REPORT TO:	**FINANCE AND MANAGEMENT COMMITTEE (SPECIAL – FINAL ACCOUNTS)**	**AGENDA ITEM: 7**
DATE OF MEETING:	**26th JUNE 2014**	**CATEGORY: DELEGATED**
REPORT FROM:	**Director of Finance & Corporate Services**	**OPEN**
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SUBJECT:	**TREASURY MANAGEMENT ANNUAL REPORT 2013/14**	**REF:**
WARD (S) AFFECTED:	**ALL**	**TERMS OF REFERENCE: FM 08**

1.0 Recommendations

1.1 That the Treasury Management Annual Report for 2013/14 is approved.

1.2 To note the Treasury Management Stewardship Report and Prudential Indicators for 2013/14 (as detailed in **Appendix 1**) and that the Council complied fully with all requirements.

1.3 That the Statement on the Minimum Revenue Provision for 2013/14 as detailed in Section 5, is recommended to Council for approval.

2.0 Purpose of Report

2.1 To detail the Council's actual borrowing and lending for 2013/14 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 but due to low rates and limitations on approved counterparties kept the interest received 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 are no significant transactions regarding borrowing.

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 Economic Overview

4.1 During 2013/14 economic growth was higher than anticipated by many forecasters, with GDP growth estimated to have increased by 1.8% on 2012. There were positive signs with unemployment rates now standing at 6.6% of the adult working population. Pay on average increased by 1.4% excluding bonuses with inflation in the last half of the financial year, reducing.

4.2 There is still a large amount of turmoil existing in the banking system with many banks continuing to suffer losses, agreeing restructure plans with the Bank of England and experiencing negative media coverage. With some credit ratings being reduced, this has constrained the Council's Counterparty Lending List.

4.3 Although there have been more positive signs that the economy is upturning, this is being tempered by some analysts advising caution around its sustainability. The Bank of England has so far resisted calls to increase the Base Bank Lending Rate.

5.0 Detail

Borrowing During 2013/14

5.1 The Council's approved borrowing strategy for 2013/14 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 in 2013/14

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 interest costs are avoided, especially when investment returns are also low. However this does require the overall level of reserves and balances to remain at a level to enable sufficient coverage.

5.7 The Council currently has a total long term borrowing of £58,423k 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 2013/14. However, given the low level of interest rates, the financial benefit in the form of interest earned is low.

5.10 The Council’s cash balances remained high throughout the year with the average cash balance being £12.4million.

Interest Rates

5.11 For the fifth consecutive year, the main bank base rate as set by the Bank of England remained at 0.5% throughout 2013/14. It has been at this level since 5th March 2009.

5.12 During 2013/14 the Council received more interest than in 2012/13 due to the high balances and this was above budget, despite the average interest rate being below the market average. Restrictive investment criteria remained in place. This is aimed at keeping funds secure and liquid, rather than prioritising yield. Interest received is not forecast to change in 2014/15 as the Bank of England rate is forecast to stay at 0.5%.

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.

5.14 This was not achieved during 2013/14 with the average investment rate being 0.33%, compared to a market average of 0.47%.

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 2013/14. This was due to the high reserve levels.

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 their 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 interest payments were made. Principal outstanding fell from £41k at the start of the year to £28k 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 recharged 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 was £40,870 compared to a budget of £32,500, of which £12,339 (30%) related to the HRA.

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 2013/14	Budget £000	Actual £000	Variance £000
Interest Payments – HRA	1,627	1,622	-5
Interest Received – HRA	-20	-12	8
Interest Received – General Fund	-33	-29	4
TOTAL	**1,574**	**1,581**	**7**

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 2013/14, 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.

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 2014/15.

Investments 2013/14

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)	£15m
• 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

Definition of Credit Ratings

5.31 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 slightly higher risk than AAA
- A: economic situation can affect financial position
- BBB: medium class companies which are satisfactory at the moment.

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

5.33 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.

5.34 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

5.35 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.

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

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

Performance Indicators

5.38 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 2013/14 (with a comparison to recent years) is shown in the following table.

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
7-Day Rate (target)	3.57%	0.39%	0.51%	0.62%	0.51%	0.47%
Actual Rate	4.38%	0.72%	0.78%	0.74%	0.31%	0.33%

Prudential Indicators

5.39 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.

5.40 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.

5.41 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.

5.42 The actual indicators for 2013/14, together with further details on treasury management activity are detailed in **Appendix 1.**

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

Minimum Revenue Provision (MRP) - Background

5.44 Local authorities are required each year to set-aside 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. There is no requirement for a MRP on the HRA.

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

5.46 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.

5.47 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

5.48 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.

5.49 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.

5.50 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

5.51 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

5.52 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.

5.53 However, during 2013/14, internal borrowing was undertaken to finance the purchase of the receptacles to extend kerbside recycling. It was approved that this borrowing would be repaid by charging a Voluntary Repayment Provision (VRP) in the General Fund. This will be made over the life of the assets purchased under the Prudential System, i.e. Option 3.

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 on the General Fund together with no unsupported borrowing, it is recommended that "prudence" be best achieved by continuing to provide a MRP under **Option 2** for supported borrowing.

5.55 As regards unsupported borrowing, it is recommended that prudence is best achieved by providing a VRP under **Option 3** to reflect the life of the assets purchased for the kerbside recycling service.

5.56 It is recommended that this policy be endorsed for 2013/14 and adopted for 2014/15. It will be kept under review depending on the Council's future capital expenditure and financing requirements.

5.57 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 <u>Financial Implications</u>

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 2013/14 was £252,600 and VRP of £55,335.

7.0 <u>Corporate Implications</u>

7.1 None directly.

8.0 <u>Community Implications</u>

8.1 None directly.

9.0 <u>Background Papers</u>

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.

Appendix 1

ANNUAL REPORT ON THE TREASURY MANAGEMENT SERVICE AND PRUDENTIAL INDICATORS 2013/14

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 2013/14.

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 82% of the debt is at fixed interest rates.

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 2013/14

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

Capital Expenditure and Financing 2013/14	Estimate 2013/14 £000	Actual 2013/14 £000
Capital Expenditure		
General Fund	5,777	2,901
HRA	5,653	4,666
Total - Capital Expenditure	**11,430**	**7,567**
Government Grants	382	370
External/Partnership Contributions	2,239	742
Internal Borrowing	885	885
Council Reserves/Earmarked Funds	702	489
Housing Capital Receipts	5,653	4,666
General Capital Receipts	1,569	415
Total - Financing	**11,430**	**7,567**

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 regards 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 Where borrowing is unsupported and has been used to finance capital under the prudential system, a VRP will be calculated based on the life of the asset and charged to revenue.

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

Capital Financing Requirement (CFR) 2013/14	Estimate 2013/14 £'000	Actual 2013/14 £'000
CFR b/fwd 1st April 2013	69,175	69,175
Add New Borrowing (Internal)	0	885
Less Debt Repaid	0	-277
Less Minimum Revenue Provision (MRP)	-253	-253
Less Voluntary Revenue Provision (VRP)	0	-55
CFR c/fwd 31st March 2014	**68,922**	**69,475**
General Fund Proportion	6,062	6,892
HRA Proportion	62,860	62,583

5.0 Treasury Position at 31 March 2014

5.1 The treasury position at 31 March 2014 compared with the previous year is shown in the following table.

	2012/13		2013/14	
Overall Borrowing Position @ 31st March	**Principal £'000**	**Average Rate**	**Principal £'000**	**Average Rate**
Fixed Interest Rate Debt	48,444	3.21%	48,437	3.21%
Variable Interest Rate Debt	10,319	0.60%	10,028	0.57%
Total Debt	**58,763**		**58,465**	
Short-term Investments	4,512	0.31%	7,029	0.33%
Net Borrowing Position	**54,251**		**51,436**	

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 have exceeded the CFR for 2013/14, plus the expected changes to the CFR over 2013/14 and 2014/15. 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 2013/14	£'000
Gross Borrowing	58,465
Net Borrowing	51,436
CFR	69,475

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 2013/14 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 2013/14	**£'000**
Authorised Limit	72,610
Operational Boundary	63,853
Borrowing Position at 31/03/2014	58,465

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 expected level of actual debt on the HRA.

HRA Limit on Indebtedness 2013/14	**2013/14 £'000**	**2013/14 £'000**
HRA Debt Cap (Fixed)	66,853	66,853
HRA CFR	62,860	62,583
Difference	3,993	4,270
HRA Debt	58,702	58,423
Borrowing Headroom (Cap less Debt)	8,151	8,430

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 2013/14	**Estimate 2013/14 £'000**	**Actual 2013/14 £'000**
General Fund		
Council Tax Income	4,411	4,411
Net Interest	-18	-29
Proportion	**- 0.41%**	**- 0.66%**
HRA		
Rent Income	11,874	11,674
Net Interest	1,627	1,620
Proportion	13.70%	13.88%

7.0 The Economy and Interest Rates

7.1 The UK economy started to show signs of recovery during the year with growth in quarter 4 increasing by 2.8% on a year by year basis.

7.2 The low Bank of England Base Rate remained at 0.5% leaving investment yielding a low return. But this has also meant our variable borrowing rate has remained a low level.

8.0 Investment Strategy Approved for 2013/14

8.1 In accordance with its policy, the Council continued to place investments giving priority to security and liquidity over yield. At year end the investments were held with Local Authorities and UK Banks in Reserve Accounts on immediate recall.

9.0 Debt Management Activity for 2013/14

9.1 There was no further borrowing during the year.

9.2 Parish Council loans of £12,000 were repaid during 2013/14.

9.3 The transferred debt was fully repaid in early 2013/14 following agreement with the neighbouring authority.

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 £12.4million with a return of £39k during the year.