Audit Committee – 26th June 2014

10. 2013/14 Treasury Management Activity Report

Chief Executive:	*Mark Williams*
Assistant Director:	*Donna Parham – Finance and Corporate Services*
Service Manager:	*Amanda Card - Finance*
Lead Officer:	*Karen Gubbins, Principal Accountant - Exchequer*
Contact Details:	*karen.gubbins@southsomerset.gov.uk or (01935) 462456*

Purpose of Report

1. To review the treasury management activity and the performance against the Prudential Indicators for the 2013/14 financial year as prescribed by the revised CIPFA Code of Practice and in accordance with the Council's Treasury Strategy and Annual Investment Policy and Treasury Management Practices.

Recommendations

2. The Audit Committee are asked to:
   - Note the Treasury Management Activity for the 2013/14 financial year;
   - Note the position of the individual prudential indicators for the 2013/14 financial year;
   - Note the outlook for the investment performance in 2014/15;
   - Recommend the 2013/14 Treasury Management Activity Report to full Council.

Background

3. The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which requires local authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities at least twice a year. The Council reports six monthly to Full Council against the strategy approved for the year. The scrutiny of treasury management policy, strategy and activity is delegated to the Audit Committee.

4. Treasury management in this context is defined as:

   "The management of the local authority's cash flows, its borrowings and its investments, the management of the associated risks, and the pursuit of the optimum performance or return consistent with those risks".

5. The Authority has invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

6. Overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

Summary of Investment Strategy for 2013/14

7. The Council's strategy for investments was based upon minimising risk and safeguarding the capital sum. This was maintained by following the Authority's counterparty policy as set out in its Treasury Management Strategy Statement for 2013/14 which defined "high credit quality" organisations as those having a long-term credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher.

8. Investments with banks and building societies were primarily fixed-rate term deposits and certificates of deposit. The maximum duration of these investments was 12 months in line with the prevailing credit outlook during the year as well as market conditions.

9. In addition, the Authority invested £4m with organisations and pooled funds without credit ratings, these included Payden and CCLA (Property fund) following external assessment and advice from the Authority's treasury management adviser, Arlingclose.

10. The Treasury Management Strategy Statement and Annual Investment Policy were both approved by Council on 21st March 2013.

Credit developments and credit risk management

11. The Authority assessed and monitored counterparty credit quality with reference to credit ratings; credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP and share price. The minimum long-term counterparty credit rating determined by the Authority for the 2013/14 treasury strategy was A- across rating agencies Fitch, S&P and Moody's.

12. The Financial Services (Banking Reform) Act 2013 gained Royal Assent in December, legislating for the separation of retail and investment banks and for the introduction of mandatory bail-in in the UK to wind up or restructure failing financial institutions. EU finance ministers agreed further steps towards banking union, and the Single Resolution Mechanism (SRM) for resolving problems with troubled large banks which will shift the burden of future restructurings/rescues to the institution's shareholders, bondholders and unsecured investors.

13. Proposals were also announced for EU regulatory reforms to Money Market Funds which may result in these funds moving to a VNAV (variable net asset value) basis and losing their 'triple-A' credit rating wrapper in the future.

14. The material changes to UK banks' creditworthiness were (a) the strong progress made by the Lloyds Banking Group in strengthening its balance sheet, profitability and funding positions and the government reducing its shareholding in the Group to under 25%, (b) the announcement by Royal Bank of Scotland of the creation of an internal bad bank to house its riskiest assets (this amounted to a material extension of RBS' long-running restructuring, further delaying the bank's return to profitability) and (c) substantial losses at Co-op Bank which forced the bank to undertake a liability management exercise to raise further capital and a debt restructure which entailed junior bondholders being bailed-in as part of the restructuring.

15. In July Moody's placed the A3 long-term ratings (equivalent to A- under Fitch & S&P) of Royal Bank of Scotland and NatWest Bank and the D+ standalone financial

strength rating of RBS on review for downgrade amid concerns about the impact of any potential breakup of the bank on creditors. As a precautionary measure the Authority reduced its duration to overnight for new investments with the bank(s). In March Moody's downgraded the long-term ratings of both banks to Baa1. As this rating is below the Authority's minimum credit criterion of A-, the banks were withdrawn from the counterparty list for further investment. NatWest is the Authority's banker and will continue to be used for operational and liquidity purposes.

Interest Rates 2013/14

16. The UK Bank Rate was maintained at 0.5% through the year. Short term money market rates also remained at very low levels which continued to have a significant impact on investment income. The average 3-month LIBID rate during 2013/14 was 0.45%, the 6-month LIBID rate averaged 0.53% and the 1-year LIBID rate averaged 0.78%. The low rates of return on the Authority's short-dated money market investments reflect prevailing market conditions and the Authority's objective of optimising returns commensurate with the principles of security and liquidity.

17. Our advisors are forecasting that the outlook is for official interest rates to remain at 0.5% until June 2016, as shown below:

	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Jun-17
Official Bank Rate												
Upside risk	0.25	0.25	0.25	0.25	0.50	0.50	0.75	0.75	0.75	1.00	1.00	1.00
Arlingclose Central Case	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.00
Downside risk									0.25	0.25	0.50	0.50

Investment Portfolio

18. The table below shows the Council's portfolio of investments at the start and end of the 2013/14 financial year:

	Value of Investments at 01.04.13 £	Value of Investments at 31.03.14 £	Fixed/ Variable Rate
Investments advised by Arlingclose			
World Bonds	3,028,271	0	Fixed
Certificates of Deposit	8,501,524	6,519,416	Fixed
Money Market Fund (Variable Net Asset Value)	1,000,000	997,565	Variable
Property Fund		3,052,479	Variable
Corporate Bonds		8,127,004	Fixed
Floating Rate Notes (FRNs)	5,985,000	3,006,315	Variable
Total	**18,514,795**	**21,702,779**	
Internal Investments			
Short Term Deposits (Banks)	12,000,000	9,000,000	Variable
Short Term Deposits (Other LAs)	5,000,000	5,000,000	Variable
Money Market Funds (Constant Net Asset Value & Business Reserve Accounts	3,810,000	7,690,000	Variable
Total	**20,810,000**	**21,690,000**	
TOTAL INVESTMENTS	**39,324,795**	**43,392,779**	

Returns for 2013/14

19. The returns to 31st March 2014 are shown in the table below:

		Actual Income £'000	% Rate of Return
Investments advised by Arlingclose			
	World Bonds	17	0.80
	Certificates of Deposit (CD's)	51	0.59
	Payden Money Market Fund (VNAV)	9	0.89
	Property Fund (CCLA)	61	4.80
	Corporate Bonds	50	1.08
	Floating Rate Notes (FRNs)	53	0.77
	Total	**241**	
Internal Investments			
	Fixed Term Deposits	116	0.71
	Money Market Funds (CNAV) & Business Reserve Accounts	61	0.61
	Total	**177**	
Other Interest			
	Miscellaneous Loans	14	
	Total	**14**	
TOTAL INCOME TO 31st MARCH 2014		**432**	**0.82**
BUDGETED INCOME		**314**	
SURPLUS		**118**	

20. The table above shows investment income for the year compared to the budget. The figures show a surplus over budget of £118,000.

21. The outturn position is affected by both the amount of cash we have available to invest and the interest base rate set by the Bank of England. Balances are affected by the timing of capital expenditure and the collection of council tax and business rate.

22. The original Treasury Management budget of £313,900 was derived by forecasting an average rate of return of 0.60%. The actual interest rate received for the year was 0.82%.

Investments

23. Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2013/14. New investments can be made with the following institutions:
    - Other Local Authorities;
    - AAA-rated Money Market Funds;

- Certificates of Deposit (CDs) and Term Deposits with UK Banks and Building Societies systemically important to the UK banking system and deposits with select non-UK Banks (Australian, Canadian and American);
- T-Bills and DMADF (Debt Management Office);
- Bonds issued by Multilateral Development Banks, such as the European Investment Bank;
- Commercial Paper;
- Other Money Market Funds and Collective Investment Schemes meeting the criteria in SI 2004 No 534, SI 2007 No 573 and subsequent amendments.

24. The graph shown in appendix A shows the performance of the in-house Treasury team in respect of all investments for the quarter ending 31st March 2014 in comparison to all other clients of Arlingclose.

25. The graph shows that SSDC is in a very good position in terms of the risk taken against the return on investments.

Borrowing

26. An actual overall borrowing requirement (CFR) of £9.7 million was identified at the beginning of 2013/14. As interest rates on borrowing exceed those on investments the Council has used its capital receipts to fund capital expenditure. As at 31st March 2014 the Council had no external borrowing.

Breakdown of investments as at 31ST March 2014

Date Lent	Counterparty	Amount	Rate %	Maturity Date
17 Feb 14	Barclays Bank Plc	1,000,000	0.85	17 Feb 15
17 Jul 13	Barclays Bank Plc	1,000,000	0.85	17 Jul 14
7 Nov 13	Barclays Bank Plc	1,000,000	0.86	7 Nov 14
12 Aug 13	Nationwide Building Society	1,000,000	0.72	12 Aug 14
30 Sep 13	Birmingham City Council	1,000,000	0.50	26 Sep 14
28 Mar 14	Bank of Scotland	1,000,000	0.70	29 Sep 14
3 Jun 13	Nationwide Building Society	1,000,000	0.70	3 Jun 14
2 Jan 14	Bank of Scotland	1,000,000	0.75	2 Jul 14
25 Oct 13	Lancashire County Council	1,000,000	0.55	24 Oct 14
4 Mar 14	Santander UK Plc	1,000,000	0.60	4 Sep 14
11 Dec 13	Lancashire County Council	1,000,000	0.60	5 Nov 14
6 Jan 14	Greater London Authority	2,000,000	1.03	6 Oct 15
31 Mar 14	Bank of Scotland	1,000,000	0.95	27 Mar 15
	Corporate Bonds			
7 Aug 13	Vodafone Group Plc	1,042,239	1.02	8 Sep 14
10 Dec 13	GE Capital UK Funding	1,065,903	1.42	18 Jan 16
20 Dec 13	Lloyds TSB Bank Plc	824,655	0.61	15 Apr 14
17 Jan 14	Places for People Capital Markets	1,069,895	2.67	27 Dec 16
10 Feb 14	Thames Water Utilities Finance Ltd	475,977	1.02	30 Jun 15
10 Feb 14	Heathrow Funding Ltd	1,030,012	1.16	8 Jun 15
10 Feb 14	Volkswagen International Finance NV	507,258	0.88	19 Dec 14
17 Feb 14	National Australia Bank Ltd	1,047,401	0.62	8 Dec 14
7 Mar 14	Standard Chartered Plc	1,063,664	0.52	28 Apr 14
	Certificates of Deposit (CDs)			
6 Jun 13	Deutsche Bank LDN	1,005,718	0.62	5 Jun 14
5 Jun 13	Rabobank	1,005,567	0.60	4 Jun 14
15 Aug 13	Rabobank	1,004,792	0.62	13 Aug 14
14 Feb 14	Deutsche Bank LDN	1,001,509	0.70	16 Feb 15
7 Mar 14	Standard Chartered	1,500,977	0.56	8 Sep 14
24 Mar 14	Barclays Bank Plc	1,000,853	0.87	25 Mar 15
	Floating Rate Notes (FRNs)			
16 Jul 13	Rabobank - 3mth Libor + 13bp	1,001,589	0.68	6 Jun 14
25 Nov 13	HSBC Bank Plc - 3 mth Libor + 28bp	1,003,820	0.83	16 May 16
25 Feb 14	Volkswagen Financial Services NV – 3mth Libor + 17bp	1,000,906	0.72	14 May 14
	Pooled Funds & Money Market Funds			
	Payden Fund VNAV	997,565	0.89	
	CCLA Property Fund	3,052,479	4.80	
	Santander Business Reserve	2,990,000	0.59	
	Handelsbanken	4,000,000	0.59	
	Federated Money Market Fund	700,000	0.41	
		43,392,779		

** Note: Money Market Funds are instant access accounts so the rate displayed is a daily rate*

Prudential Indicators – 2013/14

Background:

27. In March 2013, Full Council approved the indicators for 2013/14, as required by the Prudential Code for Capital Finance in Local Authorities. The Local Government Act 2003 allows local authorities to determine their own borrowing limits provided they are affordable and that every local authority complies with the code.

Prudential Indicator 1 - Capital Expenditure:

28. The actual capital expenditure incurred for 2013/14 compared to the original estimate was:

	2012/13 Outturn £'000	2013/14 Original Estimate £'000	2013/14 Outturn £'000	2013/14 Variance £'000	Reason for Variance
Approved capital schemes	3,078	2,140	2,244	104	There was slippage on the original programme but this was compensated by projects being moved from the reserve schemes and new in year bids being approved. The new bids included: Disaster Recovery & Business Continuity, Microsoft Lync and Northgate Business Rates Software.
Total Expenditure	**3,078**	**2,140**	**2,244**	**104**	

Prudential Indicator 2 - Ratio of Financing Costs to Net Revenue Stream:

29. A comparison needs to be made between financing capital costs and the revenue income stream to support these costs. This shows how much of the revenue budget is committed to the servicing of finance.

Portfolio	2012/13 Outturn £'000	2013/14 Original Estimate £'000	2013/14 Outturn £'000	2013/14 Variance £'000	Reason for Variance
Financing Costs	(277)	(193)	(259)	(66)	Increased income on investments
Net Revenue Stream	17,102	17,955	19,082	1,127	Carry Forwards approved from 2012/13 and incorporated within the budget for 2013/14
%*	**(1.6)**	**(1.1)**	**(1.4)**		

*figures in brackets denote income through receipts and reserves

30. The financing costs include interest payable and notional amounts set aside to repay debt less interest on investment income. The figure in brackets is due to investment income outweighing financing costs significantly for SSDC but is nevertheless relevant since it shows the extent to which the Council is dependent on investment income.

Prudential Indicator 3 - Capital Financing Requirement:

31. The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose. The year-end capital financing requirement for the council is shown below:

	2012/13 Outturn restated £'000	**2013/14 Original Estimate £'000**	**2013/14 Outturn £'000**	**2013/14 Variance £'000**	**Reason for Variance**
Opening CFR	9,502	9,666	9,499	(167)	The original estimate was based on the information held at the time which turned out to be higher than the 2012/13 actual closing balance
Capital Expenditure	3,077	3,202	3,892	690	Additional expenditure due to in year bids being approved and items being moved to the main programmed from the reserve schemes
Capital Receipts*	(1,590)	(1,744)	(2,244)	(500)	An increase in capital expenditure has increased the amount of capital receipts needed to fund these
Grants/Contributions*	(1,487)	(1,458)	(1,648)	(190)	
Minimum Revenue Position (MRP)	(148)	(121)	(173)	(52)	Additional leases have incurred additional MRP
Additional Leases taken on during the year	145	0	298	298	New leases relating to Mower, Transit Tipper box van and Printers
Closing CFR	**9,499**	**9,545**	**9,624**	**79**	

*Figures in brackets denote income through receipts or reserves.

Prudential Indicator 4 – Net external Borrowing compared to the medium term Capital Financing Requirement:

32. The Council is also required to ensure that any medium term borrowing is only used to finance capital and therefore it has to demonstrate that the net external borrowing does not, except in the short term exceed the total of capital financing requirements over a three year period.

	2012/13 Outturn £'000	2013/14 Original Estimate £'000	2013/14 Outturn £'000	2013/14 Variance £'000	Reason for Variance
Net Borrowing	(38,939)	(38,910)	(43,569)	(4,659)	The estimate was a prediction of the year-end balance based on a forecast usage of capital resources. There was slippage on the capital budget.
CFR	9,656	9,545	9,624	79	See explanations for indicator 3 above

33. The figures above in brackets described as net borrowing actually represent net investments. Our net borrowing is forecast to remain as net investment for the foreseeable future and therefore will not at any time be in excess of the capital financing requirement.

Prudential Indicator 5 - Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure:

34. The Council must set three years of upper limits to its exposure to the effects of changes in interest rates. As a safeguard, it must ensure that its limit would allow it to have up to 100% invested in variable rate investments to cover against market fluctuations. For this purpose, term deposits of less than 365 days are deemed to be variable rate deposits. Fixed rate deposits are investments in Eurobonds, Corporate Bonds and term deposits exceeding 365 days.

	2012/13 Actual %	2013/14 % Limit	2013/14 Actual %	2013/14 Variance %	Reason for Variance
Fixed	7.7	80	13	(67)	Within limit
Variable	92.3	100	87	(13)	Within limit

35. The Council must also set limits to reflect any borrowing we may undertake.

	2012/13 Actual %	2013/14 % Limit	2013/14 Actual %	2013/14 Variance %	Reason for Variance
Fixed	0	100	0	100	SSDC currently has no borrowing
Variable	0	100	0	100	SSDC currently has no borrowing

36. The indicator has been set at 100% to maximise opportunities for future debt as they arise.

Prudential Indicator 6 - Upper Limit for total principal sums invested over 364 days:

37. SSDC must also set upper limits for any investments of longer than 364 days. The purpose of this indicator is to ensure that SSDC, at any time, has sufficient liquidity to meet all of its financial commitments.

Upper Limit for total principal sums invested over 364 days	2012/13 Actual £'000	2013/14 Maximum Limit £'000	2013/14 Actual £'000	Variance £'000	Reason for Variance
Between 1-2 years	0	25,000	4,572	(20,428)	Within limit
Between 2-3 years	0	20,000	2,074	(17,926)	Within limit
Between 3-4 years	0	10,000	0	(10,000)	Within limit
Between 4-5 years	0	10,000	0	(10,000)	Within limit
Over 5 years	0	5,000	0	(5,000)	Within limit

38. The table above shows that the Council adopts a policy of safeguarding its investments by minimising investments that are redeemable more than five years ahead.

Prudential Indicator 7 – Credit Risk:

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

Credit ratings remain an important element of assessing credit risk, but they are not a sole feature in the Council's assessment of counterparty credit risk.

The Council also considers alternative assessments of credit strength, and information on corporate developments of and market sentiment towards counterparties. The following key tools are used to assess credit risk:

- Published credit ratings of the financial institution and its sovereign
- Sovereign support mechanisms
- Credit default swaps (where quoted)
- Share prices (where available)
- Economic Fundamentals, such as a country's net debt as a percentage of its GDP
- Corporate developments, news articles, markets sentiment and momentum
- Subjective overlay

The only indicators with prescriptive values remain to be credit ratings. Other indicators of creditworthiness are considered in relative rather than absolute terms.

Prudential Indicator 8 - Actual External Debt:

40. This indicator is obtained directly from the Council's balance sheet. It is the closing balance for actual gross borrowing plus other long-term liabilities (this represents our finance leases). This Indicator is measured in a manner consistent for comparison with the Operational Boundary and Authorised Limit.

Actual External Debt as at 31/03/2014	**£'000**
Borrowing	0
Other Long-term Liabilities (Finance Leases)	511
Total	**511**

Prudential Indicator 9 - Authorised Limit for External Debt:

41. This limit represents the maximum amount that SSDC may borrow at any point in time during the year. If this limit is exceeded the Council will have acted ultra vires. It also gives the Council the responsibility for limiting spend over and above the agreed capital programme. A ceiling of £12 million was set for each year.

	2012/13 Actual £'000	**2013/14 Original Estimate £'000**	**2013/14 Actual £'000**	**2013/14 Variance £'000**	**Reason for Variance**
Borrowing	0	11,000	0	(11,000)	SSDC currently has no borrowing
Other Long-term Liabilities	386	1,000	511	(489)	Within limit
Total	**386**	**12,000**	**511**	**(11,489)**	

Prudential Indicator 10 – Operational Boundary for External Debt:

42. The operational boundary sets the limit for short term borrowing requirements for cash flow and has to be lower than the previous indicator, the authorised limit for external debt. A ceiling of £10 million for each of the next three years was set.

	2012/13 Actual £'000	**2013/14 Original Estimate £'000**	**2013/14 Actual £'000**	**2013/14 Variance £'000**	**Reason for Variance**
Borrowing	0	9,200	0	(9,200)	SSDC currently has no borrowing
Other Long-term Liabilities	386	800	511	(289)	Within limit
Total	**386**	**10,000**	**511**	**(9,289)**	

Prudential Indicator 11 - Maturity Structure of Fixed Rate borrowing:

43. This indicator is relevant when we borrow, then we can take a portfolio approach to borrowing in order to reduce interest rate risk. This indicator is shown as the Council has set limits in anticipation of future borrowing.

Maturity structure of fixed rate borrowing	2012/13 Upper Limit %	2013/14 Lower Limit %	2013/14 Actual %	2013/14 Variance %
Under 12 months	100	0	0	Not applicable
12 months and within 24 months	100	0	0	Not applicable
24 months and within 5 years	100	0	0	Not applicable
5 years and within 10 years	100	0	0	Not applicable
10 years and within 20 years	100	0	0	Not applicable
20 years and within 30 years	100	0	0	Not applicable
30 years and within 40 years	100	0	0	Not applicable
40 years and within 50 years	100	0	0	Not applicable
50 years and above	100	0	0	Not applicable

Prudential Indicator 12 - Incremental Impact of Capital Investment Decisions:

44. SSDC must show the effect of its annual capital decisions for new capital schemes on the council taxpayer. Capital spend at SSDC is financed from additional receipts so the figure below actually shows the possible decreases in council tax if all capital receipts were invested rather than used for capital expenditure.

Incremental Impact of Capital Investment Decisions	2012/13 Actual £	2013/14 Original Estimate £	2013/14 Actual £	2013/14 Variance £
Decrease in Band D Council Tax	0.65	0.47	0.29	(0.18)

Prudential Indicator 13 - Adoption of the CIPFA Treasury Management Code:

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

Adoption of the CIPFA Code of Practice in Treasury Management
The Council approved the adoption of the CIPFA Treasury Management Code at its Council meeting on 18th April 2002.

Conclusion

46. The council operated within all of the Prudential Indicators during 2013/14

Background Papers: *Prudential Indicators Working Paper, Treasury Management Strategy Statement 2013/14*