CITY OF YORK COUNCIL

Cabinet **16th July 2013**

Report of the Cabinet Member for Finance, Performance and Customer Services

Treasury Management Annual Report & Review of Prudential Indicators 2012/13

Purpose of Report

1. The Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2012/13. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code). Prudential Indicators are attached at Annex A.

2. The information detailed in this report ensures the Council's treasury management activities are affordable, sustainable and prudent as approved by Council on 23 February 2012 and that the Council's debt and investment position ensure adequate liquidity for revenue and capital activities, security for investments and manages risks within all treasury management areas.

3. The Council's treasury position for 2012/13 compared to 2011/12 is summarised in the table below:

	31-Mar-13 £m	**Rate %**	**31-Mar-12 £m**	**Rate %**
GF Total Debt	**118.7**	**4.2%**	**121.3**	**4.2%**
HRA Debt	18.4	4.2%	18.8	4.2%
HRA Self Financing	121.5	3.2%	121.5	3.2%
HRA Total Debt	**139.9**	**3.4%**	**140.3**	**3.4%**
Total debt	**258.6**	**3.8%**	**261.6**	**3.8%**
Capital Financing Requirement	**321.9**		**293.2**	

Over/ (under) borrowing	**(63.3)**		**(31.6)**	
Investments:	**11.9**	**1.46%**	**26.2**	**1.45%**

Table 1 – Summary of the treasury management portfolio

Economic Background

4. The performance of the council's treasury management function is an outcome of the long-term borrowing and short-term investment decisions affected by the economic conditions during the year.

5. The financial year 2012/13 continued the challenging investment environment of previous years, namely low investment returns and continuing heightened levels of counterparty risk. The original expectation for 2012-13 was that Bank Rate would start gently rising from quarter 4 2014. However, economic growth in the UK was disappointing during the year due to the UK austerity programme, weak customer 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).

6. 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. Key to retaining the AAA rating will be a strong return to 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 to a total of £375bn. Bank 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, will a fall back to below 2% pushed back to quarter 1 2016.

7. 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.

8. Gilt yields, which affect the rate at which the Council can borrow, oscillated during the year as events in the ongoing Eurozone debt crisis ebbed and flowed, causing corresponding fluctuations in safe haven flows into and out of UK gilts. This, together with a further £50bn of quantitative easing in July and widely expected quantitative easing still to come combined to keep PWLB rates depressed for much of the year at historically low levels.

9. The Funding for Lending Scheme, announced in July, 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, perception of counterparty risk have improved after the ECB statement in July 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.

10. Figure 1 below shows the actual and projection of the bank base rate, which has remained at historically low levels since April 2009. Sector latest bank base rate forecast is November 2012 and this is compared to the January 2012 and January 2011 forecast. Other economists latest forecast are also shown for November 2012. The graph highlights the delay in the expectation of the increase in the Bank Base rate which is as a result of the decision to expand quantitative easing and deterioration of growth prospects.

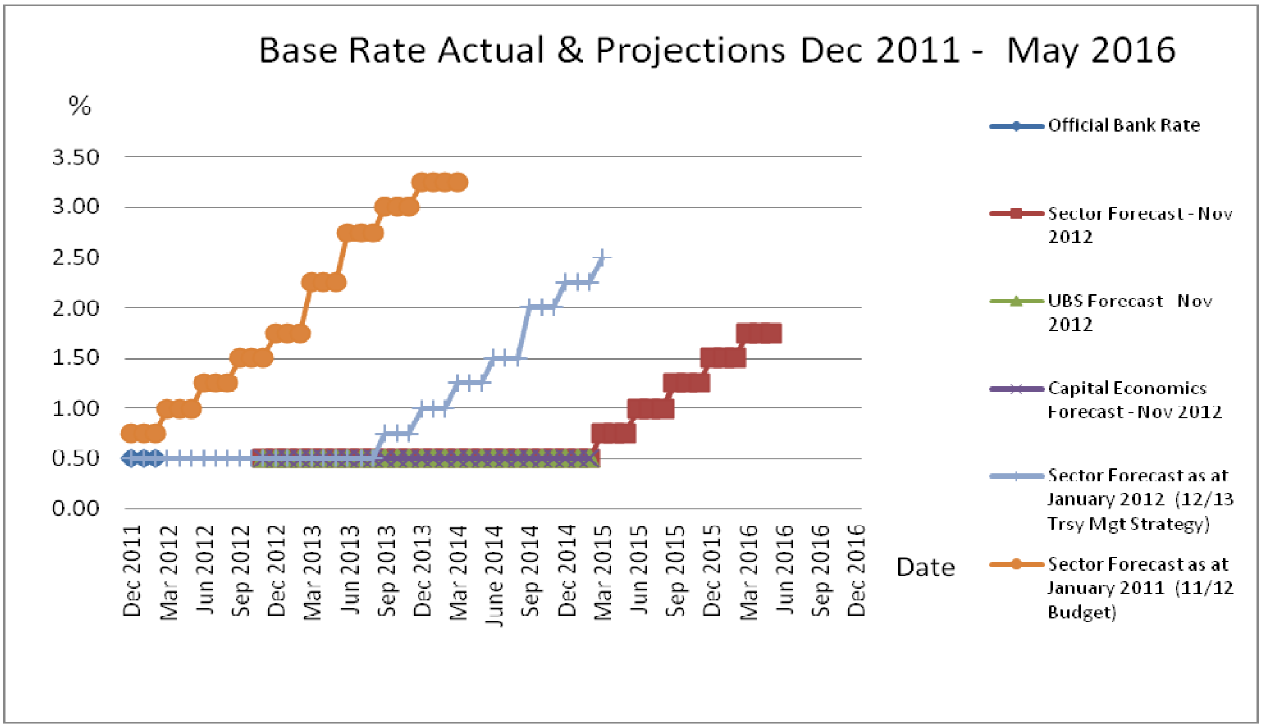

Figure 1 – Forecast Base Rates 2011- 2016

Treasury Management Strategy

11. The Council's borrowing strategy for 2012/13 was set at Council on 23 February 2012 and followed advice from Sector, the council's treasury management advisors, to have a balanced approach and

lock into some long term borrowing in 2012/13 where interest rates were expected to be lower than in the coming years, whilst also considering reducing the Councils surplus funds due to investment rates giving relatively low returns compared to borrowing rates.

14. External borrowing would be taken throughout the financial year when interest rates seemed most favourable at a target interest rate of 5%. The maturity profile of the debt portfolio was taken into account, so the Council was not exposed to the concentration of debt being in any one year.

15. Also running down the investment portfolio and using the Council's surplus cash rather than taking further external borrowing was also deemed a favorable approach. Due to continued uncertainty in the aftermath of the 2008 financial crisis consideration was given to postponing borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

16. The actual movement in gilt yields meant borrowing rates fell sharply during the year and continued at historically very low levels

17. Figure 2 shows the PWLB interest rates from 1 October 2010 to 31 March 2013 and includes the loans borrowed by the council. .

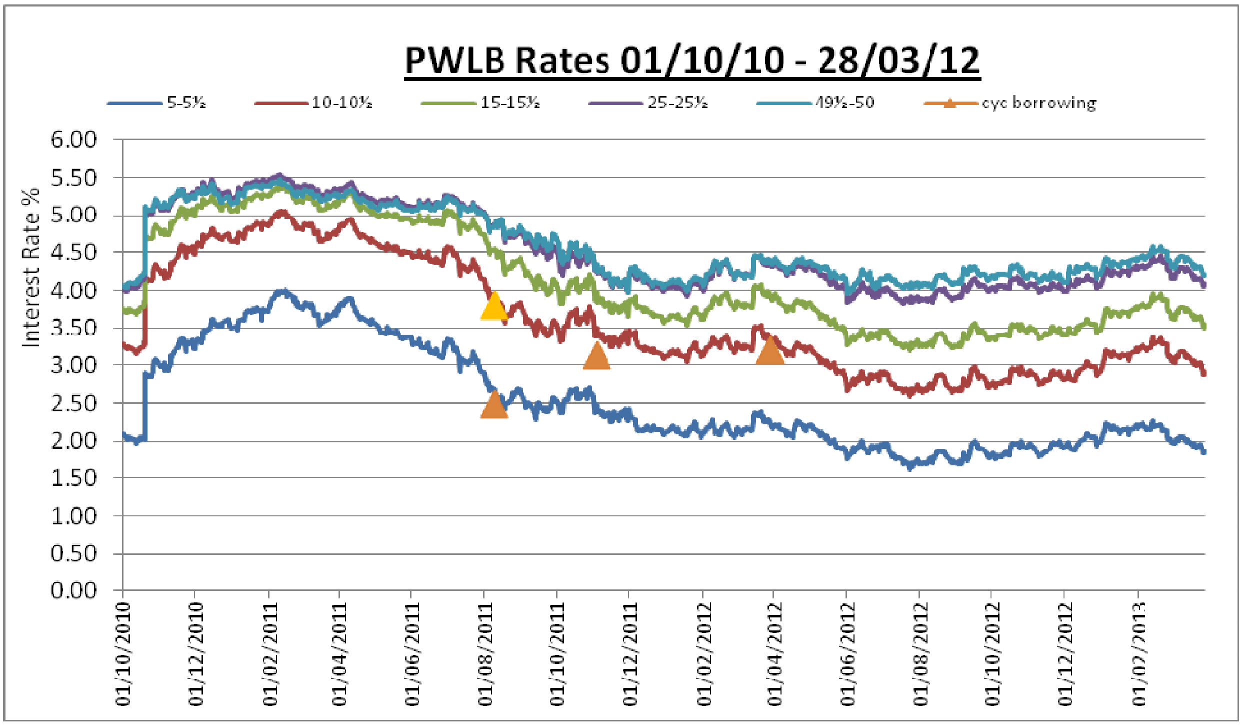

Figure 2 - PWLB rates and CYC borrowing levels

18. Figure 2, illustrates that over 2012/13, that PWLB rates have remained broadly flat over the period supporting the Councils decision to delay borrowing.

Borrowing Outturn 2012/13

19. The Council undertakes capital expenditure on long-term assets as part of the Capital programme. The way that the capital programme is financed affects the treasury management activity of the Council, and ultimately borrowing. The prudential indicators which control the borrowing activity of the Council are contained in Annex A.

20. The purpose of the Council's underlying need to borrow is to finance capital expenditure and this is termed the Capital Financing Requirement (CFR).

21. The total CFR for the council at the end of 2012/13 was £321.9m and this was split between the General Fund at £181.5m and the HRA at £140.3m. In accordance with the flexibility allowed by the borrowing strategy, no external borrowing was taken to finance this requirement as surplus funds were used and the investment portfolio was reduced.

22. Total borrowing at the start of 2012/13 was £261.6m (General Fund £121.3m / HRA £140.3m) and at the end of 2012/13 was £258.6m (General Fund £118.7m / HRA £139.9m).

24. Table 2 shows the movement in borrowing during the year split between the General Fund and HRA. Details on the interest rates obtained on new borrowing, the average rate of the portfolio and the year of maturity are also shown.

General Fund					
Loan Type	**Date Raised**	**Date Matured**	**Amount**	**Interest Rate**	**Duration**
Matured	09/06/2005	05/05/2012	3,000,000	4.400%	7.00
			3,000,000		
		Loans net position 2012/13	**7,000,000**		
		Opening loan balance 2012/13	**140,065,956**		
		Closing loan balance 2012/13	**137,065,956**		

Table 2 - Movement in General Fund Borrowing 2012/13 (including HRA split element – 13.4%)

26. The Council did not restructure any of its borrowing portfolio during the year as no opportunities arose when taking into consideration the associated premium that would be generated.

27. The overall position of the borrowing activity has not caused any variation in the average interest rate that remains at 3.8%.

Investment Outturn 2012/13

29. Bank Rate remained at its historic low of 0.5% throughout the year; it has now remained unchanged for four years. Market expectations of the start of monetary tightening were pushed back during the year to early 2015 at the earliest. The Funding for Lending Scheme resulted in a sharp fall in deposit rates in the second half of the year.

30. The Council's investment policy is governed by CLG guidance, which was implemented in the annual investment strategy approved by the Council on 23 February 2012. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies (Fitch, Standard & Poors, Moody's) supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

31. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

32. The Council maintained an average investment balance of £40.2m compared to £63.8m in 2011/12. The surplus funds earned an average rate of return in 2011/12 of 1.46% compared to 1.45% in 2011/12. The movement downwards is due to the use of cash balances to fund capital investment activities in accordance with the Councils borrowing policy. The comparable performance indicator is the average 7-day LIBID rate, which was 0.39% in 2012/13 and the three month LIBID rate of 0.56%. All investments occurred in line with the investment strategy that the security of capital is of prime importance.

34. Figure 3 illustrates the investment interest rates available for 2012/13 including the rate of return on investments achieved. The Council's rate of return is continually higher than all yields. The Council could not invest further in 1 year deposits due to the security of the Councils surplus fund being of prime importance.

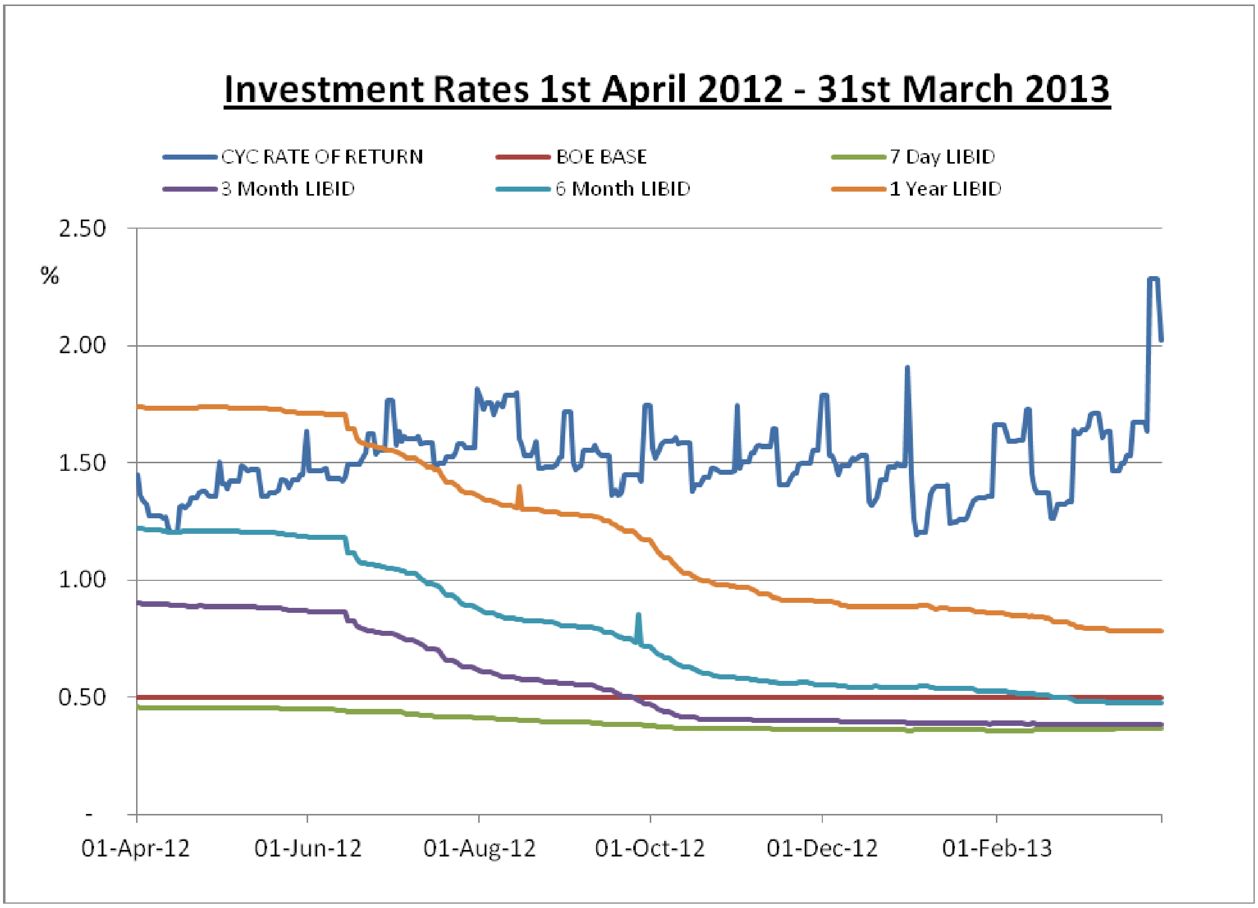

Figure 3 – Investment Rates vs. Rate of Return on CYC Investments

Consultation

35. This report is for information purposes and reports on the performance of the treasury management function. Members through the budget process set the level of budget and expected performance of the Councils treasury management function.

Options

36. In accordance with the Local Government Act 2003, it is a requirement under the CIPFA Prudential code and the CIPFA Treasury Management in Local Authorities that the Cabinet receives

an annual treasury management review report of the previous year – 2011/12- by 30 September 2012. It is also a requirement that the Council delegates the role of scrutiny of treasury management strategy and policies to a specified named body which in this Council is the Audit & Governance Committee. This annual treasury management report is scheduled at Audit & Governance Committee on 25th July 2012.

Corporate Priorities

37. Treasury Management is aimed at ensuring the Council maximises its return on investments and minimises the cost of its debts. This will allow more resources to be freed up to invest in the Council's priorities, values and imperatives, as set out in the Council's plan. Effective treasury management is concerned with the management of the council's cash flows, it's banking, money market and capital transactions, the management of debt, the effective control of the risks associated with those activities, and the pursuit of optimum performance consistent with those risks.

Implications

38.

(a) **Financial** These are detailed in the body of the report

(b) **Human Resources (HR)** There are no HR implications as a result of this report

(c) **Equalities** There are no equalities implications as a result of this report

(d) **Legal** Treasury Management activities have to conform to the Local Government Act 2003, which specifies that the Council is required to adopt the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice.

(e) **Crime and Disorder** There are no crime and disorder implications as a result of this report.

(f) **Information Technology (IT)** There are no IT implications as a result of this report

(g) **Property** There are no property implications as a result of this report

Risk Management

39. The treasury function is a high-risk area because of the level of large money transactions that take place. As a result of this there are strict procedures set out as part of the Treasury Management Practices statement. The scrutiny of this and other monitoring reports is carried out by Audit & Governance Committee as part of the council's system of internal control.

Recommendations

40. The Cabinet, in accordance with the Local Government Act 2003 is asked to:

    (i) Note the 2012/13 performance of Treasury Management activity and

    (ii) Note the movements in the Prudential Indicators in Annex A

Reason: to ensure the continued performance of the Council's Treasury Management function can be monitored.

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Annex A - Prudential Indicators 2012/13 Outturn

	Prudential Indicator		2011/12 actual	2012/13 Monitor 3	2012/13 actual
1	**Capital Expenditure** To allow the authority to plan for capital financing as a result of the capital programme and enable the monitoring of capital budgets.	Non HRA HRA Total	£41.5m £129.9m £171.4m	£48.6m £8.7m £57.3m	£39.6m £6.8m £46.5m
2	**Ratio of financing costs to net revenue stream** An estimate of the cost of borrowing in relation to the net cost of Council services to be met from government grant and council taxpayers. In the case of the HRA the net revenue stream is the income from rents.	Non HRA HRA	6.5% 2.0%	9.7% 2.1%	11.1% 1.7%
3a	**Incremental impact of capital investment decisions – Council Tax** Shows the actual impact of capital investment decisions on council tax. The impact on council tax is a fundamental indicator of affordability for the Council to consider when setting forward plans. The figure relates to how much of the increase in council tax is used in financing the capital programme and any related revenue implications that flow from it.	Increase in band D Council Tax per annum	£19.62	£18.29	£18.65
3b	**Incremental impact of capital investment decisions – Housing Rents** Shows the actual impact of capital investment decisions		£0	£0	£0

	Prudential Indicator		2011/12 actual	2012/13 Monitor 3	2012/13 actual
	on HRA rent. For CYC, the HRA planned capital spend is based on the government's approved borrowing limit so there is no impact on HRA rents.				
4	Net borrowing should not exceed the CFR 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 and so not exceed the CFR.		£235.4m	£225.6m	£258.6m
5	CFR as at 31st March Indicates the Council's underlying need to borrow money for capital purposes. The majority of the capital programme is funded through government support, government grant or the use of capital receipts. The use of borrowing increases the CFR.	Non HRA HRA Total	£152.9m <u>£140.3m</u> £293.2m	£174.2m <u>£140.3m</u> £314.5m	£181.6m <u>£140.3m</u> £321.9m
6a	Authorised Limit for External Debt The authorised limit is a level set above the operational boundary in acceptance that the operational boundary may well be breached because of cash flows. It represents an absolute maximum level of debt that could be sustained for only a short period of time. The council sets an operational	Borrowing Other long term liabilities Total	£337m <u>£10m</u> £347m	£337.9m <u>£20m</u> £357.9m	£337m <u>£10m</u> £347m

	Prudential Indicator		2011/12 actual	2012/13 Monitor 3	2012/13 actual
	boundary for its total external debt, gross of investments, separately identifying borrowing from other long-term liabilities for 3 financial years.				
6b	**Operational Boundary for external debt** **The operational boundary is a measure of the most likely, prudent, level of debt. It takes account of risk management and analysis to arrive at the maximum level of debt projected as part of this prudent assessment. It is a means by which the authority manages its external debt to ensure that it remains within the self-imposed authority limit. It is a direct link between the Council's plans for capital expenditure; our estimates of the capital financing requirement; and estimated operational cash flow for the year.**	**Borrowing** **Other long term liabilities** **Total**	**£317m** **£10m** **£327m**	**£307.9m** **£20m** **£327.9m**	**£317m** **£10m** **£327m**
7	**Adoption of the CIPFA Code of Practice for Treasury Management in Public Services**		✓	✓	✓
8a	**Upper limit for fixed interest rate exposure** **The Council sets limits to its exposures to the effects of changes in interest rates for 3 years. The Council should not be overly exposed to fluctuations in interest rates**		**107%**	**109%**	**110%**

	Prudential Indicator		2011/12 actual	2012/13 Monitor 3	2012/13 actual
	which can have an adverse impact on the revenue budget if it is overly exposed to variable rate investments or debts.				
8b	Upper limit for variable rate exposure The Council sets limits to its exposures to the effects of changes in interest rates for 3 years. The Council should not be overly exposed to fluctuations in interest rates which can have an adverse impact on the revenue budget if it is overly exposed to variable rate investments or debts.		-7%	-9%	-10%
9	Upper limit for total principal sums invested for over 364 days To minimise the impact of debt maturity on the cash flow of the Council. Over exposure to debt maturity in any one year could mean that the Council has insufficient liquidity to meet its repayment liabilities, and as a result could be exposed to risk of interest rate fluctuations in the future where loans are maturing. The Council therefore sets limits whereby long-term loans mature in different periods thus spreading the risk.		£0	£0	£0
10	Maturity structure of new fixed rate borrowing		£261.6m	£258.6m	£261.4m

	Prudential Indicator		2011/12 actual	2012/13 Monitor 3	2012/13 actual
	The Council sets an upper limit for each forward financial year period for the level of investments that mature in over 364 days. These limits reduce the liquidity and interest rate risk associated with investing for more than one year. The limits are set as a percentage of the average balances of the investment portfolio.	under 12 months 1 to 2 years 2 to 5 years 5 to 10 years 10 years and above	1% 0% 5% 15% 79%	2% 3% 7% 15% 75%	3% 2% 7% 14% 74%

Glossary of abbreviations
HRA – Housing Revenue Account
CFR – Capital Financing Requirement

Analysis of Prudential Indicators

1. In accordance with the Prudential Code, the Prudential Indicators set by full Council on 23 February 2012 for the financial year 2012/13 must be monitored and reported at Outturn. The Prudential Indicators are detailed above and the key points are explained below:

2. **Indicator 1 - Capital Expenditure:** The capital programme expenditure for 2012/13 was estimated at £57.3m for monitor 3 and had decreased to £46.5m at outturn. The Capital Programme Outturn report has further detail with regards to this movement.

2. **Indicator 2 – Ratio of Finance Costs to Net revenue Stream**: This indicator represents how much borrowing for the capital programme will cost as a percentage of the net revenue stream of the Council. The General Fund indicator at Monitor 3 was 9.7% compared to the outturn of 11.1%, with the marginal increase due to increased finance costs. The Housing Revenue Account (HRA) version of the indictor is 1.7% compared to the monitor 3 level of 2.1%, the reduction is mainly due to a higher HRA balance which earned investment income than was originally estimated.

3. **Indicator 3 (a) & (b) - Incremental Impact of Capital Investment Decisions on the Level of Council Tax (3a) and Housing Rents (3b):** This indicator shows the impact of capital investment decision on the bottom line level of Council Tax. The Council can fund its discretionary capital programme from two main sources, from borrowing or using capital receipts from the sale of surplus assets. The Council's policy is to use capital receipts to fund the Capital programme, where possible. However in the current economic environment with reduced capital receipts there is the requirement to use borrowing to support the capital programme, which has an impact on Council Tax through the revenue cost of financing the borrowing. The borrowing is not taken unless it is affordable, sustainable and prudent and can be supported by an existing budget. The increase in Council tax (band D) per annum is £18.65 compared to £18.29 estimated at Monitor 3.

4. **Indicator 4 – Net Borrowing not exceed 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. This essentially means that the Council is not borrowing to support revenue

expenditure. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2012/13 plus the expected changes to the CFR over 2013/14 and 2014/15. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2012/13. The table highlights the Council's net borrowing position against the CFR, it confirms that no borrowing occurred in advance of need and the net borrowing position was below the CFR.

5. **Indicator 5 - Capital Financing Requirement (CFR)**: The CFR represents the Council's underlying need to borrow for all capital investment over time. The CFR represents the capital expenditure (which has not yet been paid for by revenue or other resources) which is required to be funded by borrowing. Under Statute, the council is permitted to borrow to fund capital expenditure. When borrowing is undertaken it is not taken for a specific capital scheme but rather to fund the council's capital financing requirement as a whole.

6. **Indicator 6(a) - Authorised Limit**: The authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. The Council does not have the power to borrow above this level, which is approved at Full Council every year. The table confirms that the Council has maintained gross borrowing within its authorised limit of £347m. Borrowing is currently £258.6m, the headroom available within this limit allows the Council the ability to borrow in advance of need in accordance with its 3 year forecast Capital programme.

7. **Indicator 6(b) – Operational Boundary:** This is the estimated borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached. At outturn the actual borrowing level was below the operational boundary.

8. **Indicator 7 - Adoption of the CIPFA Code of Practice in Treasury Management:** In accordance with the Prudential Code, the Council has adopted the CIPFA Treasury Management in the Public Services Code of Practice "the Code" prior to the beginning of the financial year. The table shows the code has been adhered to.

9. **Indicator 8(a) & (b) - Upper Limit for Fixed and Variable Interest rate Exposure:** Interest rate exposure on debt is positive due to it being in relation to interest paid and on investments is negative as it is interest being received. When the variable and fixed interest rates are totalled, it will always be 100%. The majority of the interest received for the Council

relates to variable rated investments, where as the interest paid on debt is fixed. The limits set in the budget are similar to those at Monitor 3 at 110% for fixed interest rate exposure and –10% for variable interest rate exposure.

10. **Indicator 9 - Upper Limit for total principal sums invested for over 364 days:** This has been set at £10m and is approximately 25% of the average portfolio throughout the year. To date no investments for longer than 364 days have been taken due to the credit ratings assigned to counterparties. In the current environment it is viewed as high risk to have long term exposure. The banks which are nationalised have the backing of government and therefore investment up to 1 year are considered.

11. **Indicator 10 - Maturity Structure of Fixed rate Borrowing:** The borrowing portfolio is spread across different time periods to ensure that the Council is not exposed to the requirement to take new borrowing in any one year and be exposed to interest rates in any one year. The borrowing portfolio maturity profile is within the limits set as represented in the table.