Annual Report 2012/13
Treasury Management and Actual Prudential Indicators

1. Introduction

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

- The Local Government in Scotland 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 Scottish Ministers to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (although no restrictions were made in 2012/13); and
- Statutory Instrument (SSI) 29 2004, requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities, and therefore to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services; and the treasury activity with regard to the CIPFA Code of Practice for Treasury Management in Local Authorities.

1.2 This Council has adopted the CIPFA Code of Practice for Treasury Management in the Public Sector and operates its treasury management service in compliance with this Code and the above requirements. These require that the prime objective of the treasury management activity is the effective management of risk, and that its borrowing activities are undertaken in a prudent, affordable and sustainable basis.

1.3 During 2012/13 the minimum reporting requirements were that the Council receive an annual treasury strategy in advance of the new financial year, a mid-year report and an annual report following the financial year-end describing the activity compared to the strategy (this report).

1.4 This report sets out:

- A summary of the strategy agreed for 2012/13;
- The Council's treasury position at 31 March 2013;
- The main Prudential Indicators and compliance with limits;
- A summary of the economic factors affecting the strategy over 2011/13;
- The Treasury activity during 2012/13;
- Performance indicators set for 2012/13; and
- Risk and Performance.

2. A Summary of the Strategy Agreed for 2012/13

2.1 The expectation for interest rates within the strategy for 2012/13 anticipated a low but rising Bank Rate (starting in quarter 4 of 2014) with similar gradual rises in medium and longer term fixed borrowing rates over 2012/13. Variable or short-term rates were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by counterparty risk considerations, resulting in relatively low returns compared to borrowing rates. As a result, the Council chose to take a cautious approach to its strategy and took necessary actions on borrowings, investments and debt rescheduling, in conjunction with market conditions at that time

3. The Council's Treasury Position at 31 March 2013

3.1 During 2012/13, the Head of Finance and Resources managed the debt position with the use of internal funds as well as external borrowing, and the treasury position at 31 March 2013 compared with the previous year was:

Table 1

Treasury position	31 March 2013		31 March 2012	
	Principal	Average Rate	Principal	Average Rate
Fixed Interest Rate Debt	£217.766m	5.05%	£219.303m	5.16%
Variable Interest Rate Debt	£0.461m	0.77%	£0.461m	0.93%
Total Debt	**£218.226m**	**5.04%**	**£219.763m**	**5.15%**
Total Investments	**£2.244m**	**0.59%**	**£11.861m**	**0.77%**
Net borrowing position	**£215.982m**		**£207.903m**	

3.2 From the above table, it can be seen that the average interest rate on debt held on 31 March 2013 has reduced from 5.15% to 5.04%. At the same time the average interest rate has reduced on the investments held on 31 March 2012 to 2013 from 0.77% to 0.59%.

3.3 There are four treasury prudential indicators which cover the activity of the treasury function within certain limits, thereby reducing the risk of an adverse movement in interest rates impacting negatively on the Council's overall position:

- Upper limits on variable rate exposure;
- Upper limits on fixed rate exposure;
- Maturity structures of borrowing; and
- Total principal funds invested for greater than 364 days. During 2012/13 the Council decided not to invest for longer than 364 days, so this indicator is set at nil.

3.4 The indicators within table 2 shows that the upper limits set for debt type and maturity were not breached during the year to 31 March 2013.

Table 2

	2012/13 Actual	**2012/13 Indicator**	
Upper limits on variable interest rates *(against maximum position)*	0.21%	50%	
Upper limits on fixed interest rates *(against maximum position)*	99.79%	100%	
Maturity structure fixed rate borrowing *(%)*	**Year end Position**	**Max**	**Min**
Under 12 months	48.30%	50%	0%
12 months to 2 years	8.30%	50%	0%
2 years to 5 years	12.60%	50%	0%
5 years to 10 years	7.90%	50%	0%
10 years to 20 years	3.20%	50%	0%
20 years to 30 years	1.40%	50%	0%
30 years to 40 years	12.60%	50%	0%
40 years to 50 years	5.70%	100%	0%
50 years to 60 years	0.00%	100%	0%
60 years to 70 years	0.00%	100%	0%
Maximum principal funds invested *>364 days*	Nil	Nil	

4. The Main Prudential Indicators and Compliance with Limits

4.1 The Council is required by the Prudential Code to report the actual prudential indicators after the year end.

4.2 **Capital Expenditure and its Financing**
This forms one of the required prudential indicators and shows total capital expenditure for the year and how this was financed. The reduction in total capital expenditure between revised estimate and actual as noted below in Table 3 is due to expenditure which slipped from 2012/13 into the 2013/14 capital programme, together with resources. The indicators for 2013/14 will be revised in line with this.

Table 3

	2012/13 Actual	**2012/13 Estimate**
Total capital expenditure	£44.109m	£57.118m
Resourced by:		
Capital receipts and grants	£18.813m	£20.976m
Revenue	£1.360m	£1.494m
Capital expenditure - additional need to borrow	**£23.936m**	**£36.648m**

4.3 **Net Borrowing and the Capital Financing Requirement (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 used for capital purposes. Net borrowing should not therefore, except in the short term, exceed the CFR for 2012/13 plus the expected changes to the CFR over 2013/14 and 2014/15.

4.5 The Executive Director of Corporate Services reports that the Council has complied with the requirement to keep adjusted net borrowing below the CFR in 2012/13 as noted below in Table 4.

Table 4

	2012/13 Actual	2012/13 Indicator
Net borrowing position per Table1	£215.982m	£236.751m
PPP long term liability	£91.442m	£91.912m
Adjusted net borrowing position	**£307.424m**	**£328.663m**
Capital Financing Requirement	**£325.371m**	**£336.591m**

4.6 The reduction in the adjusted net borrowing position from the revised 2012/13 indicator to the actual position is due to the Council not borrowing to fund the capital programme during 2012/13 while the reduction in the capital financing requirement is due slippage in the both the General Services and HRA capital programme.

4.7 The Authorised Limit
The Authorised Limit is the "Affordable Borrowing Limit" required by Section 35 of the Local Government in Scotland Act 2003. The Council does not have the power to borrow above this level. The information in Table 5 demonstrates that during 2012/13 the Council has maintained gross borrowing within its Authorised Limit.

4.8 The Operational Boundary
The Operational Boundary is the borrowing position that the Council expects to work around during the year, and periods where the actual position is either below or over the Boundary is acceptable subject to the Authorised Limit not being breached.

4.9 Incremental Impact of capital investment decisions
This indicator identifies the trend of the proposed changes in the capital programmes compared to existing commitments and current plans, measured against Band D council tax and weekly housing rents.

4.10 Actual financing costs as a proportion of net revenue stream
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. The cost of capital is described as loan charges within the revenue budgets.

4.11 The General Services indicator for both has increased from the estimate due to application of previously agreed prudential borrowing in the capital programme.

Table 5

	2012/13	
Revised Indicator - Authorised Limit	**£394.396m**	
Revised Indicator - Operational Boundary	**£361.529m**	
Maximum gross borrowing position during 2012/13	**£312.868m**	
Minimum gross borrowing position during 2012/13	**£286.187m**	
	Estimated	**Actual**
Incremental Impact of capital investment decisions:		
Council Tax (excluding year-end flexibility)	£2.13	£5.93
Rent	£2.33	£2.14
Financing costs as a proportion of net revenue stream:		
Housing	38.17%	38.38%
Non housing	5.98%	6.56%

5. Summary of the Economic Factors affecting the Strategy over 2012/13

5.1 Economic Background for 2012/13

5.1.1 Interest Rates

2012/13 saw an ongoing challenging investment environment, namely low investment returns and continuing heightened levels of counterparty risk.

The original expectation for 2012/13 was that the Bank Base Rate would start gently rising from quarter 4 of 2014. However, economic growth in the UK was disappointing during the year due to the UK austerity programme, weak consumer confidence and spending, a lack of rebalancing of the UK economy to exporting and weak growth in our biggest export market - the European Union (EU). The UK coalition Government maintained its tight fiscal policy stance against a background of warnings from two credit rating agencies that the UK could lose its AAA credit rating.

Moody’s followed up this warning by actually downgrading the rating to AA+ in February 2013 and Fitch then placed their rating on negative watch, after the Budget statement in March. Key to retaining the AAA rating from Fitch and Standard & Poors will be a return to strong economic growth in order to reduce the national debt burden to a sustainable level, within a reasonable timeframe.

Weak UK growth resulted in the Monetary Policy Committee increasing quantitative easing by £50bn in July 2012 to a total of £375bn. The Bank Base Rate therefore ended the year unchanged at 0.5% while CPI inflation fell from 3% at the start of the year to end at 2.8% in March, with a fall back to below 2% expected to be pushed back to quarter 1 of 2016.

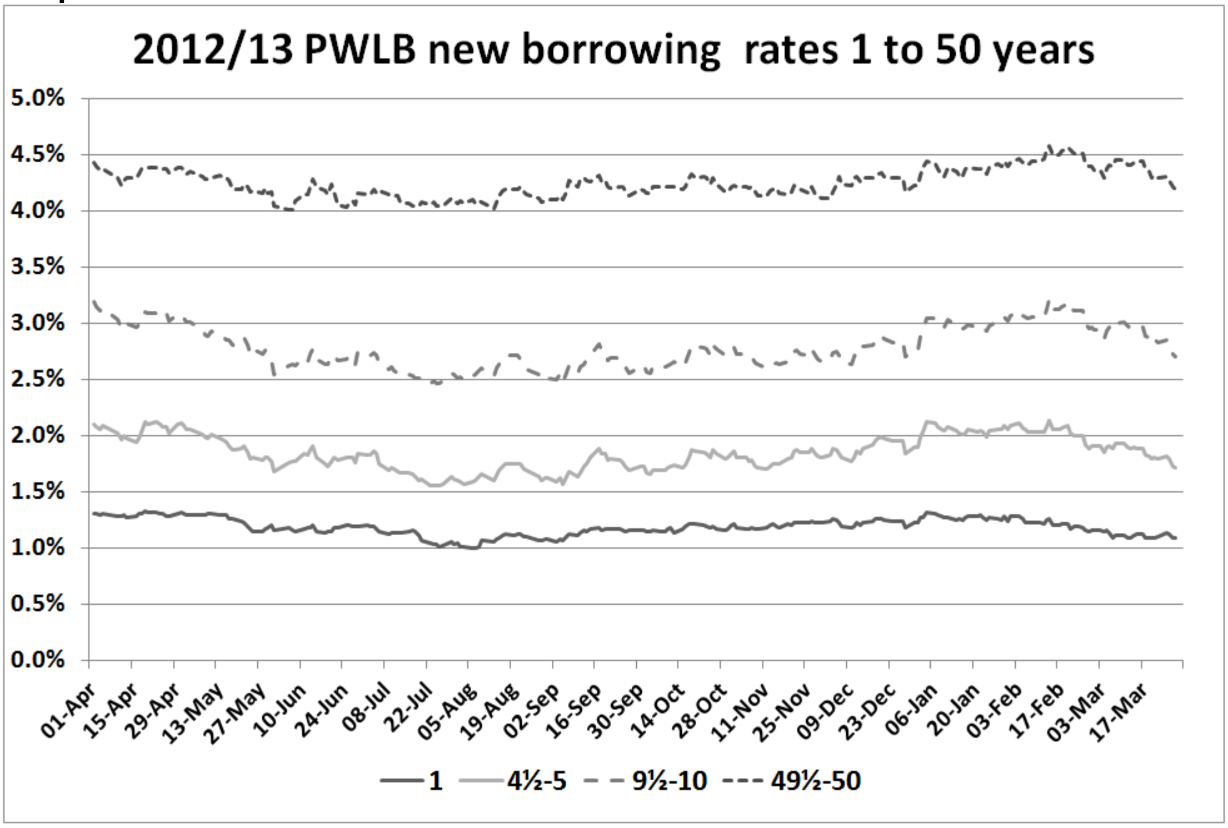
The EU sovereign debt crisis was an ongoing saga during the year with first Greece and then Cyprus experiencing crises which were met with bailouts after difficult and fraught negotiations.

5.1.2 Gilt yields oscillated during the year as events in the ongoing Eurozone debt crisis ebbed and flowed, causing corresponding fluctuations in safe haven flows into / out of UK gilts. This, together with a further £50bn of Quantitative Easing (QE) in July 2012 and widely expected further QE still to come, combined to keep Public Works Loan Board (PWLB) rates depressed for much of the year at historically very low levels.

5.1.3 Deposit rates - The Funding for Lending Scheme, announced in July 2012, resulted in a flood of cheap credit being made available to banks and this has resulted in money market investment rates falling sharply in the second half of the year. However, perceptions of counterparty risk have improved after the European Central Bank statement in July 2012 that it would do “whatever it takes” to support struggling Eurozone countries. This has resulted in some return of confidence to move away from only very short term investing.

5.1.4 PWLB borrowing rates - the graph below shows how PWLB rates remained close to historically very low levels during the year.

Graph 1



6. Treasury Activity during 2012/13

6.1 Borrowing – The Council raised new long term loans of £5m and new short term loans of £19.5m during 2012/13 for the replacement of naturally maturing debt.

6.2 Rescheduling – No debt rescheduling was carried out in 2012/13.

6.3 Repayment – The Council repaid naturally maturing debt of £26.537m.

6.4 Summary of Debt Transactions – The overall position of the debt activity resulted in the average interest rate at 31 March year on year falling slightly to 5.04%.

6.5 **Investment Policy –** The Scottish Government issued The Local Government Investments (Scotland) Regulations 2010 on 1 April 2010.

6.6 The regulations applied from 1 April 2010 and the Council's policy was included in the annual treasury strategy approved by Council on 30 March 2012. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

6.7 The Council's investments decreased from £11.861m at the beginning of the year to £2.244m at the end of the year with an average balance of £13.804m and received an average return of 0.59% over the year.

6.8 The Economic Background for 2012/13 (see 5.1 above) set out the fragility and inconsistency of economic conditions during this period. As a result, interest rates remained low impacting adversely on investment returns.

7. Performance Indicators set for 2012/13

7.1 Security, liquidity and yield benchmarks were first introduced for 2010/11. Yield benchmarks are currently widely used to assess investment performance.

- **Security** - In the context of benchmarking, assessing security is a very subjective area. Security is currently evidenced by the application of minimum quality criteria to financial institutions that the Council may choose to invest in, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody's and Standard & Poors). The Council has benchmarked security risk by assessing the historical likelihood of default for investments placed with any institution with a long term credit rating of A- (this is the minimum long term credit rating used in the Council's investment strategy). The Council's maximum security risk is that 0.09% of investments placed with financial institutions could theoretically default based on global historical data. The Executive Director of Corporate Services can report that all investments within the Council's portfolio were repaid on their due dates with no defaults of the principal sums recorded.

- **Liquidity** – As required by the CIPFA Treasury Management Code of Practice the Council has stated that it will "ensure that it has adequate, though not excessive, cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives". In respect to liquidity as defined above the Executive Director of Corporate Services can report that liquidity arrangements during the year were maintained in line with the facilities and benchmarks previously set by the Council as follows:

  - Bank overdraft - £1.000m
  - Liquid short term deposits of at least £5.000m available on an overnight basis.

- **Yield** – The Executive Director of Corporate Services can report that investment return averaged 0.59% which is a year on year decrease of 0.18% with an average external investment period of 60 days. Table 6 illustrates that the average return of 0.59% was greater than the local measures of yield investment benchmarks approved in March 2012.

Table 6

Benchmark	Benchmark Return	Average Return
Internal returns above the 7 day LIBID rate	0.37%	0.59%
Internal returns above the 1 month LIBID rate	0.37%	0.59%
Internal returns above the Council investment account	0.50%	0.59%

8. Risk and Performance

8.1 The Council has complied with all relevant statutory and regulatory requirements which require the Council to identify and, where possible, quantify 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.

8.2 The Council is aware of the risks of passive management of the treasury portfolio and, with the support of the Council's treasury advisers, has proactively managed its treasury position within the current economic climate. The Council has complied with its internal and external procedural requirements. There is little risk of volatility of costs in the current debt portfolio as the interest rates are predominantly fixed, utilising long-term loans.

8.3 Shorter-term rates and likely future movements in these rates predominantly determine the Council's investment return. These returns can therefore be volatile and, whilst the risk of loss of principal is minimised through the annual investment strategy, accurately forecasting future returns can be difficult.