WIRRAL COUNCIL

CABINET

10 OCTOBER 2013

SUBJECT	**TREASURY MANAGEMENT ANNUAL REPORT 2012/13**
WARD/S AFFECTED	**ALL**
REPORT OF	**ACTING DIRECTOR OF FINANCE**
RESPONSIBLE PORTFOLIO HOLDER	**COUNCILLOR PHIL DAVIES**
KEY DECISION	**NO**

1.0 EXECUTIVE SUMMARY

1.1 This report presents a review of Treasury Management activities in 2012/13 and confirms compliance with treasury limits and prudential indicators. It has been prepared in accordance with the revised CIPFA Treasury Management Code and the revised Prudential Code.

2.0 BACKGROUND AND KEY ISSUES

2.1 Treasury management is defined as: “The management of the local authority investments and 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.”

2.2 The Council has adopted the CIPFA Code of Practice on Treasury Management. This requires public sector authorities to determine an annual Treasury Management Strategy and as a minimum, formally report on their treasury activities and arrangements in mid-year and after the year-end. These reports enable those tasked with implementing policies and undertaking transactions to demonstrate that they have properly fulfilled their responsibilities. They also enable those with responsibility/governance of the treasury management function to scrutinise and assess its effectiveness and compliance with policies and objectives.

2.3 Cabinet approves the Treasury Management Strategy at the start of each financial year. This identifies how it is proposed to finance capital expenditure, borrow and invest in the light of capital spending requirements, the interest rate forecasts and the expected economic conditions. During the year Cabinet receives a quarterly monitoring report on treasury management activities and at the end of each financial year this Annual Report. Scrutiny of treasury policy, strategy and activity is delegated to the Transformation & Resources Policy and Performance Committee.

ECONOMIC BACKGROUND

2.4 The global outlook stabilised mainly due to central banks maintaining low interest rates and expansionary monetary policy for an extended period.

Equity market assets recovered sharply with the FTSE 100 registering a 9.1% increase over the year. This was despite economic growth in G-7 nations remaining low. Aided by the summer Olympic Games, growth registered at 0.2% over the calendar year 2012. The expected boost to net trade from the fall in the value of sterling did not materialise, but raised the price of imports, especially low margin goods such as food and energy. Avoiding a 'triple-dip' recession became contingent on upbeat services sector surveys translating into sufficient economic activity to overhaul contractions in the struggling manufacturing and construction sectors.

2.5 During 2012-13 inflation remained above the Bank of England's 2% CPI target (the official measure). Household financial conditions and purchasing power were constrained as wage growth remained subdued at 1.2% and was outstripped by inflation. Annual CPI dipped below 3%, falling to 2.4% in June before ticking up to 2.8% in February 2013. Higher food and energy prices and higher transport costs were some of the principal contributors to inflation remaining.

2.6 The Bank of England's Monetary Policy Committee maintained the status quo on the Bank Rate as the lack of growth and the fall in inflation were persuasive enough for the Bank of England to continue with a Bank Rate at 0.5% and also sanction additional £50 billion Quantitative Easing (QE) in July, taking total QE to £375 billion.

2.7 With the national debt metrics out of kilter with a triple-A rating, it was not surprising that the UK's sovereign rating was downgraded by Moody's to Aa1. The AAA status was maintained by Fitch and S&P, albeit with a Rating Watch Negative and with a Negative Outlook respectively

2.8 The government's Funding for Lending (FLS) initiative commenced in August which gave banks access to cheaper funding on the basis that it would then result in them passing this advantage to the wider economy. There was an improvement in the flow of credit to mortgagees, but was still below expectation for Small/Medium Enterprises.

2.9 One direct consequence of the Funding for Lending Scheme was the sharp drop in rates at which banks borrowed from local government. 3-month, 6-month and 12-month Libid rates which were 1%, 1.33% and 1.84% at the beginning of the financial year fell to 0.44%, 0.51% and 0.75% respectively. Gilt yields ended the year lower than the start in April. By September the 2-year gilt yield had fallen to 0.06%, raising the prospect that short-dated yields could turn negative. 10-year yields fell by nearly 0.5% ending the year at 1.72%.

2.10 The Euro region suffered a further period of stress when Italian and Spanish government borrowing costs rose sharply and Spain was also forced to officially seek a bailout for its domestic banks. Markets were calmed after the ECB's declaration that it would do whatever it takes to stabilise the Eurozone and the central bank's announcement in September of its Outright Monetary Transactions (OMT) facility, buying time for the necessary fiscal adjustments required. Neither the Italian elections which resulted in political gridlock nor the bailout of Cyprus which necessitated ‘bailing-in’ non-guaranteed depositors proved sufficient for a market downturn. Growth was hindered by the rebalancing processes under way in the Euro region economies, most of which contracted in Q4 2012.

INVESTMENT ACTIVITY

2.11 The Department for Communities and Local Government (DCLG) issued revised Investment Guidance which came into effect on 1 April 2010 and reiterated the need to **focus on security and liquidity, rather than yield**. It also recommended that strategies include details of assessing credit risk, reasons for borrowing in advance of need and the use of treasury advisers.

2.12 The opening and closing investment portfolio for 2012/13:-

INVESTMENTS	**Balance at 31 March 2012 £m**	**%**	**Balance at 31 March 2013 £m**	**%**
Current Assets (Cash Equivalents) Loans and Receivables - Specified	15	15	14	20
Available for sale financial assets - Specified	19	18	0	0
Current Assets (Short Term Investments) Loans and Receivables - Specified	37	- 36	35	49
Available for sale financial assets - Specified	1	1	8	11
Long Term Investments Loans and Receivables - Non Specified	23	- 22	14	20
Available for sale financial assets - Non Specified	8	8	0	0
TOTAL INVESTMENTS	**103**		**71**	

2.13 A breakdown of investments and the movement throughout the year is provided below:

Investments with:	**30 Jun 12 £m**	**30 Sep 12 £m**	**31 Dec 12 £m**	**31 Mar 13 £m**
UK Banks	36	47	47	25
UK Building Societies	0	0	2	2
Money Market Funds	41	22	4	0
Other Local Authorities	35	36	39	36
Gilts and Bonds	8	8	8	8
TOTAL	**120**	**113**	**100**	**71**

2.14 Security of capital remained the main investment objective. This was maintained by following the counterparty policy as set out in the Treasury Management Strategy Statement for 2012/13. Investments included:-

- Deposits with other Local Authorities.
- Investments in AAA-rated Stable Net Asset Value Money Market Funds.
- Call accounts and deposits with UK Banks.
- Bonds issued by Multilateral Development Banks.
- Pooled funds (collective investment schemes) meeting the criteria in SI 2004 No 534 and subsequent amendments.

2.15 Counterparty credit quality was assessed and monitored with reference to credit ratings (minimum long-term counterparty rating of A- across all three rating agencies, Fitch, S&P and Moody's); credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; any potential support mechanisms and share price. Counterparty credit quality has progressively strengthened throughout the year. In June 12 Moody's downgraded a swathe of banks with global capital market operations, including the UK banks on the Council's lending list - Barclays, HSBC, Royal Bank of Scotland/Natwest, Lloyds TSB Bank/Bank of Scotland, Santander UK plc – but none of the ratings fell below the Council's minimum A- credit rating threshold.

2.16 In keeping with the DCLG Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds and the use of call accounts.

2.17 The Council sought to optimise returns commensurate with the objectives of security and liquidity. The Council considered an appropriate risk management response to uncertain and deteriorating credit conditions in Europe was to shorten maturities for new investments. Short term money market rates also remained at very low levels which had a significant impact on investment income. Income earned on longer-dated investments made previous years provided some cushion against the low interest rate environment.

2.18 In respect of Icelandic investments the Council had £2 million deposited with Heritable Bank, a UK registered Bank, at an interest rate of 6.22% which was due to mature on 28 November 2008. The Company was placed in administration on 7 October 2008. Members have received regular updates regarding the circumstances and the latest situation. In March 2009 an Audit Commission report confirmed that Wirral Council had acted, and continues to act, prudently and properly in all its investment activities.

2.19 The latest creditor progress report issued by the Administrators Ernst and Young, dated 28 July 2011, outlined that the return to creditors is projected to be 90p in the £ by the end of 2012/13 and the final recovery could be higher. To date, over £1.6 million has been received. However, it should be noted that the amount and timing of future payments are estimates and are not definitive. Favourable changes in market conditions could lead to higher than estimated repayments.

2.20 In summary the budgeted investment income for the year had been estimated at £0.86 million and the actual interest earned was £1.1 million with this additional £0.24 million principally due to:-

- Average investment balances during the year being higher than originally budgeted which was mainly due to slippage in capital expenditure;
- Continuing proactive daily cash flow management by the Treasury Management Team.

2.21 The average return on investments for 2012/13 was 0.79%. To place this in context, in 2012/13 the average Bank of England base rate was 0.5%.

BORROWING ACTIVITY

2.22 The underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31 March 2013 was estimated at £367 million. This compares with the total external debt of £306 million.

	Balance on 31-Mar-12 £m	**Debt Maturing £m**	**New Borrowing £m**	**Balance on 31-Mar-13 £m**
CAPITAL FINANCING REQUIREMENT (CFR)	**378**			**367**
PWLB borrowing	90	14		76
Market borrowing	174	3		171
Total Borrowing	**264**	**17**	**0**	**247**
Other Long Term Liabilities	62	3		59
TOTAL EXTERNAL DEBT	**326**	**20**	**0**	**306**

2.23 The average rate of interest paid on Council borrowings as at 31 March 2013 was 5.8%. The average life of Council borrowings is 25 years.

2.24 The PWLB remained the preferred source of borrowing given the transparency and control that this continues to provide. In 2012/13 no new loans were raised.

2.25 Given the significant cuts to local government funding putting pressure on Council finances, the strategy followed was to minimise debt interest payments without compromising the longer-term stability of the portfolio. The differential between the cost of new longer-term borrowing and the return generated on the temporary investments was significant (between 2% - 3%). The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding capital expenditure. This has, for the time being, lowered overall treasury risk by reducing both external debt and temporary investments. Whilst this position is expected to continue in 2013/14, it will not be sustainable over the medium term and there will be a need to borrow for capital purposes in the near future.

2.26 During the year the four loans matured and have been repaid and four loans which, as per the terms of the loans, have been partially repaid.

Loans maturing in 2012/13	Principal £m	Fixed/ Variable	Rate %	Loan start date	Terms
*PWLB	3.00	Fixed	8.13	06-Dec-95	Maturity
*Landesbank Hessen	3.10	Fixed	6.52	05-Feb-02	Maturity
PWLB	6.00	Fixed	5.10	19-Mar-07	Maturity
PWLB	3.00	Fixed	4.35	13-Feb-08	Maturity
PWLB	0.50	Fixed	3.04	10-Feb-10	E I P
PWLB	0.50	Fixed	2.94	03-Mar-10	E I P
PWLB	0.50	Fixed	1.89	14-Oct-10	E I P
PWLB	0.50	Fixed	2.30	09-Nov-11	E I P
Total Maturing Borrowing	**17.1**				

** Loan repaid was in respect of Merseyside Residual Debt Fund*

Other Long-Term Liabilities

2.27 Other Long-Term Liabilities include the schools PFI scheme and finance leases used to purchase vehicles plant and equipment. Under the International Financial Reporting Standards (IFRS) these items are now shown on the balance sheet as a Financial Liability and therefore need to be considered within any Treasury Management decision making process.

2.28 During 2012-13, the Council procured one new lease contract for IT equipment and catering equipment to the value of £127k.

2.29 As at 31 March 2013 the PFI liability was valued at £59m to be repaid by 2031 and there were thirteen finance leases with a total value £0.5m, repayable over 1 – 5 years.

Minimum Revenue Provision (MRP)

2.30 The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 (SI 2008/414) place a duty on local authorities to make a prudent provision for debt redemption. Guidance on Minimum Revenue Provision has been issued by the Secretary of State and local authorities are required to “have regard” to such Guidance under section 21(1A) of the Local Government Act 2003.

2.31 There are four MRP options available namely Option 1: Regulatory Method; Option 2: CFR Method; Option 3: Asset Life Method and Option 4: Depreciation Method.

2.32 Options 1 and 2 may be used only for supported expenditure. Methods of making prudent provision for self financed expenditure include Options 3 and 4 (which may also be used for supported expenditure if the Council chooses).

2.33 The MRP policy for 2012/13 was approved by Cabinet on 20 February 2012 when it was agreed that Option 1 would be adopted for Supported Borrowing and Option 3 for Unsupported Borrowing. When Option 3, the asset life method, is applied to the funding of an asset with a life greater than 25 years a default asset life of 25 years is applied. Estimating assets lives over 25 years is difficult to achieve accurately; therefore, using a default of 25 years is considered the most prudent approach and is in keeping with the Regulations. MRP in respect of PFI and leases brought on Balance Sheet under International Financial Reporting Standards (IFRS) is also calculated using Option 3 and will match the annual principal repayment for the associated deferred liability.

2.34 In 2012/13 the decision to use internal resources in lieu of borrowing for capital purposes and the beneficial timing of the new borrowing has helped generate savings of £1.5 million in complying with the Regulations.

COMPLIANCE WITH PRUDENTIAL INDICATORS

2.35 The Council can confirm that it has compiled with its Prudential Indicators for 2012/13, which were approved on 20 February 2012 as part of the Council's Treasury Management Strategy Statement. Details can be found in Appendix 1.

2.36 In compliance with the requirements of the CIPFA Code of Practice this report provides Members with a summary report of the treasury management activity during 2012/13. None of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

3.0 RELEVANT RISKS

3.1 The Council is responsible for treasury decisions and activity and none of these decisions are without risk. The successful identification, monitoring and control of risk are important and the main risks are:-

- Liquidity Risk (Inadequate cash resources).
- Market or Interest Rate Risk (Fluctuations in interest rate levels).
- Inflation Risk (Exposure to inflation).
- Credit and Counterparty Risk (Security of investments).
- Refinancing Risk (Impact of debt maturing in future years).
- Legal and Regulatory Risk.

4.0 OTHER OPTIONS CONSIDERED

4.1 There are no other options considered in this report.

5.0 CONSULTATION

5.1 There has been no consultation undertaken or proposed for this report. There are no implications for partner organisations arising out of this report.

6.0 IMPLICATIONS FOR VOLUNTARY, COMMUNITY AND FAITH GROUPS

6.1 There are none arising out of this report.

7.0 RESOURCE IMPLICATIONS: FINANCIAL; IT; STAFFING; AND ASSETS

7.1 In the financial year 2012/13 the treasury management activities resulted in a saving of £1.7 million from the capital financing activities. This sum has been returned to the General Fund balances.

8.0 LEGAL IMPLICATIONS

8.1 The Council's has adopted the CIPFA Code of Practice on Treasury Management. This requires the annual production of Prudential Indicators and a Treasury Management Strategy Statement and the reporting of treasury management activities at least twice a year.

9.0 EQUALITIES IMPLICATIONS

9.1 There are none arising out of this report and an Equality Impact Assessment (EIA) is not required.

10.0 CARBON REDUCTION IMPLICATIONS

10.1 There are none arising out of this report.

11.0 PLANNING AND COMMUNITY SAFETY IMPLICATIONS

11.1 There are none arising out of this report.

12.0 RECOMMENDATIONS

12.1 That the Treasury Management Annual Report for 2012/13 be agreed.

12.2 That the transfer of the saving of £1.7 million from capital financing activities in 2012/13 to the General Fund balance be noted.

13.0 REASON FOR RECOMMENDATIONS

13.1 Wirral has adopted the CIPFA Code of Practice on Treasury Management ("the Code"), which includes quarterly reports to Members of treasury activity. This report is the year end review for 2012/13.

13.2 Under the Council's financial regulations any surplus resources are returned to balances and so used to support the delivery of other Council services.

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APPENDICES

PRUDENTIAL INDICATORS 2012-13

REFERENCE MATERIAL

DCLG Local Authority Investment Guidance,2004

DCLG Changes to the Capital Financing System Consultation, 2009

Code of Practice for Treasury Management in Public Services (Fully Revised Second Edition), CIPFA 2009.

Prudential Code for Capital Finance in Local Authorities (Fully Revised Second Edition), CIPFA 2009.

SUBJECT HISTORY

Council Meeting	**Date**
Cabinet - Treasury Management and Investment Strategy 2012 to 2015	20 February 2012
Cabinet – Treasury Management Annual Report 2011/12	21 June 2012
Cabinet - Treasury Management Performance Monitoring	06 September 2012
Cabinet - Treasury Management Performance Monitoring	8 November 2012
Cabinet – Treasury Management Performance Monitoring	7 February 2013

PRUDENTIAL INDICATORS 2012/13

APPENDIX 1

Capital Financing Requirement

Estimates of the Council's maximum external borrowing requirement for 2012/13 to 2014/15 are shown in the table below:

	31 Mar 13 Actual £m	31 Mar 14 Estimate £m	31 Mar 15 Estimate £m
Capital Financing Requirement	367	365	349
Less:			
Existing Profile of Borrowing	247	217	204
Other Long Term Liabilities	59	55	53
Cumulative Maximum External Borrowing Requirement	61	93	92

Authorised Limit and Operational Boundary for External Debt

The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of the indebted status. This statutory limit should not be breached and was set at £482 million for 2012/13.

The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit. For 2012/13 this was set at £467 million.

Upper Limits for Fixed and Variable Interest Rate Exposure

These allow the Council to manage the extent to which it is exposed to changes in interest rates. The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on the portfolio of investments.

Interest Rate Exposure	**Fixed Rate of Interest**	**Variable Rate of Interest**	**Total**
Borrowings	£247m	£0m	**£247m**
Proportion of Borrowings	100%	0%	**100%**
Upper Limit	100%	50%	
Investments	£14m	£57m	**£71m**
Proportion of Investments	20%	80%	**100%**
Upper Limit	100%	100%	
Net Borrowing	**£233m**	**£-57m**	**£176m**
Proportion of Total Net Borrowin(	132%	-32%	**100%**

The table shows that borrowing is mainly at fixed rates of interest and investments are mainly at variable rates. This was considered a good position when interest rates were rising as the cost of existing borrowing remained stable whilst investments, at variable rates of interest, generated increasing income. As the position has changed to one of low interest rates, the Treasury Management Team continues to seek to adjust this but is restricted by a number of factors:

- the level of uncertainty in the markets make investing for long periods at fixed rates of interest more risky and, therefore, the Council continues to only invest short term at variable rates of interest;
- Many of the loans have expensive penalties for early repayment or rescheduling which makes changing the debt position difficult.

Maturity Structure of Fixed Rate Borrowing

This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

Maturity structure of Fixed Rate Borrowing	Upper Limit %	Lower Limit %	Actual Fixed Rate Borrowing as at 31 Mar 13 £m	% of Fixed Rate Borrowing as at 31 Mar 13 %
under 12 months	20	0	30	12
12 months and within 24 months	20	0	13	5
24 months and within 5 years	50	0	24	10
5 years and within 10 years	50	0	30	12
10 years and above	100	20	150	61
			247	**100**

Actual External Debt

This indicator is obtained directly from the Authority's balance sheet. It is the closing balance for actual gross borrowing (short and long term) plus other deferred liabilities. The indicator is measured in a manner consistent for comparison with the Operational Boundary and Authorised Limit.

Actual External Debt	31 Mar 13 £m
Borrowing	247
Other Long Term Liabilities	59
Total	**306**

Total principal sums invested for periods longer than 364 days

This indicator allows the Council to manage the risk inherent in investments longer than 364 days and for 2012/13 the limit was set at £30 million.

As at 31 March 2013 the Council had £14m of investments longer than 364 days, all with other Local Authorities.

Capital Expenditure
This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits and in particular, to consider the impact on Council Tax.

A full breakdown of capital expenditure and capital financing in 2012/13 can be found within the Capital Outturn report, reported to Cabinet 13 June 2013.

Ratio of financing costs to net revenue stream
This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs. The ratio is based on costs net of investment income.

Ratio of Finance Costs to net Revenue Stream	2012/13 Estimate %	2013/14 Esimate %	2014/15 Estimate %
Ratio	8.36	10.17	10.82

Incremental Impact of Capital Investment Decisions
This is an indicator of affordability that shows the impact of capital investment decisions on Council tax levels. The incremental impact is calculated by comparing the total revenue budget requirement of the current approved capital programme with the equivalent calculation of the revenue budget requirement arising from the proposed capital programme.

Incremental Impact of Capital Investment Decisions	2012/13 Estimate £	2013/14 Estimate £	2014/15 Estimate £
Increase in Band D Council Tax	5.30	8.61	4.53

Adoption of the CIPFA Treasury Management Code
This indicator demonstrates that the Authority adopted the principles of best practice.

Adoption of the CIPFA Code of Practice in Treasury Management
Council approved the revised Cipfa's Code of Treasury Management at its meeting of 1 March 2012