PERTH AND KINROSS COUNCIL

2 October 2013

ANNUAL TREASURY REPORT 2012/13

Report by the Head of Finance

PURPOSE OF REPORT
This report summarises the Council's treasury activities for the 2012/13 financial year and compares actual performance with the approved Treasury and Investment Strategy for 2012/13.

1. BACKGROUND / MAIN ISSUES

1.1 A requirement of the Council's approved Treasury Management Practice 6 (TMP6 – Reporting Requirements & Management Information Arrangements) is the reporting to the Council of the expected treasury activity for the forthcoming year (i.e. the Treasury and Investment Strategy), and the subsequent reporting of the actual results and activities (i.e. this Annual Treasury Report). The Council meeting on 22 February 2012 approved the Treasury Strategy for the 5 financial years 2012/13 to 2016/17 and the annual Investment Strategy for 2012/13 (Report No. 12/78 refers).

1.2 This Annual Treasury Report covers:

- The Council's treasury position
- The forecast economic outlook and borrowing strategy for 2012/13
- The actual economic situation for 2012/13
- Actual long term borrowing and debt restructuring in 2012/13
- The investment strategy and outurn for 2012/13
- Compliance with treasury policies and limits during 2012/13

2. THE TREASURY POSITION

2.1 In order to place this report in context, the Council's Treasury position at the beginning and at the end of the year is shown below:

	Principal Outstanding 31 Mar 2012 £M	Average Rate %	Principal Outstanding 31 Mar 2013 £M	Average Rate %
Fixed Rate Funding				
• Public Works Loan Board (PWLB)	160.0	4.06	156.9	4.00
• Market Bonds	43.2	4.59	43.2	4.59
• Local Loans & Bonds	0.3	0.75	0.3	0.75
	203.5	4.16	200.4	4.12
Variable Rate Funding				
• Temporary Loans	0.0	0.00	0.0	0.00
• Local Loans	2.3	0.10	1.5	0.10
	2.3	0.10	1.5	0.10
TOTAL DEBT	**205.8**	**4.12**	**201.9**	**4.09**
SHORT TERM INVESTMENTS	**40.0**	**1.93**	**39.6**	**1.93**

3. THE FORECAST ECONOMIC OUTLOOK AND BORROWING STRATEGY 2012/13

3.1 The strategy for the year was based on the view that the global economy was going through a period of extreme volatility which made it difficult to forecast interest rates with any degree of certainty. It was, however, anticipated that the Bank Base rate would remain at 0.5% throughout the year before increasing steadily from 2013, whilst longer term interest rates were expected to rise steadily throughout 2012 and future years. It was expected that Public Works Loan Board (PWLB) rates would follow a similar trend over this same period, but with shorter and medium term PWLB rates expected to remain at a lower level than longer term rates.

3.2 The effect on interest rates for the UK was therefore expected to be as follows:

- <u>Short-Term Interest rates</u> – it was anticipated that the Bank Rate would remain at its low level of 0.5% throughout 2012/13, with steady increases over the subsequent years.

- <u>Long-Term Interest Rates</u> – The view on longer-term fixed rates was that long term (over 25 years) Public Works Loan Board (PWLB) rates would increase during 2012/13, reaching around 4.50% by year end. The 10 year rate was expected to reach around 2.50% by the end of 2012/13.

3.3 The estimated capital borrowing requirement for 2012/13 at the start of the year was £36.0M, and included deferment of some new borrowing from 2011/12. The new borrowing requirement over the whole five year period totalled £158.1M, and included some refinancing of maturing debt over the 5 year period. This was particularly significant as 2012/13 co-incided with the period of lowest forecast interest rates. Effective Treasury Management considers the longer-term position in order to minimise costs and risks in the Council's portfolio. This includes consideration of borrowing for future year requirements earlier within the 5 year period, whilst rates were at their forecast low point. This approach is consistent with the Prudential Code, however it must also be considered in conjunction with the assessment of the associated additional risks and low returns from the resultant increase in the level of investments in the short term.

3.4 These factors gave rise to the anticipated strategy that Best Value would be achieved by taking advantage of short dated borrowings throughout the period. However, consideration would also be given to the use of longer term borrowing to make longer term savings and reduce the refinancing risk in later years. LOBO's (Lender Option Borrowers Option) or other appropriate market instruments were also to be considered and used where they offered favourable rates in comparison to PWLB. However, these would be considered in conjunction with the associated risks with LOBO's due to their variable rate nature after their initial period elapses, and their less flexible terms.

3.5 The Council has traditionally adopted a policy of minimising exposure to risk, thus favouring fixed longer term borrowing, and the above strategy was viewed as low risk. However, it was acknowledged that there were several factors which could impact on interest rates in the year ahead. Therefore the Council continued to apply its well developed approach to managing risk and monitoring interest rates with a view to reviewing this strategy should circumstances change.

4. ACTUAL ECONOMIC SITUATION 2012/13

4.1 2012/13 proved to be another unsettled year for the financial markets. Economic growth in the UK remained at a low level throughout the year, whilst sovereign debt issues in some Eurozone countries continued. The weak growth in the UK led the Bank of England to leave the Bank Rate unchanged at 0.5% throughout the year. During this period, Consumer Price Index (CPI) inflation fell significantly in the first half of the year from 3.4% at the start of the year to 2.2% in September 2012. For the remainder of the year, inflation increased slightly, and remained around 2.8%.

4.2 The UK's level of national debt and low growth led 2 credit agencies to cut the UK's AAA credit-rating, reducing it to AA+. However, this had become widely anticipated within the financial markets, and so the actual cut to the UK's credit rating had little immediate impact on borrowing costs for the UK Government.

4.3 Gilt yields remained low throughout the year as the financial markets regard the UK as a safe haven due to it having monetary policy independence unlike the Eurozone. Further, the Eurozone sovereign debt concerns also acted to keep UK gilt yields low. From January 2013, yields did increase slightly in response to the American “fiscal cliff” being avoided at that time, and hopes that global economic growth would improve. However these small increases were reversed by the end of the financial year.

4.4 Investment deposit rates remained at low levels. However, with the Funding for Lending Scheme announced by the Bank of England, giving banks access to cheaper funding, the investment rates for deposits offered by banks fell even further.

4.5 All PWLB fixed rates fell slightly over the year. For example, the 9-10 year PWLB rate at 1 April 2012 was 3.15%, and fell as low as 2.53% in July 2012, before finishing the year at 2.74%. Similarly, the 25 year PWLB rate fell from 4.44% to 3.97%, and ended the year at 4.19%. The same pattern emerged for all PWLB rates and various PWLB rates for the year are shown graphically at Appendix I.

5. ACTUAL LONG TERM BORROWING AND DEBT RESTRUCTURING

5.1 The actual treasury activities during 2012/13 are comprehensively detailed in the 4 quarterly reports previously submitted to the Council (Report No’s 12/436, 12/588, 13/101 and 13/222 refer).

5.2 As noted in Section 4.3, before the start of the year the Council’s estimated new Capital borrowing requirement for 2012/13 was £36M. The actual borrowing requirement by the end of the year reduced to £29.1M due to rephasing and slippage within the Capital programme and by new borrowing from the previous year being deferred into 2012/13.

5.3 In summary, a total of £10M was borrowed from the PWLB, at an average rate of 2.74% and for an average time period of 8.75 years, all of which was borrowed in May 2012. This is slightly higher than the average actual PWLB rate during 2012/13 for 10 years of 2.69%. In contrast, the average long term rate available from the PWLB for 25 years was 4.1% and for 50 years was 4.25%. There was £13.2M of maturing debt with the PWLB repaid during the year, but due to the low interest rates there were no rescheduling or premature repayments made.

5.4 The average PWLB debt portfolio rate for the Council reduced from 4.06% at the start of the year, to 4.00% at the end of the year for the total of £156.9M PWLB debt held by the Council. The total PWLB borrowing reduced by £3.2M over the year, as a result of the activities discussed above compared to the actual borrowing requirement of £29.1M. This reduction in the portfolio was as a result of the revised borrowing strategy approved by the Council at its meeting of 19 December 2012 (report 12/586 refers) as one of the funding options for additional capital expenditure. The revised strategy was to utilise investment balances to fund expenditure over the next two years by not undertaking any further borrowing in 2012/13 and 2013/14. This strategy gave rise to short term savings by reducing investments with low returns rather than undertaking borrowing at higher rates. It was, however, also acknowledged that this gave rise to greater risks in the longer term if the Council needed to borrow when interest rates may have increased.

5.5 The LOBOs (Lender Option Borrower Options) average rate remained at 4.59% over the year as all of the loans had already moved into their "step-up" period and no rate changes were instigated. There were no new LOBOs entered into during the year.

5.6 As a result of the above strategy and actual treasury activities in the year, the Council's average Consolidated Loans Fund (CLF) interest rate reduced from 3.70% in 2011/12 to 3.58% in 2012/13 (based on applying statutory guidance). The estimated CLF rate for 2013/14 is forecast to reduce even further to 3.32% reflecting a full year's impact of the revised strategy. A comparison of the Council's CLF rate over recent years with the average for other Scottish Local authorities is shown graphically at Appendix II. Whilst figures for the Scottish average have not yet been published for 2012/13, this graph shows that over time, this Council's average borrowing costs have reduced year-on-year at a faster rate than the Scottish average. This equates to savings in Loan Charges of approximately £2.28M (or 27%) per annum compared to the Scottish average.

6. INVESTMENT STRATEGY AND OUTURN 2012/13

6.1 The tight monetary conditions and economic uncertainty continued through 2012/13. Shorter term deposit rates remained at low levels throughout the year, and steadily reduced even further following the Funding for Lending Scheme introduced by the Bank of England in July 2012. Throughout the financial year the Bank (Base) Rate remained at 0.5%. Counterparty concerns, mostly as a result of the Eurozone sovereign debt crisis, also continued, however, the European Central Bank (ECB) has assisted by providing short term liquidity to banks. This highlighted the ongoing need for caution in treasury investment activity.

6.2 As a result, advantage was taken where possible (and within counterparty limits) of the higher interest rates available for longer time periods (up to 12 months). For shorter lending periods, the notice deposit investment accounts and money market funds held by the Council provided a higher return on investments than rates available on fixed deposits in the money markets, whilst also helping meet daily cashflow requirements and keeping within counterparty limits. During the year, no investment was made for more than 12 months. All these investment activities were in line with the approved strategy for 2012/13. As a result of this strategy, the average rate achieved on investments outstanding at 31 March 2013 was 1.93%. This remained unchanged from that achieved in the previous year, despite falling interest rates, because a higher proportion of investments were started on fixed rate terms before rates fell, and were still outstanding at the year end date (31 March 2013). For further comparison, the average temporary borrowing rate for the year was 0.16%. Total interest received on investments in 2012/13 amounted to £1,028,051 (£685,165 in 2011/12).

6.3 The original Strategy also anticipated that investments would not exceed £50M during the year unless, for example, new borrowing was undertaken. As described in Section 6.3 there was new borrowing undertaken totalling £10M early in the year, and in addition the level of expenditure by the Council was below cashflow forecasts. Consequently, the level of investments exceeded this forecast in the first half of the year and peaked at £76.825M on 15 August 2012. The level of investments slowly reduced over the remainder of the year and at the end of the financial year stood at £39.6M.

6.4 The Council's strategy of reducing its level of investments could only partly be continued by the deferment of some of the new borrowing requirement. However due to the low level of interest rates, the premature repayment of debt was not considered desirable. Additionally, lower levels of expenditure, particularly in the Capital Programme, acted to increase the Council's cash balances and as a result the level of investments fell more slowly than originally anticipated.

6.5 Following the distribution of funds in March 2012 by Glitnir, currency restrictions imposed by the Icelandic Central Bank have resulted in ISK 39.7M (£211K as at 31 March 2013) still remaining in Iceland. Any further developments will continue to be reported to the Council as part of the Quarterly Treasury Activity and Compliance reports.

6.6 All financial investments by the Council's Common Good Funds were made through the Council's Loans Fund, in accordance with their policy for Permitted Investments. Any other investments held with external fund managers are outside the scope of the investment regulations, as they all relate to funds held by Council operated Charities or Trusts.

6.7 The Annual Property Investment Strategy for 2012/13 was also approved by the Council at its meeting on the 22 February 2012 (Report 12/78 refers) and was complied with in full, with no breaches in compliance with permitted investment limits.

6.8 The budgeted income from the Council's property portfolio for 2012/13 was originally projected to be £1,987,000, however this was subsequently revised down to £1,887,000. The actual Income for the Council's property portfolio for 2012/13 was £1,970,000, exceeding the revised projection by £83,000.

6.9 There were neither additional risks indentified nor new property investments entered into over the year. The strategy action plan remained on programme.

7. COMPLIANCE WITH TREASURY POLICIES AND LIMITS

7.1 There were no breaches of compliance with the Council's approved lending policy in 2012/13. All aspects of the Prudential Code, including Prudential Indicators and limits, were fully adhered to throughout the year.

8. CONCLUSION AND RECOMMENDATIONS

8.1 The original approved borrowing strategy for the year was to minimise exposure to risk, and was designed to take advantage of shorter and longer term rates as opportunities arose throughout the year. Economic uncertainties and debt issues in Europe acted to keep UK interest rates low. Some new PWLB borrowing was undertaken early in the year when the rates were favourable for medium term repayment periods and on fixed rate terms. However, this borrowing strategy was revised in December 2012, and no further borrowing was undertaken in the financial year. There was no premature repayment of debt undertaken in the year, as the low level of interest rates meant that rescheduling of debt was not cost-effective.

8.2 There was some investment of cashflow surpluses undertaken for longer periods (up to 12 months) to take advantage of more attractive rates. For shorter term cashflow surpluses the investment deposit accounts and Money Market Funds (MMF) were generally used in order to manage cashflow and liquidity. Investment rates remained at low levels and fell further from those in the previous year.

8.3 There were no breaches of compliance within the lending policy during the year, and all Prudential Indicators were complied with during the year. As a result of the activities undertaken throughout 2012/13 the Council's plans remain affordable, prudent and sustainable.

8.4 It is recommended that the Committee:

1. Notes the content of this report, which is submitted in accordance with the Council's approved Treasury Management Practices (TMPs).

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Approved

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Council Text Phone Number 01738 442573

ANNEX

1. IMPLICATIONS, ASSESSMENTS, CONSULTATION AND COMMUNICATION

The undernoted table should be completed for all reports. Where the answer is 'yes', the relevant section(s) should also be completed

Strategic Implications	**Yes / None**
Community Plan / Single Outcome Agreement	None
Corporate Plan	Yes
Resource Implications	
Financial	Yes
Workforce	Yes
Asset Management (land, property, IST)	Yes
Assessments	
Equality Impact Assessment	Yes
Strategic Environmental Assessment	Yes
Sustainability (community, economic, environmental)	Yes
Legal and Governance	None
Risk	None
Consultation	
Internal	Yes
External	Yes
Communication	
Communications Plan	None

1. Strategic Implications

1.1. <u>Corporate Plan</u>

1.1.1. The Council's Corporate Plan 2013 – 2018 lays out five outcome focussed strategic objectives which provide clear strategic direction, inform decisions at a corporate and service level and shape resources allocation. They are as follows:

(i) Giving every child the best start in life;
(ii) Developing educated, responsible and informed citizens;
(iii) Promoting a prosperous, inclusive and sustainable economy;
(iv) Supporting people to lead independent, healthy and active lives; and
(v) Creating a safe and sustainable place for future generations.

1.1.2 This report relates to all of these objectives.

2. Resource Implications

2.1. Financial

2.1.1. There are no direct financial implications arising from this report other than those reported within the body of the main report.

2.2. Workforce

2.2.1. There are no direct workforce implications arising from this report other than those reported within the body of the main report.

2.3. Asset Management (land, property, IT)

2.3.1. There are no direct asset management implications arising from this report other than those reported within the body of the main report.

3. Assessments

3.1. Equality Impact Assessment

3.1.1. Under the Equality Act 2010, the Council is required to eliminate discrimination, advance equality of opportunity, and foster good relations between equality groups. Carrying out Equality Impact Assessments for plans and policies allows the Council to demonstrate that it is meeting these duties.

3.1.2. The information contained within this report has been considered under the Corporate Equalities Impact Assessment process (EqIA) and has been assessed as **not relevant** for the purposes of EqIA.

3.2 Strategic Environmental Assessment

3.2.1 The Environmental Assessment (Scotland) Act 2005 places a duty on the Council to identify and assess the environmental consequences of its proposals.

3.2.2 The information contained within this report has been considered under the Act. However, no action is required as the Act does not apply to the matters presented in this report.

3.3 Sustainability

3.3.1 Under the provisions of the Local Government in Scotland Act 2003 the Council has to discharge its duties in a way which contributes to the achievement of sustainable development. In terms of the Climate Change Act, the Council has a general duty to demonstrate its commitment to sustainability and the community, environmental and economic impacts of its actions.

3.3.2 The information contained within this report has been considered under the Act. However, no action is required as the Act does not apply to the matters presented in this report.

4. Consultation

4.1 The Chief Executive, and the Council's Treasury advisors, Sector Treasury Services, have been consulted in the preparation of this report.

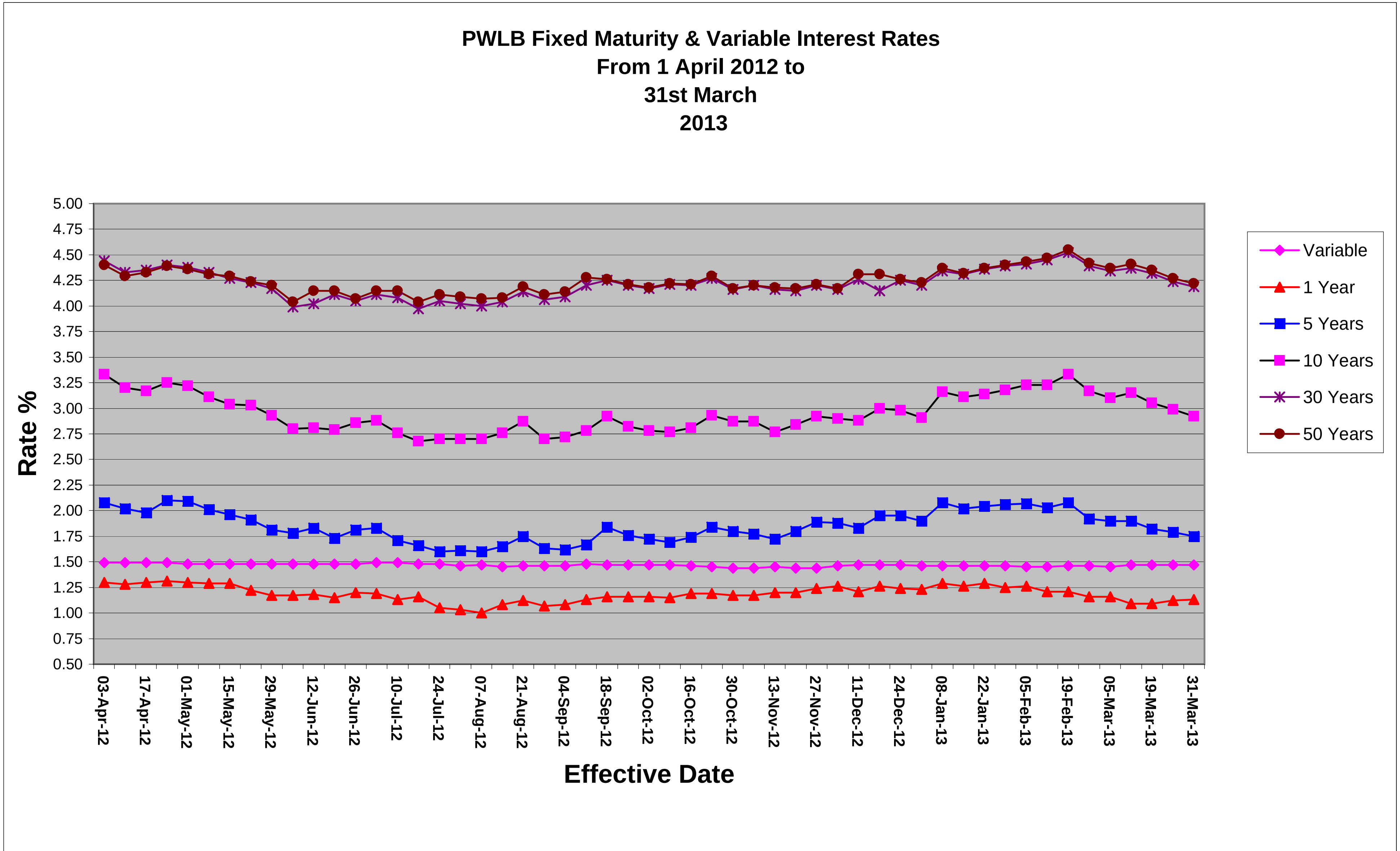
5. BACKGROUND PAPERS

5.1 No background papers, as defined by Section 50D of the Local Government (Scotland) Act 1973 (other than any containing confidential or exempt information) were relied on to any material extent in preparing the above report.

6. APPENDICES

Appendix I – PWLB Fixed Maturity & Variable Interest Rates From 1 April 2012 to 31st March 2013.

Appendix II – Average Loans Fund Rates.


PWLB Fixed Maturity & Variable Interest Rates
From 1 April 2012 to
31st March
2013
Rate %
5.00
4.75
4.50
4.25
4.00
3.75
3.50
3.25
3.00
2.75
2.50
2.25
2.00
1.75
1.50
1.25
1.00
0.75
0.50
03-Apr-12
17-Apr-12
01-May-12
15-May-12
29-May-12
12-Jun-12
26-Jun-12
10-Jul-12
24-Jul-12
07-Aug-12
21-Aug-12
04-Sep-12
18-Sep-12
02-Oct-12
16-Oct-12
30-Oct-12
13-Nov-12
27-Nov-12
11-Dec-12
24-Dec-12
08-Jan-13
22-Jan-13
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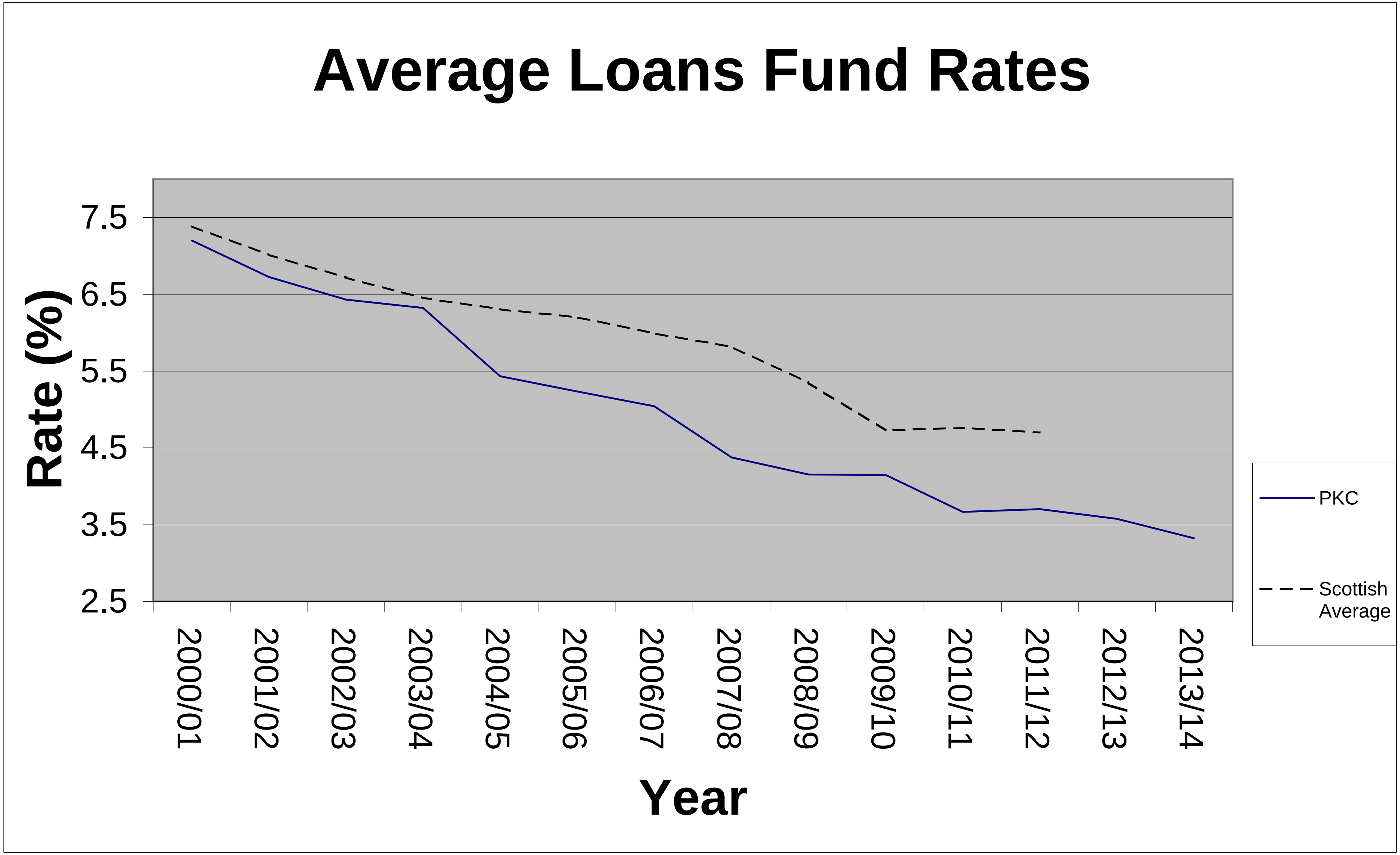
5 Years
10 Years
30 Years
50 Years


Average Loans Fund Rates
Rate (%)
7.5
6.5
5.5
4.5
3.5
2.5
2000/01
2001/02
2002/03
2003/04
2004/05
2005/06
2006/07
2007/08
2008/09
2009/10
2010/11
2011/12
2012/13
2013/14
Year
PKC
Scottish Average