**	**Nationwide**	**Lloyds**
	%	%	%	%	%
1 Month	0.28	0.25	0.39	0.43	0.42
2 Months	0.28	0.25	0.43	0.46	not quoted
3 Months	0.28	0.25	0.48	0.50	0.57
6 Months	0.38	0.25	0.61	0.64	0.70
9 Months	0.48	not quoted	0.82	0.80	0.80
1 Year	0.58	not quoted	1.00	0.97	0.95
2 Years	not quoted	not quoted	not quoted	not quoted	1.20
3 Years	not quoted	not quoted	not quoted	not quoted	1.70
5 Years	not quoted	not quoted	not quoted	not quoted	2.45

4.7.5 While borrowing costs are around 3-4% it is still prudent to utilise the Council's high cash balances (as shown in paragraph 4.3.4) for short-term internal borrowing. However as borrowing costs start to increase this position may change as future borrowing becomes more expensive. The decision and timing of when to borrow is being monitored by officers.

4.7.6 The Council's treasury position for the year was as follows;

Table Four: Treasury Position as at 31 March						
	31 March 2013 Principal £'000s	**Rate / Return %**	**Average Life (Yrs)**	**31 March 2014 Principal £'000s**	**Rate / Return %**	**Average Life (Yrs)**
Fixed rate borrowing - PWLB	213,915	3.31	20.2	214,283	3.37	19.5
Fixed rate borrowing - Other Local Authority	0			1,500	1.98	5
Total Borrowing	**213,915**	**3.31**	**20.2**	**215,783**	**3.34**	**19.5**
CFR	230,095			229,265		
Under borrowing*	(16,180)			(13,482)		
Investments portfolio	**11,650**	**0.78**		**24,920**	**0.56**	

** financed by internal borrowing.*

Reduction of Under-borrowing as at 31 March 2014	**£'000s**
Prudential borrowing identified for 2013/14 Capital Programme	1,831
Actual borrowing taken out in year (Town Square para 4.3.1)	(4,000)
MRP reduces CFR, consequently reduces the under-borrowing by	(529)
Total effect to under-borrowing is a reduction	**(2,698)**

4.7.7 The maturity structure of the debt portfolio was as follows (see also Appendix B):

Table Five: Maturity of Debt Portfolio			
Time to maturity	**31 March 2013 Actual £'000's**	**31 March 2014 Actual £'000's**	**30July 2014 Actual £'000's**
Maturing within one year	2,000	0	0
1 year or more and less than 2 years	0	5,500	5,500
2 years or more and less than 5 years	8,000	5,241	5,241
5 years or more and less than 10 years	1,241	2,368	2,368
10 years or more	202,674	202,674	202,674
Total	**213,915**	**215,783**	**215,783**

4.7.8 All of the investments held during 2013/14 were due to mature within one year. A summary of the Council's exposure to fixed and variable rate investments is shown below in table six. (see also Appendix B).

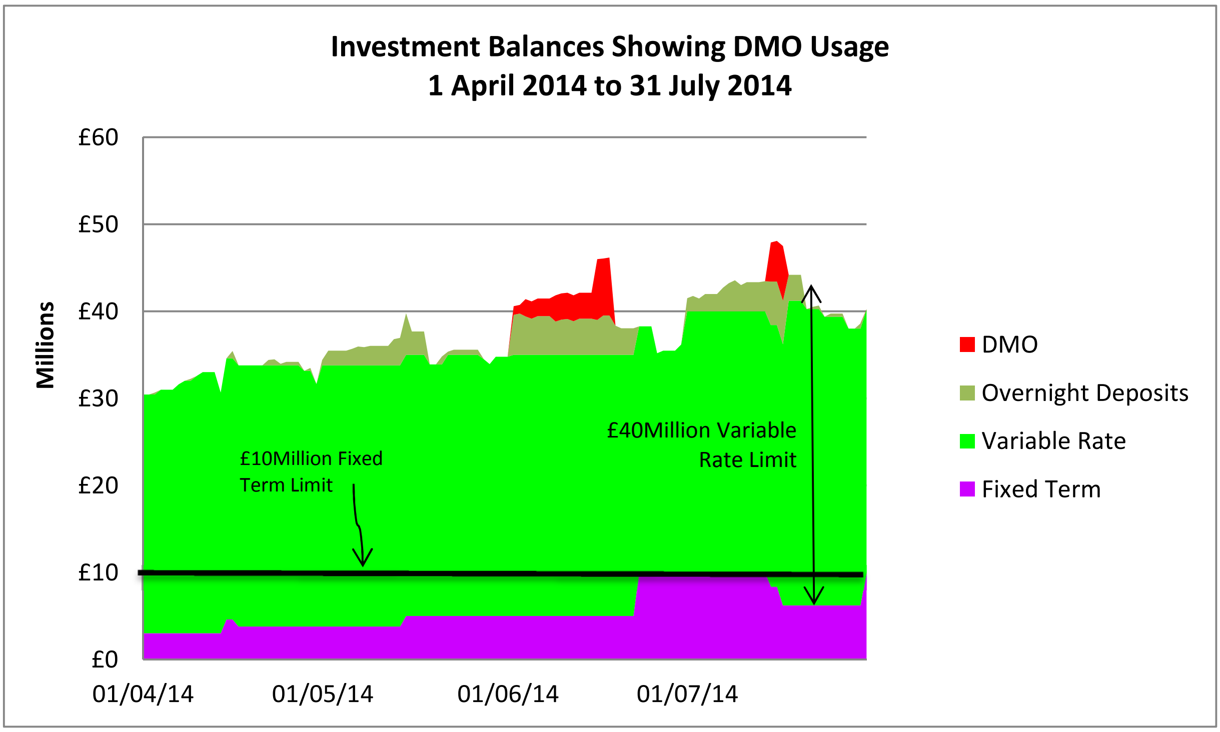
Table six: Fixed and Variable Rate Investment Totals			
	31 March 2013 £'000's	**31 March 2014 £'000's**	**30 July 2014 £'000's**
Fixed rate investment	0	3,000	10,000
Variable rate investment	11,650	21,920	30,200
Total	**11,650**	**24,920**	**42,200**

4.7.9 The Debt Management Office (DMO) is used as a 'safe haven' and permission for unlimited deposits. When cash balances are high the DMO is used so that counter party limits are not breached. No investments were deposited with the DMO in 2013/14, however this position changed in 2014/15 as cash balances increased (see chart two).

4.8 The Strategy for 2014/15

4.8.1 The Council's cash balances are significantly higher in 2014/15 compared to other years (as shown in Chart One and mentioned in paragraph 4.3.2). As cash balances have increased it has become increasingly difficult to find additional counter parties that meet the Council's strict lending criteria necessitating the use of the DMO to place cash balances. This can be seen in the chart two below.

Chart Two : Use of DMO when cash balances are high



4.8.2 As a result of higher cash balances which are projected to continue during 2014/15 and in the short to medium term a number of changes to the treasury management limits are proposed. This will enable Officers to manage the investment portfolio and minimise the use of DMO which offers lower interest rates than other counter parties (as shown in Table 3 paragraph 4.7.4) when cash balances exceed £30Million.

- **It is recommended that the cap on counter party limits (currently £5million) is increase to £7million when the cash balance exceeds £30million.** When cash balances fall below £30Million counter party limits would revert back to £5Million.
- **It is recommended that the current upper limit for the total of fixed term investments, with maturity of up to 12 months is increased to £15million.**
- **It is recommended that a limit for fixed rate investments with maturity over 12 months is set at £5Million.**
- **It is recommended that a minimum of £10million (or 100% if cash balances fall below £10Million) be available in instant access investments.**

4.8.3 The Table Seven below summaries the proposed changes to the treasury management limits.

Table Seven: Summary of Proposed Treasury Limit Change		
Investment	**Cash balances Less than £30million Limits**	**Cash balances higher that £30million Limits**
Variable Rate Investments	Maximum holding £30M	Maximum holding 100%
Counter party limits	Maximum £5M	Maximum £7M
Instant Access holding at least £10m (or 100% of cash balances if below £10M)		
Overnight Investment (fixed rate) maximum £20M		
Fixed Rate less than 12 month maturity (excluding overnight investments)	Maximum £15M	
Fixed Rate more than 12 months to maturity	Maximum £5M	

4.8.4 There is a slight risk that these limits may be breached temporarily should cash balances fall unexpectedly below £30Million but this breach, should it occur, would be notified to the Chief Finance Officer.

4.8.5 Officers have also reviewed the Operational Boundary limits for borrowing following a review of the capital programme and known changes to the programme.

- **It is recommended that the Operational Boundary for General Fund borrowing is increased by £1Million (and therefore the Authorised Limit for General Fund, linked to the Operational Boundary would rise by £1Million).**

4.9 Local Government Association Municipal Bonds Agency

4.9.1 The creation of the Municipal Bonds Agency is led by the Local Government Association (LGA) with the aim to give Councils greater control over interest rates and to introduce competition and diversity to the public sector borrowing market place, currently dominated by the Public Works Loan Board (PWLB) which lends 75% of councils' borrowing.

4.9.2 The broad principle of the agency is that it will raise capital on the financial markets through the sale of bonds and lend on the proceeds to eligible councils at a lower rate than the PWLB or other Councils' own bonds.

4.9.3 This lower rate will be attained by achieving a AAA/sovereign-like credit rating through a joint and several guarantee, adequate risk capital of three to five per cent of the total volume of bonds and issuing bonds in benchmark sizes of £250Million to £300Million.

4.9.4 Stevenage BC is intending to contribute £10,000 towards the set up costs of the Municipal Bonds Agency and would seek to use the Municipal Bond Agency for future borrowing requirements should the rates offered be favourable. A report on this proposed investment will be reported to a future meeting of the Executive.

4.10 Changes to Legislation for Money Market Funds (MMF)

4.10.1 In September 2013, the European Commission proposed a new regulatory framework for Money Market Funds. Part of the proposal was to change the funds from Constant Net Asset Value (CNAV) to Variable Net Asset Value (VNAV). This would increase the risk of Money Market fund investment as the principal investment may fall in value and hence the Council would not receive the full amount invested back on maturity.

4.10.2 In July 2014, US Securities and Exchange Commission agreed to implement this change for some MMF within two years. The US decision does not affect funds domiciled in Europe which are the funds used by the Council.

4.10.3 The regulatory reform in Europe is still in progress and at present the Council's MMF are unaffected by the proposed change

4.10.4 Officers will monitor the progress of the regulatory reforms and advise Members if the treasury strategy needs to be revised in light of the risk profile change.

4.11 Compliance with Prudential Limits 2013/14

4.11.1 During the financial year the Officers has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices.

4.11.2 The full list of approved Treasury Prudential Indicators and their corresponding actual expenditure for 2013/14 are shown on Appendix A.

4.12 Economic Review & Interest Rate Outlook

4.12.1 **UK Growth** - UK GDP growth was 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, and 0.8% in the first quarter of 2014. There are indications that recovery is starting to broaden away from reliance on consumer spending and the housing market into construction, manufacturing, business investment and exporting. Accordingly, markets are expecting the first rise in Bank of England Base Rate around the end of 2014. Our Treasury advisors, Capita, are forecasting this rise in the first quarter of 2015.

4.12.2 **Wage inflation** – The unemployment rate among those aged 16 and above, has fallen over the last year to 6.6% (April 2014). However, despite an improving economic position wage inflation continues to be suppressed at 0.9%.

4.12.3 **UK Credit Rating** - In June 2014, Standard & Poor restored the UK's AAA credit rating by removing the 'negative outlook' to reflect the broadening economic recovery in the UK. Previously the UK's AAA credit rating had been downgraded by one notch to AA+ by Moody (February 2013) and Fitch (April 2013) owing to weak economic and fiscal outlook.

4.12.4 **UK Debt** - The forecasted increase in Government debt was lowered by £73bn in the 2013 Autumn Statement. The March 2014 Budget statement further reduced the debt forecast by £24bn anticipating a budget surplus of £5bn in 2018/19.

4.12.5 **Inflation -** Consumer Price Index (CPI) grew by 1.6% in July 2014 (from 1.9% in June). Falls in clothing prices provided the largest contribution to the fall in the rate. This is below Monetary Policy Committee (MPC) target of 2%. It is forecast that inflation is likely to fall further in 2014.

4.12.6 **Interest Rate** - The Council's treasury advisor, Capita Asset Services, undertook a review of its interest rate forecasts in May, after the Bank of England's Inflation Report. However, more recent developments to the Bank of England's forward guidance have necessitated a second updating in this quarter carried out on 30 June. This latest forecast now includes an increase in Bank Base Rate in quarter 1 of 2015. The rise was previously forecast to be in quarter 4 of 2015.

4.12.7 Capita Asset Services has provided the following interest rate forecast (as at 30 June 2014):

	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	2.00%	2.00%
5yr PWLB rate	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.60%
10yr PWLB rate	3.70%	3.70%	3.80%	3.90%	4.00%	4.00%	4.10%	4.20%	4.20%	4.30%	4.40%	4.40%
25yr PWLB rate	4.40%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	4.90%	5.00%
50yr PWLB rate	4.40%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	4.90%	5.00%

5. IMPLICATIONS

5.1 Financial Implications

5.1.1 This report is of a financial nature and reviews the treasury management function for the 2013/14. Any consequential financial impacts of the Strategy have been reflected in the July Capital Strategy update and the 4th Quarter 2013/14 budget monitoring report.

5.2 Legal Implications

5.1.2 Approval of the Prudential Code Indicators and the Treasury Management are intended to ensure that the Council complies with relevant legislation and best practice.

5.2 Risk Implications

5.1.3 The table below identifies the risks if the recommendations are agreed. The risks have been assessed in accordance with the Council's risk management strategy.

	Description of risk	Mitigation	Residual Risk Level
1.	Investment balances increase and monies placed with banking groups exceed approved Counter Party Limits	The Treasury Team would actively seek to find alternative Counter Parties to lend to, or seek Council approval to increase the Counter Party Limits	M
2.	There is an increase in the capital programme which cannot be resourced from available resources and can exceed the Council's borrowing limit.	Operational and authorised boundary should have sufficient headroom above CFR to meet the Council's borrowing requirement arising from the Capital Strategy.	L
3	The Council is unable to defer spend within the General Fund capital programme in future years or identify resources to fund the unsupported borrowing in the Capital Strategy.	This would increase the cost of borrowing to the General Fund and would require funding.	M
4	The Council invests funds with a bank which is unable to meet the repayment.	The Counter Party ratings are reviewed on a weekly basis and should prevent placing funds with banks at risk. The Council has a very strict lending criteria.	L

5.4 Equalities and Diversity Implications

5.4.1 All the services identified in the report have their own Equalities Impact Assessments, which are reviewed where appropriate.

6 BACKGROUND DOCUMENTS

BD1 Treasury Management Strategy Statement and Annual Investment Strategy – Mid-Year Review 2013/14 (4 December 2013 Council)

BD2 Prudential Code Indicators and Treasury Management Strategy 2014/15 (26 February 2014 Council)

7 APPENDICES

- Appendix A – Prudential Indicators 2013/14 Actuals, 2014/15 revised.
- Appendix B – Investment and Borrowing Portfolio