REPORT TO:	**FINANCE AND MANAGEMENT COMMITTEE (SPECIAL – FINAL ACCOUNTS)**	**AGENDA ITEM: 6**
DATE OF MEETING:	**27th JUNE 2013**	**CATEGORY: DELEGATED**
REPORT FROM:	**DIRECTOR OF FINANCE & CORPORATE SERVICES**	**OPEN**
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SUBJECT:	**TREASURY MANAGEMENT ANNUAL REPORT 2012/13**	**REF:**
WARD (S) AFFECTED:	**ALL**	**TERMS OF REFERENCE: FM 08**

1.0 Recommendations

1.1 That the Treasury Management Annual Report for 2012/13 is approved.

1.2 To note the Treasury Management Stewardship Report and Prudential Indicators for 2012/13 (as detailed in **Appendix1**) and that the Council complied fully with all requirements.

1.3 That the Statement on the Minimum Revenue Provision for 2012/13 is recommended to Council for approval.

2.0 Purpose of Report

2.1 To detail the Council's actual borrowing and lending for 2012/13 compared to the approved strategy, including performance against its Prudential Indicators. This is in accordance with the Local Government Act 2003 and associated regulations.

3.0 Executive Summary

3.1 The Council's borrowing and investment strategy for the year required that its cash flow requirements were managed through short-term borrowings and bank deposits. Overall, the Council's cash flow remained positive throughout the year. However, due to low rates and limitations on approved counterparties, interest received was lower than budgeted.

3.2 As financial monitoring reports throughout the year highlighted, the main Bank of England Base Rate remained at 0.5% throughout the year. This continued to limit the amount of interest earned on short term investments and bank deposits.

3.3 During the year there were no significant transactions regarding borrowing compared to the previous year 2011/12, with the borrowing for HRA self financing.

3.4 In undertaking its treasury management functions during the year, the Council managed its activities within its prudential indicators and approved lending policy.

4.0 <u>Economic Overview</u>

During 2012/13 economic growth was lower than anticipated and it was feared the UK would enter into a triple dip recession. The debate regarding the benefit to the UK of the current austerity measures continued throughout 2012/13.

The UK lost its AAA credit rating in February with Moody's and this was followed by the Fitch Rating Agency in April 2013. The UK had done well to keep its credit rating until this point with the USA and France being downgraded previously.

No interest rate changes were seen in 2012/13 as it was predicted this would force a rise in the price of money. This is the basis on which the Public Works Loan Board fix their rates.

5.0 <u>Detail</u>

Borrowing During 2012/13

5.1 The Council's approved borrowing strategy for 2012/13 was:

- To manage its cash flow requirements through short-term borrowings and bank deposits

- That in accordance with capital investment requirements, no longer-term borrowing is undertaken in the year

- That the one remaining Money Market loan of £1m be repaid should the Lender invoke their option to increase the interest rate.

The Council's Cash Flow During 2012/13

5.2 The Council's cash flow can fluctuate on a daily basis depending on the timing of income and expenditure.

5.3 At certain times of the year, the Council may need to borrow to cover shortfalls on a temporary basis, whilst when cash flow is positive any surplus funds are invested on a temporary basis. However, the Council still has a long-term underlying need to borrow.

5.4 For several years the Council has not undertaken any form of new long-term borrowing to finance General Fund capital expenditure but has chosen to fund this from other sources such as government grants and external funding, together with “internal” borrowing from reserves and balances.

5.5 This is a result of the Council having, over recent years, generated substantial receipts for which expenditure is then spread over a number of years, e.g. Section 106 contributions and partnership funding received in advance.

5.6 In addition, the Council’s general level of both allocated and non-allocated reserves has remained sufficiently high to enable internal borrowing. This is generally a more efficient means of borrowing as external interest costs are avoided. However, this does require the overall level of reserves and balances to remain adequate.

5.7 The Council currently has a total long term borrowing of £58,430k relating to the HRA and is made up of both fixed and variable rate borrowing.

5.8 The Council effectively invests its balances and reserves over the year generating interest for the General Fund and Housing Revenue Accounts. In addition, the Council is generally able to collect its main income in the form of Council Tax and Business Rates before it is spent or re-distributed. This is invested on a short-term basis and generates a return for the Council.

5.9 Overall, the Council continued to have a positive cash flow position in 2012/13. However, given the low level of interest rates, the financial benefit in the form of interest earned was low.

5.10 The Councils cash balances remained high throughout the year with the average cash balance being approximately £9.8million. This average was boosted by receiving £4million from Central Government half way through the year in error and this was not repaid until the later part of 2012/13.

Interest Rates

5.11 For the fourth consecutive year, the main Bank Base Rate as set by the Bank of England remained at 0.5% throughout 2012/13. It has been at this level since 5th March 2009.

5.12 The Council’s Budget for 2012/13 originally assumed a higher level of interest would be obtained. However, this was not possible as restrictive investment criteria were in place. As reported in budget monitoring the interest received was not as high as forecast. The budget for 2013/14 has been reduced to represent the reduction in interest currently being obtained.

5.13 The Council’s benchmark, as approved in the Treasury Management Strategy, is to achieve at least the average 7-day market rate over the year. This was not achieved during 2012/13 with the Council’s average investment rate being 0.31%, compared to 0.51%.

5.14 The Council is struggling to meet the average 7 day market rate due to its Treasury Strategy limiting who the Authority invests with. Under the current policy there are very few UK financial institutions who meet the Councils criteria thus limiting the interest to be received on cash balances. However, security and liquidity is given priority over yield (interest returned) in any investment decision.

5.15 The Council placed funds predominantly with the Government's Debt Management Office, instant access investment accounts and other local authorities. Although these are the safest form of deposit available and are "guaranteed," interest rates are lower than the market average.

Temporary Borrowings

5.16 The Council was not required to undertake any temporary borrowings during 2012/13. This was due to high reserve levels relating to the General Fund, HRA and Capital Receipts, etc.

5.17 The Council holds money on deposit for Parish Councils. This money is classed as temporary as it can be recalled on immediate notice. Traditionally, Parishes have placed funds with the Council to ensure security and liquidity of funds.

5.18 The Council pays 1% below the prevailing Bank of England Base rate. As this rate was 0.5% throughout the year, no payments were made. Principal outstanding fell from £78,000 at the start of the year to £41,000 as some Parishes recalled their deposits due to the lack of interest being received.

5.19 This facility offered to Parishes does not have a significant impact upon the overall treasury management operations of the Council.

Budgetary Implications

5.20 The level of interest actually received and paid is built into the General Fund Revenue Account. A proportion of this is transfererd into the Housing Revenue Account (HRA) under a statutory calculation to recognise that some interest on investments is attributable to the HRA.

5.21 The actual interest received compared to that included in the approved budget is summarised below.

SHORT TERM INVESTMNENTS - INTEREST 2012/13	**BUDGET £000**	**ACTUAL £000**
Overall interest received from money on deposit	50	35
Less – Interest payments on temporary borrowings	0	0
Net Interest Received	**50**	**35**

Other Interest Paid and Received

5.22 In addition, the Council paid and received other interest during the year as set out in the following table. This demonstrates the influence lower interest rates on investments had on the budgets overall.

Overall Interest 2012/13	Budget £000	Actual £000	Variance £000
Interest Payments – HRA	1,611	1,608	-3
Interest Received – HRA	-20	-14	6
Interest Payments – General Fund	0	0	0
Interest Received – General Fund	-30	-22	8
TOTAL	**1,561**	**1,572**	**11**

Money Market Debt

5.23 The Council still has one money market loan for £1m. This borrowing was undertaken some years ago to fund capital commitments at that time. The loan costs £48k per year in interest charges at a fixed rate of 4.875%. It is due to mature in 2032.

5.24 Potentially, there is a break clause. The lender has the option of reviewing the interest rate at any time and increasing it if they so wish. However, the Council then has the option of rejecting this and can instead choose to repay without incurring any penalty.

5.25 In setting the borrowing strategy for 2012/13, it was approved that should the lender exercise their option to increase the interest rate, then the loan should be repaid at that time. This would be financed “internally” from reserves and balances, but would reduce the Capital Financing Requirement and future Minimum Revenue Provisions.

5.26 The lender did not invoke their option during the year and the situation will be kept under review. Given that current borrowing rates are low compared to the rate of this loan (at 4.875%) the penalty for early redemption would not make it cost effective to repay early.

5.27 The same principle regarding this loan was adopted as part of the Treasury Management Strategy for 2013/14.

Investments 2012/13

5.28 The Council does not have any long-term investments but the Council is required to maintain an investment strategy covering short-term investments such as the deposit of surplus funds.

5.29 The overall strategy in the year was to effectively invest surplus funds to meet cash flow requirements within the year. In addition, there was no proposal to enter into longer term and externally managed funds.

5.30 The Council invests surplus funds in accordance with an approved policy and associated lending list. This is summarised in the following table.

Institution	Limit
Specified Investments	
• UK Debt Management Office (DMO)	£10m
• Local, Police, Fire and Parish Authorities	£5m
• Other Bodies with a High Credit Rating of F1+/AA-	£7.5m
Non-Specified Investments	
• F1/AA Rated Bodies – First Call	£2m
• F1/A Rated Bodies – Second Call	£1m
• F2/A Rated Bodies – Third Call	£0.25m

5.31 During the year the Council temporarily breached the limit with the DMO, mainly due to a Central Government grant received in error. This was not believed to have put the Council at any significant risk and was reported to the Committee previously.

Definition of Credit Ratings

5.32 The long-term rating is based on an investment grade categorised by “Fitch” on the following scale:

- AAA: the best quality companies, reliable and stable
- AA: quality companies, a bit higher risk than AAA
- A: economic situation can affect finance
- BBB: medium class companies which are satisfactory at the moment.

5.33 Intermediate modifiers are also used for each category between AAA and BBB (i.e. AA+, AA, AA-, A+, A, A-, etc.).

5.34 Short-term credit ratings indicate the potential level of default within a 12-month period, based on the following scale.

- F1+: best quality grade, indicating exceptionally strong capacity to meet financial commitments.
- F1: best grade, indicating strong capacity to financial commitments.
- F2: good quality grade with satisfactory capacity to financial commitments.

5.35 The scale then falls from F3 to B, then C and finally down to D, which indicates the institution is likely to, or has failed to meet its financial commitments.

General Policy

5.36 As approved, priority is given to specified investments in any investment decision. The length of investment is made in accordance with overall cash flow requirements.

5.37 The Council's policy is to seek investments with those institutions graded at least AA and F1+.

5.38 All deposits made in the year were in accordance with the approved lending list.

Performance Indicators

5.39 As previously highlighted, the main indicator is for the return on short-term investments to meet the average 7-Day Rate, a standard measure of performance. The Council's performance for 2012/13 (with a comparison to recent years) is shown in the following table.

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
7-Day Rate (target)	5.61%	3.57%	0.39%	0.51%	0.62%	0.51%
Actual Rate	5.81%	4.38%	0.72%	0.78%	0.74%	0.31%

Prudential Indicators

5.40 Under a national Code of Practice for Capital Finance, the Council must set and regularly monitor Prudential Indicators. These indicators are designed to measure and place controls over the level of borrowing and capital financing during the year.

5.41 They are set following the annual budget round where the Section 151 (Chief Finance) Officer is required to provide an assessment of these indicators, their implications for the Council's spending plans and overall financial position.

5.42 The prudential system provides the flexibility for these indicators to be changed depending on local circumstances. It is the responsibility of the Section 151 Officer to advice the Council accordingly.

5.43 The actual indicators for 2012/13, together with further details on treasury management activity are detailed in **Appendix 1.**

5.44 The Council operated within its capital budgets and limits for external borrowing at all times during the year.

Minimum Revenue Provision (MRP) - Background

5.45 Local authorities are required each year to <u>set-aside</u> some of their revenues as a provision to repay any borrowings or other credit (shorthand this is technically called "debt"). This set-aside is known as MRP and is a charge on the Council's General Fund.

5.46 This requirement has existed for many years and is designed to ensure that authorities, prudently, make provision to meet their credit liabilities into the future.

5.47 This was to ensure that authorities continue to make a sufficient and prudent provision in their accounts, in particular where they have made any unsupported borrowing under the Prudential System.

5.48 It is the responsibility of the Section 151 Officer to advise on the treatment of MRP and to recommend a suitable policy for adoption. Consequently, authorities are also required to prepare an annual statement on making a MRP.

The Calculation

5.49 MRP traditionally had been calculated (at a rate of 4%) based on an authority's borrowing requirement. As highlighted previously, the Council has an underlying requirement based on past borrowing approvals issued by the Government.

5.50 However, due to its strong and positive cash flow position, the Council has financed this borrowing "internally." Therefore, over time, actual debt does not match the underlying requirement shown in the Council's accounts.

5.51 However, by charging a MRP into the accounts, this is reducing the underlying requirement as effectively it is providing the resources to "repay" on a yearly basis.

The 4 Options

5.52 The calculation is designed to ensure that a "prudent" provision is made for debt repayment. The 4 options are as follows:

- **Option 1** - For debt that is supported by the Government through the grant system, authorities may continue to use the formula in current regulations (4%), since revenue support grant is calculated on that basis. Technically however, this option has now been revoked, but has been maintained temporarily as a measure for capital expenditure incurred before 1st April 2008.

- **Option 2** – A simplified method of option 1 that reflects supported debt based on an authority's capital financing requirement. This method has been in place since 2004 when the Prudential System was first introduced.

- **Option 3** – The method to use for new borrowing under the Prudential System for which no Government support is given, MRP being based on the life of the asset being purchased.

- **Option 4** – As above, but MRP relates to the depreciation charge on the asset purchased.

Effect on South Derbyshire

5.53 The Council is operating under Option 2. Technically, the Council has been debt free under these regulations since 2004 (having repaid its Government borrowings). In addition, it has not entered into any new borrowing in recent years to finance its capital expenditure. Therefore, similar to previous years, the following statement is recommended for adoption.

Council Statement on MRP

5.54 The Council still has an assumed level of debt (or capital financing requirement) that is being subsidised through grant. Therefore, given no actual debt outstanding (other than the £1m money market loan) together with no unsupported borrowing, it is recommended that “prudence” be best achieved by continuing to provide a MRP under **Option 2**.

5.55 It is recommended that this policy be endorsed for 2012/13 and adopted for 2013/14. It will be kept under review depending on the Council’s future capital expenditure and financing requirements.

5.56 Any proposed changes will be reported as necessary to this Committee for consideration and recommendation to Council. The impact on the MRP will be considered in any decision to enter into any borrowing under the Prudential System.

6.0 Financial Implications

6.1 As detailed in the report regards the MRP and the proposed Statement, there are no additional financial implications for the Council as the budget in the Medium Term Financial Plan has been calculated to reflect this approach. The MRP made in 2012/13 was £263,000.

7.0 Corporate Implications

7.1 None directly.

8.0 Community Implications

8.1 None directly.

9.0 Background Papers

9.1 Local Government Act 2003 and associated Statutory Instruments detailing regulations under the Local Authorities (Capital Finance and Accounting England Regulations) of 2003, 2006 and 2008.

ANNUAL REPORT ON THE TREASURY MANAGEMENT SERVICE AND PRUDENTIAL INDICATORS 2012/13

1.0 Introduction

1.1 The annual treasury report summarises:

- Confirmation of compliance with treasury limits and Prudential Indicators
- Capital activity for the year and how this was financed
- The Council's overall treasury position
- The reporting of the required Prudential Indicators
- Summary of interest rate movements in the year
- Debt and investment activity

2.0 Regulatory Framework, Risk and Performance

2.1 The Council's treasury management activities are regulated through statute and codes of practice. Statutory provisions are contained in the Local Government Act 2003, which provides the powers to borrow and invest as well as providing controls and limits on this activity.

2.2 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 that may be undertaken; no restrictions were made in 2012/13.

2.3 Amended regulations develop the controls and powers within the Act and require the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities. It 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.

2.4 Under the Act the Government have also issued Investment Guidance to structure and regulate the Council's investment activities.

2.5 The Council has complied with all of the above requirements, which 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 capital expenditure has to prudent, affordable and sustainable and its treasury practices demonstrate a low risk approach.

2.6 There is minimal risk of volatility of costs for current debt as the interest rate is largely fixed across the debt portfolio (82%).

2.7 Due to the potential volatility of short-term interest rates, this affects the Council's investment return. These returns are changeable and whilst the risk of loss of principal is minimal through the annual investment strategy, accurately forecasting returns can be difficult.

3.0 The Council's Capital Expenditure and Financing 2012/13

3.1 The Council undertakes capital expenditure on long-term assets. These activities may either be financed through revenue, capital receipts, capital grants or borrowing.

3.2 Part of the Council's treasury activities is to address the borrowing requirement, either through borrowing from external bodies, or utilising temporary cash resources within the Council (internal borrowing).

3.3 The actual capital expenditure is a key prudential indicator. The table below shows how all capital expenditure in the year was financed with no requirement for any new borrowing.

Capital Expenditure 2012/13			
General Fund	£2,751,750	£1,155,287	-£1,596,463
Housing Revenue Account	£4,824,994	£4,017,979	-£807,015
Total - Capital Expenditure	£7,576,744	£5,173,266	-£2,403,478
Financed By:			
Government Grants	£269,000	£334,890	£65,890
External/Partnership Contributions	£1,693,978	£951,520	-£742,458
Capital Reserves	£4,824,994	£4,017,979	-£807,015
Capital Receipts	£788,772	£104,845	-£683,927
Total - Financing	£7,576,744	£5,409,234	-£2,167,510
Net Financing - New Borrowing	£0	-£235,968	-£235,968

***Note**: Total financing was £235,968 greater than total expenditure in the year due to additional financing received for disabled facility grants; this will be carried forward to fund works earmarked in 2013/14.*

4.0 The Council's Overall Borrowing Need

4.1 The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). The CFR is a measure of the Council's underlying need to borrow for capital investment and is based on the value of its assets contained in the Balance Sheet.

4.2 The capital expenditure that has not been immediately paid for will increase the CFR through additional borrowing. The Council is required to pay off an element of the accumulated General Fund CFR (<u>but not HRA</u>) each year through a revenue charge called the Minimum Revenue Provision (MRP).

4.3 As the Council has no unsupported borrowing, MRP will continue to be based upon the "assumed" level of debt for the General Fund as existed on introduction of the Prudential Code in 2004.

4.4 The Council's CFR for the year is shown below.

Capital Financing Requirement (CFR) 2012/13	Estimate 2012/13 £'000	Actual 2012/13 £'000
CFR b/fwd 1st April 2012	71,070	69,438
Add New Borrowing	0	0
Less Debt Repaid	0	0
Less Minimum Revenue Provision (MRP)	-262	-263
Less Voluntary Revenue Provision (VRP)	0	0
CFR c/fwd 31st March 2012	**70,808**	**69,175**
General Fund Proportion	7,926	6,315
HRA Proportion	62,882	62,860

4.5 The assumed (underlying) debt on the General Fund of £6.315m is being written down each year through the MRP.

5.0 Treasury Position at 31 March 2013

5.1 The treasury position at 31 March 2013 compared with the previous year is shown in the following table.

	2011/12		2012/13	
Overall Borrowing Position @ 31st March	**Principal £'000**	**Average Rate**	**Principal £'000**	**Average Rate**
Fixed Interest Rate Debt	48,460	3.21%	48,445	3.34%
Variable Interest Rate Debt	10,355	0.70%	10,318	0.63%
Total Debt	**58,815**		**58,763**	
Short-term Investments	- 3,133	0.25%	- 4,512	0.31%
Net Borrowing Position	**55,682**		**54,251**	

6.0 Prudential Indicators and Compliance Issues

6.1 The prudential indicators provide an overview and specific limits on treasury activity. These are detailed below.

a) **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. Net borrowing should not exceeded the CFR for 2012/13, plus the expected changes to the CFR over 2012/13 and 2013/14. The table below highlights the Council's gross and net borrowing position against the CFR and demonstrates that the Council has complied with this prudential indicator.

Borrowing Compared to CFR 2011/12	Estimate 2012/13 £'000	Actual 2012/13 £'000
Gross Borrowing	58,833	58,763
Net Borrowing	57,833	54,251
CFR	70,808	69,175

b) **The Authorised Limit** – is the ‘affordable borrowing limit’ required by Section 3 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 has maintained gross borrowing within its Authorised Limit.

c) **The Operational Boundary** – is based on the expected maximum external debt (as described above) during the course of the year but it is not a limit. It is designed to help the Council’s Chief Finance Officer to manage treasury activity on a daily basis and acts as an early warning sign of any potential issues.

Authorised Limit and Operational Boundaries 2012/13	**Estimate 2012/13 £'000**	**Actual 2012/13 £'000**
Authorised Limit	74,779	73,168
Operational Boundary	63,423	63,679
Borrowing Position at 31/03/2013	58,833	58,763

d) **HRA – Limit on Indebtedness** – under self-financing, the HRA debt pool has been set a cap over which no borrowing is allowed. This is prescribed by the Government and is fixed. The Cap is shown in the following table with a comparison to the CFR and the level of actual debt on the HRA.

HRA Limit on Indebtedness 2012/13	**Estimate 2012/13 £'000**	**Actual 2012/13 £'000**
HRA Debt Cap (Fixed)	66,853	66,853
HRA CFR	62,882	62,860
Difference	3,971	3,993
HRA Debt	57,813	58,700
Borrowing Headroom (Cap less Debt)	9,040	8,153

e) **Actual Financing Costs as a Proportion of Net Revenue Stream** – this identifies the trend in the cost of capital (borrowing and other long-term obligation costs net of investment income) against the net revenue stream.

Financing Ratios 2012/13	**Estimate 2012/13 £'000**	**Actual 2012/13 £'000**
General Fund		
Council Tax Income	4,837	4,837
Net Interest	- 30	- 22
Proportion	- 0.62%	- 0.45%
HRA		
Rent Income	10,975	11,062
Net Interest	1,591	1,594
Proportion	14.50%	14.41%

7.0 The Economy and Interest Rates

7.1 The year continued to be dominated by financial uncertainty in the Euro Zone markets, together with the impact of the economic downturn. This kept interest rates low with the Bank of England Base Rate remaining at 0.5% for the third consecutive year.

7.2 This low Bank of England Base Rate has reduced the return on investments but has also kept variable rate borrowing low.

8.0 Investment Strategy Approved for 2012/13

In accordance with its policy, the Council continued to place investments giving priority to security and liquidity over yield. At year end the majority of investments were held with Local Authorities or the Debt Management Office.

9.0 Debt Management Activity for 2012/13

9.1 There was no further borrowing during the year.

9.2 Loans repaid during the year equated to £52,000. These related to sums deposited by Parish Councils.

10.0 Investment Performance 2012/13

10.1 The Council's investment policy is governed by regulations and best practice guidance. These are included in the Council's approved Investment Strategy. All investment activity during the year conformed to the approved strategy and the Council had no liquidity issues.

10.2 The Council's longer-term cash balances comprise primarily of unallocated revenue and capital reserves held as a contingency, earmarked reserves and usable capital receipts, together with sums received in advance of spend to meet future commitments.

10.3 The low bank base rate has continued to have a detrimental impact on the Council’s investment returns. The Council maintained an average cash balance of approximately £9.8million with a return of £34,935 during the year.