Agenda Item 5

Mole Valley District Council

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Subject	Treasury Management – Annual Report and Prudential Indicators – 2013/2014

RECOMMENDATIONS

That Audit Committee is asked to recommend to Council;

1. That the Treasury Management Annual Outturn report for 2013/2014 be noted.
2. That the actual Prudential Indicators reported for 2013/2014, as detailed in Appendix A to this report, be approved.

EXECUTIVE SUMMARY

Treasury management is the control and management of all the Council's cash, regardless of its source. It covers management of the daily cash position and investments. The Council has no borrowings. Officers carry out this function within the parameters set by the Council each year in the Treasury Management Strategy Report.

This report reviews the performance of the Prudential Indicators and Treasury Management Strategy and Annual Plan 2013/2014 as agreed by Council on 19th February 2013.

The report meets the requirements of both the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code). The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003. The primary requirements of the Codes are the:

- Creation and maintenance of a Treasury Management Policy Statement (TMPS) that sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices (TMPs) that set out the manner in which the Council will seek to achieve those policies and objectives.

- Receipt by Council of an annual strategy report for the year, a mid-year treasury update report and a subsequent annual review report (this report) after the end of the financial year.

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.

Council have delegated the responsibilities for implementing and monitoring treasury management policies and practices to the Audit Committee and for the operation and administration of treasury management decisions to the Strategic Director (Section 151 Officer), who will act in accordance with the organisation's treasury management policy statement and TMP's, and CIPFA's Standard of Professional Practice on Treasury Management.

In summary, the Council's in-house team together with some externally managed funds achieved a rate of return on investments of 1.22%. The Council achieved an overall return of £425,884 in 2013/14 approximately £106,000 above budget. Investment balances at balance sheet dates increased from £24.452m (31/03/13) to £25.983m (31/03/14). The 2013/14 financial year continued the challenging environment of previous years with low investment returns and continuing counterparty risk.

In conducting the treasury management activities of the Council there were no breaches of the agreed Strategy and the in-house team operated within the Prudential Indicators set by Council.

1. **Background**

1.1 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."

1.2 The annual treasury management outturn report for 2013/14 covers:

- The economy and interest rates
- The Council's capital expenditure and financing
- Investment rates
- The borrowing strategy
- The borrowing outturn
- Compliance with treasury limits and Prudential Indicators
- Investment strategy
- Investment outturn
- Debt rescheduling
- Other issues

2. The economy and interest rates in 2013/14

The financial year 2013/14 continued the challenging investment environment of previous years, namely low investment returns, although levels of counterparty risk had subsided somewhat. The original expectation for 2013/14 was that Bank Rate would not rise during the year and for it only to start gently rising from quarter 1 2015. This forecast rise has now been pushed back to a start in quarter 3 2015. Economic growth (Gross Domestic Product (GDP)) in the UK was virtually flat during 2012/13 but surged strongly during the year. Consequently there was no additional quantitative easing during 2013/14 and the Bank Rate ended the year unchanged at 0.50% for the fifth successive year. While Consumer Price Index (CPI) inflation had remained stubbornly high and substantially above the 2% target during 2012, by January 2014 it had fallen below the target rate to 1.9% and then fell further to 1.7% in February. It is also expected to remain slightly below the target rate for most of the two years ahead.

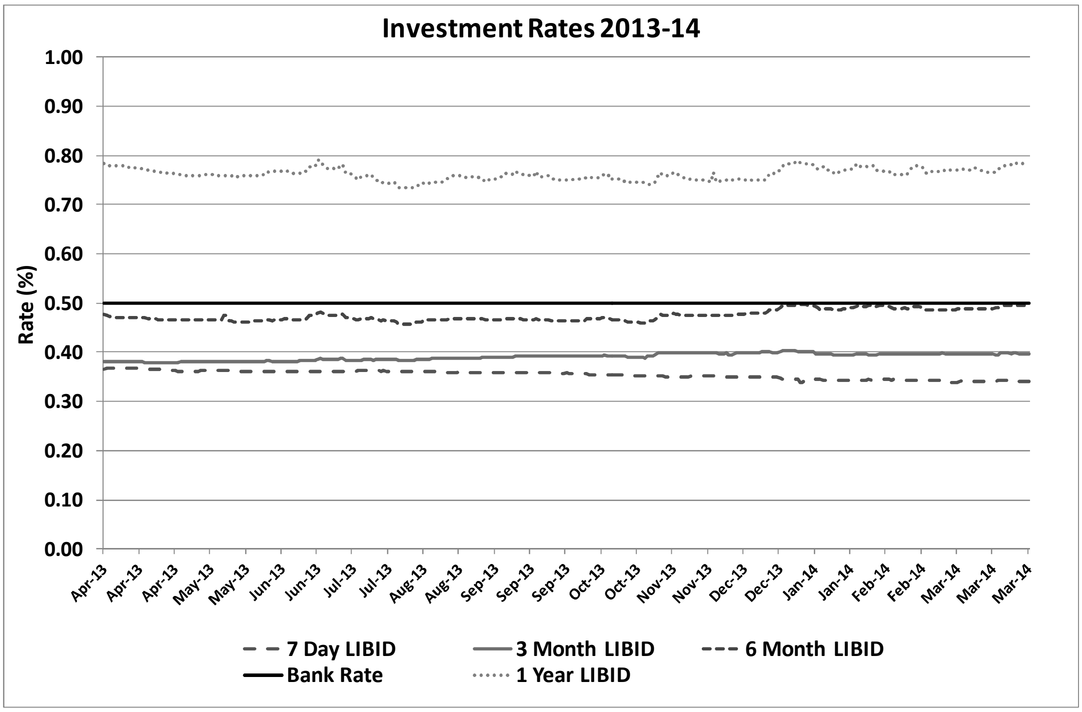
Gilt yields were on a sharply rising trend during 2013 but volatility returned in the first quarter of 2014 as various fears sparked a flight to quality. The Funding for Lending Scheme, announced in July 2012, resulted in a flood of cheap credit being made available to banks which then resulted in money market investment rates falling drastically in the second half of that year and continuing into 2013/14. That part of the Scheme which supported the provision of credit for mortgages was terminated in the first quarter of 2014 as concerns rose over resurging house prices.

The UK Coalition Government maintained its tight fiscal policy stance but recent strong economic growth has led to a cumulative, (in the Autumn Statement and the March Budget), reduction in the forecasts for total borrowing, of £97bn over the next five years, culminating in a £5bn surplus in 2018-19.

The European Union sovereign debt crisis subsided during the year and confidence in the ability of the Eurozone to remain intact increased substantially. Perceptions of counterparty risk improved after the European Central Bank (ECB) statement in July 2012 that it would do ‘whatever it takes’ to support struggling Eurozone countries. This led to a return of confidence in its banking system which has continued into 2013/14 and led to a move away from only very short term investing. However, this is not to say that the problems of the Eurozone, or its banks, have ended as the zone faces the likelihood of weak growth over the next few years at a time when the total size of government debt for some nations is likely to continue rising. Upcoming stress tests of Eurozone banks could also reveal some areas of concern.

The **Bank Rate** remained at its historic low of 0.5% throughout the year, it has now remained unchanged for five years. Market expectations as to the timing of the start of monetary tightening ended up unchanged at early 2015. The Funding for Lending Scheme resulted in deposit rates remaining depressed during the whole of the year, although the part of the scheme supporting provision of credit for mortgages came to an end in the first quarter of 2014.

Bank rate v London Interbank BID (LIBID) investment rates



3. **Capital Expenditure and Financing 2013/14**

3.1 The Council finances capital expenditure resulting in an increase in long-term assets. These may either be;

- Financed immediately through the application of capital receipts, capital grants etc, or
- If insufficient financing is available the expenditure will give rise to a borrowing need

3.2 The Council finances capital expenditure out of capital reserves and does not currently have a borrowing need.

3.3 The table below shows how capital expenditure was financed over the past two years. The decrease in actual expenditure over the estimate and subsequent financing was mainly as a result of an under spend in the disability adaptations and home improvement and Section 106 projects budgets.

	2012/13 Actual £000	2013/14 Estimate £000	2013/14 Actual £000
Total capital expenditure	**2,881**	**3,890**	**3,264**
Resourced by :			
Capital receipts	2,092	3,370	2,047
Capital grants	594	270	412
Capital reserves	195	250	805
Repairs & Renewals Fund	0	0	0
Total Resources Applied	**2,881**	**3,890**	**3,264**

4. **Investment Rates in 2013/14**

4.1 The market interest rates at the start and end of the year are shown below. As can be seen rates have stabilised albeit at historically low levels. The reduction in interest rates, including the effect of the introduction of the Funding for Lending Scheme by the Government, has had a significant bearing on the interest earnings of the Authority on internal investments and will do so moving forward.

Market Rates:

Notice	31/03/12	31/03/13	31/03/14
	%	%	%
Overnight	0.40	0.45	0.45
1 Week	0.40	0.48	0.48
1 Month	0.50	0.46	0.46
3 Months	0.80	0.55	0.55
6 Months	1.25	0.70	0.65
364 Day	1.70	0.84	0.90

5. **Borrowing strategy for 2013/14**

5.1 The major objectives to be followed in 2013/14 if there had been an underlying borrowing requirement were:

- To forecast average future interest rates and movements in future interest rates
- To secure the cheapest cost for financing capital schemes commensurate with future risk
- To ensure that, where possible, the Council's debt free status is retained
- To manage the Council's short-term debt, if any so arises, ensuring prompt payment of interest and principal on the due dates

6. **Borrowing outturn for 2013/14**

6.1 The Council did not raise any funds through the money market or through the Public Works Loans Board (PWLB), either in the short or long term, during 2013/14. This has been the case since 1987. The Council's last external loan was repaid in February 1997 and Mole Valley became debt free on 1st April 1997.

7. **Compliance with Treasury Limits and Prudential Indicators**

7.1 During the financial year the Council operated within the Prudential Indicators 2013/14 – 2015/16 and Treasury Management Strategy and Plan 2013-14 as agreed by Council on 19th February 2013. The outturn for the Treasury and Prudential Indicators is detailed in Appendix A of this report.

8. **Investment Strategy for 2013/14**

8.1 The Investment Strategy's primary objectives are safeguarding the re-payment of the principal and interest of its investments on a timely basis first and ensuring adequate liquidity second, with the investment return being the third objective.

8.2 Members will recall that as part of the Treasury Management Strategy Report 2013/14 to 2015/16 agreement was given to increased licence in terms of the scope and range of its investments. The change was required as initial preparatory work on the Medium Term Financial Strategy had demonstrated an imbalance between reducing funding sources and increased costs.

8.3 The focus of the new strategy remained primarily on safeguarding sufficient of the Council's balances in secure and liquid investments to ensure overall stability. However, it was recommended that between £8m and £12m could be diverted in the interests of securing a higher return and providing a more substantial income stream for the Council's revenue account. This was dependent on the options that became available. These options would include extending the investment portfolio (eg through longer term investments or property funds) and/or diverting part of the investment portfolio into property purchases.

8.4 The Council predominantly manages its investments in-house and invests with the institutions listed in the Council's approved lending list. The Council primarily invests for a range of periods less than one year dependent on the Council's cash flows, its interest rate view and the rates of interest on offer. The Base Rate remained at 0.50% for the duration of the financial year.

8.5 The expectation for interest rates within the Strategy for 2013/14 anticipated a low but rising Bank Rate (starting in quarter 1 of 2015). 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.

8.6 No institutions in which investments were made during 2013/14 had any difficulty in repaying principal and interest in full during the year.

9. Investment outturn for 2013/14

9.1 The Council's investment policy is governed by Communities and Local Government (CLG) guidance, which has been implemented in the annual investment strategy approved by the Council on 19th February 2013. This policy sets out the approach for selecting investment counterparties, and is based on credit ratings provided by the three main credit rating agencies. Counterparties are selected and limits applied using rating criteria. The application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria. This is in compliance with the CIPFA Treasury Management Code of Practice. Credit rating information is supplied by our treasury management advisor.

9.2 Detailed below is the result of the investment strategy undertaken by the Council.

<u>Internally Managed Funds</u>

9.3 The Council maintained its investment activities during the year, as agreed by Council on 19th February 2013.

9.4 During the year all investments were made in full compliance with the Council's treasury management policies and practices and the Council had no liquidity difficulties.

9.5 The limit to be placed, with each counterparty, remained at £7.5 million. The Council also operated a 'group limit', whereby the collective investment exposure to individual banks within the same banking group was restricted to a group total set also at £7.5 million.

9.6 The analysis below shows the activity undertaken on internally managed funds during 2013/14.

	£
Balance outstanding 01/04/13	24,452,000
Investments made during the year	132,580,000
Upward revaluation of CCLA Property Fund investment (at 31/03/14)	78,000
	157,110,000
<u>Less:</u> Investments maturing during the year	131,127,000
Balance outstanding 31/03/14	25,983,000

9.7 These investments generated interest of approximately £426,000 in the year (£342,000 in 2012/13), gross of all associated charges against a budget of £320,000. The majority of income is received from short-term investments (investments that mature in, or are held for, 12 months or less) but the increase over the budget has been achieved by investing some funds longer-term (investments that are placed for a period longer than 12 months). In particular attractive yields are still being achieved on two 'cap and collar' investments (arrangements where limits are placed on the minimum and maximum coupon rates receivable against a benchmark). Also good returns are being achieved on the investment of £5m that was made in the CCLA Property Fund on 30th June 2013 (refer to paragraph 9.10). There has been no movement in the Base Rate since the 0.50% reduction on 5th March 2009 to the current level of 0.50%.

2013/2014	Original Estimate £	Actual Outturn £	Variance £
Internally Managed Funds	320,000	425,884	105,884

9.8 Mole Valley achieved a rate of return of 1.22% on its internally managed funds during the year, this was based on an average fund value of approximately £34,790,000. The formal method used to compare performance is to contrast the rate of return against the average uncompounded 7-day LIBID rate (0.354% for 2013/14). The long-term 'cap and collar' investments previously alluded to have in part enhanced the return on internally managed funds when compared to the benchmark.

9.9 Detailed below is the result of the investment strategy undertaken by the Council.

Funds	Average Fund Value	Rate of Return	Benchmark Return *
Internally / Externally Managed	£34,790,000	1.22%	0.354%

* 7-day LIBID uncompounded 0.354%

The uncompounded rates are for internally managed funds and exclude the roll-up of principal and interest. Upon maturity of the investment, interest is paid over with the original principal sum.

Externally Managed Funds – Churches, Charities and Local Authorities (CCLA)

9.10 On 30th June 2013 the Council invested £5m in the Charities, Churches and Local Authorities (CCLA) Property Fund. This is a high quality, well diversified property fund. To realise the full potential of this investment it should be considered as a medium to long term placement. Income is received quarterly and in the current economic climate good yields are anticipated.

9.11 Good returns of 3.89% were achieved from this Fund for the three quarter year period to 31st March 2014. With the property market remaining buoyant it is anticipated that these returns will continue during 2014/15.

10. **Debt rescheduling**

10.1 The Council did not raise any funds through the money market or through the Public Works Loans Board (PWLB) during the year. The last external loan was repaid in February 1997 and Mole Valley became debt free on 1st April 1997. Therefore, debt rescheduling was not an issue.

11. **Other issues**

11.1 The Treasury Management Strategy Report for 2015/16 to 2017/18 will be presented to the November Audit Committee.

12. **<u>Corporate Implications</u>**

12.1 **Legal Implications**

The Council's treasury management activities are regulated by a variety of professional codes, statutes and guidance:

- The Local Government Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity.
- The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (no restrictions were made in 2013/14).
- Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act.
- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities. The Prudential Code required indicators to be set, some of which are limits, for a minimum of three forthcoming years.
- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services.
- Under the Act the DCLG has issued Investment Guidance to structure and regulate the Council's investment activities. Updated guidance became available on 1st April 2010. The emphasis of the Guidance is on the security and liquidity of investments.

The Council has complied with all of the above relevant statutory and regulatory requirements that limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means both that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

12.2 **Financial and Risk Implications**

The Council considers security, liquidity and yield, in that order, when making investment decisions:

Security – counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swaps, gross domestic product (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. The minimum long-term counterparty credit rating determined for 2013/14 was A/A2/A (Fitch/Moody's/Standard and Poors).

Liquidity – the Council maintained a sufficient, though not excessive, level of liquidity during the year using various call accounts and short-term, fixed-rate, deposits.

Yield – the Council sought to optimise returns commensurate with its objectives of security and liquidity. Short-term money market rates remained at very low levels throughout the year which had a significant impact on investment income.

A high reliance on investment income can place the Council at significant risk of budget variation as interest rates rise and fall, which has an impact upon future Council Tax levels. The Council's Medium Term Financial Strategy addresses this risk and seeks to reduce this reliance over time.

Locking significant investments into long-term fixed-rate deals means the Council has a potential disadvantage in a rising interest market, especially if the interest rate rises above the assumption made when the long-term deal was placed.

To mitigate this, the Council's in-house team predominantly invest up to periods of three months only, hence advantage can be taken of prevailing interest rates upon the investments maturity. This minimises the disadvantage whilst maintaining certainty over the level of future return and stability in planned future Council Tax levels. With interest rates remaining at historically low levels the Authority has made some longer term investments that are higher yielding, although less liquid. This has proved to be a good decision as interest rates have remained at low levels throughout the year.

The Council will continue to look to diversify its investment portfolio and the 2014/15 Treasury Management Strategy provides for alternative investment funds should the opportunity arise.

12.3 **Equalities Implications**

None within the report

12.4 **Employment Issues**

None within the report

12.5 **Sustainability Issues**

None within the report

12.6 Consultation

A number of meetings were convened during the year involving Capita Asset Services, Members and Officers.

13. BACKGROUND PAPERS

CIPFA Treasury Management in the Public Services – Code of Practice and Cross-Sectoral Guidance Notes (2011 edition).

CIPFA Treasury Management in the Public Services – Guidance Notes for Local Authorities including Police Authorities and Fire Authorities (2011 edition).

CIPFA the Prudential Code for Capital Finance in Local Authorities (2011 edition).

Treasury Management Annual Strategy Report 2013-14 and Prudential Indicators 2013-14 to 2015-16.

Performance management information from Capita Asset Services.

2013/14 final accounts working papers.

APPENDIX A

1. PRUDENTIAL INDICATORS AND COMPLIANCE ISSUES

1.1 The treasury management service is an important part of the overall financial management of the Council's affairs. Whilst the Prudential Indicators consider the affordability and impact of capital expenditure decisions, the treasury management service covers the effective funding of these decisions.

1.2 The 2003 Prudential Code for Capital Finance in Local Authorities requires that actual prudential indicators be reported after the year-end. The table below summarises the key prudential indicator performance for 2013/14.

1.3 The Council at its meeting on 19th February 2013 adopted the prudential indicators for 2013/14.

2012/13	Prudential Indicator	2013/14
Actual		**Actual**
	CAPITAL EXPENDITURE / AFFORDABILITY	
£000's	**Capital Expenditure**	**£000's**
2,881	General Fund	3,264
2,881	**Total**	**3,264**
£000's	**Capital Financing Requirement**	**£000's**
3,392	General Fund	3,085
3,392	**Total**	**3,085**
%	**Ratio of Financing Costs to Net Revenue Stream**	**%**
3.30	General Fund	4.40
3.30	**Total**	**4.40**
£p	**Increase in Council Tax (Band D) per annum**	**£p**
0.00	Mole Valley DC (2013/14 = 1.9% increase)	2.88
	TREASURY MANAGEMENT	
£000's	**External Debt**	**£000's**
0	General Fund	0

Capital Financing Requirement (CFR)

1.4 The CFR is derived from the Authority's balance sheet and measures its underlying need to borrow for a capital purpose. This Authority fully finances its capital expenditure (including the value of assets acquired under finance leases) without borrowing. Where capital expenditure is to be financed in future years by charges to revenue as assets are used by the Authority, the expenditure results in an increase in the Capital Financing Requirement, a measure of the capital expenditure incurred historically by the Authority that has yet to be finalised.

1.5 In accordance with best practice this Authority does not associate borrowing with particular items or types of expenditure, in day-to-day cash management no distinction can be made between capital cash and revenue cash. Any external borrowing would arise as a consequence on all financial transactions whereas this measure reflects the Authority's underlying need to borrow for a capital purpose only.

Net Borrowing and the CFR

1.6 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. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2013/14 plus the expected changes to the CFR over 2014/15 and 2015/16. The Council has complied with this prudential indicator.

The Authorised Limit

1.7 The Authorised Limit is the "Affordable Borrowing Limit" required by S3 of the Local Government Act 2003 irrespective of the Authority's indebted status. The limit is the maximum amount of external debt that can be outstanding at any one time during the financial year. The Authorised Limit also provides some headroom for unexpected cash movements. The introduction of International Financial Reporting Standards (IFRS) required finance leases to be included under other long-term liabilities on the balance sheet. A limit of £5.5m was used for the Authorised Limit. The actual outturn was £3.2m (£3.5m in 2012/13) for finance lease liabilities. There was no borrowing during 2013/14.

The Operational Boundary

1.8 The Operational Boundary is the expected borrowing position of the Council during the year, and periods where the actual position is either below or over the Operational Boundary is acceptable subject to the Authorised Limit not being exceeded. The Operational Boundary does not allow for additional headroom as is the case with the Authorised Limit. A limit of £4m was used for the Operational Boundary. The actual outturn was £3.2m (£3.5m in 2012/13) for finance lease liabilities. There was no borrowing during 2013/14.

Actual financing costs as a proportion of net revenue stream

1.9 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. Since the Council is a debt free authority this indicator is not relevant.

1.10 A "debt free" Authority does not incur financing costs because it does not have any long-term debt. Instead, this indicator measures the investment income earned by the Council as a percentage of the Council Tax budget requirement, so as to show the level by which investment income is being used to underpin the Council's operational budget. See table at paragraph 1.3.

Adoption of the CIPFA Treasury Management Code

1.11 This indicator demonstrates that the Council has adopted the principles of best practice.

1.12 The Council approved the adoption of the CIPFA Treasury Management Code at its full Council meeting on 20th January 2004.

1.13 The Council has incorporated the changes from the revised CIPFA Treasury Management Code of Practice into its treasury policies, procedures and practices. Council approved the revised Treasury Management Policy on 19th February 2013.

Investment Activity

1.14 The purpose of the following indicators is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates.

1.15 **Interest rate exposure**

Interest rate exposures			
	2012/13 Actual	2013/14 Original	2013/14 Actual
	Upper	Upper	Upper
Limits on fixed interest rates : (investments only)	86.52%	100%	73.04%
Limits on variable interest rates : (investments only)	13.48%	60%	26.96%

1.16 **Maturity structure of fixed interest rate borrowing 2013/14**

Maturity structure of fixed interest rate borrowing 2013/14		
	Lower	Upper
Under 12 months	0%	0%
12 months to 2 years	0%	0%
2 years to 5 years	0%	0%
5 years to 10 years	0%	0%
10 years and above	0%	0%

1.17 The Council has been debt free since 1st April 1997. These indicators have therefore not moved from 0% in the estimate or the actual outturn.

1.18 **Maximum principal sums invested > 364 days**

Maximum principal sums invested > 364 days			
	2012/13 Actual	2013/14 Original	2013/14 Actual
Principal sums invested > 364 days	£2m	£12m	£7m