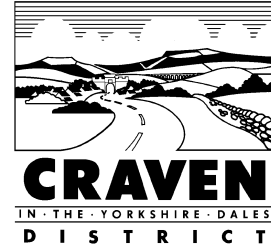


## Policy Committee – 9<sup>th</sup> July 2013

### Treasury Management Annual Report 2012/13



Report of the Corporate Head of Financial Management

Ward(s) affected: All

#### 1. **Purpose of Report**

To inform Members of the treasury activity undertaken in the year in the context of current and forecast economic climates.

#### 2. **Recommendations**

Members are recommended to:

- Note the Treasury Management Annual Report for 2012/13;
- Note the actual Treasury Management Indicators for 2012/13.

#### 3. **Introduction**

The CIPFA (the Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management recommends that Members be updated on treasury management activities regularly (TMSS, annual and midyear reports). This report therefore ensures this council is implementing best practice in accordance with the Code.

#### 4. **Economic Review**

41 During the quarter ended 31 March: -

- Indicators suggest that the economy was very near to a second consecutive quarter of negative growth in GDP;
- Household spending strengthened, both on and off the high-street;
- Unemployment rose for the first time for a year;
- Inflation remained stubbornly above the MPC's 2% target;
- Three members of the MPC voted for further QE;
- UK equity prices rose and sterling fell;
- The US economic recovery gathered pace.

4.2 It remains touch-and-go whether the UK economy contracted again in this first quarter: if so, it would result in a triple-dip recession. On the basis of past form, the CIPS/Market business surveys point to next to no growth and the first official sets of output data have been fairly disappointing. Although the index of services rose by a monthly 0.3% in January, this did not fully reverse its drop in December. Meanwhile, industrial production posted a 1.2% monthly

fall in January. This was partly driven by lower output in the volatile energy sector, but manufacturing output was down 1.5% on the month too. Note also that unusually bad weather at the end of the quarter may have depressed activity in certain sectors, such as retail and construction.

- 4.3 Household spending appears to have started the year on a stronger footing. The 2.1% monthly rise in retail sales in February more than offset January's 0.7% fall. Non-high street spending has been robust too, with new car registrations up by 7.9% in the year to February.
- 4.4 The latest data tentatively suggested that the labour market's recent resilience is coming to an end. Employment continued to grow, by 131,000 in the three months to January, but this was slower than the 175,000 gain seen in the fourth quarter. The unemployment data was also softer, with the ILO measure showing a 7,000 rise in unemployment in the three months to January, the first increase in a year. Admittedly, the timelier claimant count measure still fell in February, albeit by a trivial 1,500. Meanwhile, pay growth remained subdued, with the headline (3m average of the annual rate) measure of earnings falling to 1.2% in January.
- 4.5 Elsewhere, the housing market has been revived a bit by the Bank of England's Funding for Lending Scheme (FLS) which helped to bring down some mortgage rates, primarily on fixed products. The quoted interest rate on a 2-year fixed mortgage at a 90% loan-to-value ratio has fallen around 80 basis-points since the introduction of the FLS back in August.
- 4.6 This is helping to support house prices. Both the Halifax and Nationwide measures reported monthly gains in February, rising by 0.5% and 0.2% respectively. The Halifax measure rose by 1.9% on a 3-month-on-3-month basis, the fastest pace since the beginning of 2010. But there were some early signs of weakness in the housing market in the January to March quarter. Mortgage approvals as measured by the BBA fell in both January and February, and are now 8% lower compared with the end of last year. But this may be overstating the fall, as smaller lenders, not measured by the BBA figures, have been gaining market share recently. The broader Bank of England data, which also includes non-bank lenders, showed that approvals fell by just 1.6% in January.
- 4.7 On the fiscal front, the public borrowing figures for this year have been flattered by a number of one-offs, including the transfer of the Royal Mail pension fund and the revenues of interest generated by the Bank of England's Asset Purchase Facility. On an underlying basis, however, the OBR forecast net borrowing of £121.9bn in 2012/13, is basically unchanged from the outturn seen in the last financial year. Underlying borrowing is now not forecast to fall substantially until 2014/15.
- 4.8 This year's Budget contained many good individual measures, but they were on a small scale and their overall effect was fiscally neutral. The further 1p cut in corporation tax and the "employment allowance", which helps to reduce employers' national insurance contributions, were welcome moves that should

help business. But giveaways were matched by further cuts, including a further 1% reduction in departmental spending in the next two fiscal years.

- 4.9 The Budget also contained a reaffirmation of the MPC's 2% inflation target along with some minor tweaks to the MPC's remit, which will allow the MPC more flexibility in the communication of its policy. This fell short of speculation that the government could suspend, or even scrap entirely, the 2% inflation target.
- 4.10 Inflation, meanwhile, remained high, with the CPI measure rising from 2.7% to 2.8% in February. The latest rises have been driven, mainly, by higher energy prices. This reflected a sharp rise in sterling oil prices as well as the final price rise from a "big six" utility company filtering through.
- 4.11 The MPC has said that it would "look through" the latest energy driven price rises when setting monetary policy. Indeed, the minutes of February's meeting showed that three members of the MPC, including Governor, Mervyn King, voted for further quantitative easing. The size of the Bank's asset purchase programme has remained at £375bn since November.
- 3.12 Turning to the markets, both UK and global equity prices have rallied since the start of the year, with the FTSE 100 rising from 5,897 to over 6,400 at 31 March 2013. Gilt prices were volatile over the quarter, with the yield on 10-year gilts hitting 2.2% in early March, before falling back to 1.72% at the end of March, similar to the level seen at the start of the year. Meanwhile, the pound has fell sharply against the dollar, from \$1.63 to \$1.51 at 31 March 2013 and was slightly weaker against the euro, too, slipping from €1.23 to €1.19.
- 4.13 Internationally, the economic recovery in the US appeared to gather momentum over the first quarter. A weighted average of the ISM indices is consistent with annualised GDP growth of close to 3%. What is more, the growth in private payrolls accelerated to a 3-month average of 200,000 in February. While the expiry of the payroll tax cut at the start of the year will hit real incomes, the 0.4% rise in underlying retail sales in February looks consistent with consumption growth of 2% annualised.
- 4.14 The Eurozone crisis flared up again at the end of the quarter, after it was agreed that bank deposits could be subject to a "haircut" as part of an international bail-out package for Cyprus. While a bailout package agreed by European Finance Ministers should avert disaster, the episode has raised fears about the safety of bank deposits in other periphery countries. Meanwhile, the underlying Eurozone economy looks weak. On past form the composite Eurozone PMI points to a 0.3% quarterly contraction of GDP in the January to March quarter.

## 5. Interest Rate Forecast

The Council's treasury advisor, Sector, provides the following forecast:

|                       | Jun-13 | Sep-13 | Dec-13 | Mar-14 | Jun-14 | Sep-14 | Dec-14 | Mar-15 |
|-----------------------|--------|--------|--------|--------|--------|--------|--------|--------|
| <b>Bank rate</b>      | 0.50%  | 0.50%  | 0.50%  | 0.50%  | 0.50%  | 0.50%  | 0.50%  | 0.75%  |
| <b>5yr PWLB rate</b>  | 1.80%  | 1.80%  | 1.80%  | 1.90%  | 2.00%  | 2.10%  | 2.20%  | 2.40%  |
| <b>10yr PWLB rate</b> | 2.90%  | 2.90%  | 2.90%  | 3.00%  | 3.10%  | 3.20%  | 3.30%  | 3.50%  |
| <b>25yr PWLB rate</b> | 4.10%  | 4.10%  | 4.10%  | 4.20%  | 4.20%  | 4.30%  | 4.40%  | 4.60%  |
| <b>50yr PWLB rate</b> | 4.20%  | 4.20%  | 4.20%  | 4.40%  | 4.40%  | 4.50%  | 4.60%  | 4.70%  |

- 5.1 Sector undertook a review of its interest rate forecasts following the issue of the Bank of England Inflation Report in February 2013. The forecast for the first increase in Bank Rate in March 2015 was left unchanged. However, forecasts for PWLB rates were increased as a result of the marked recovery in confidence in equity markets, anticipating stronger economic recovery in America, supported by growth in the Far East. The rise in equity prices has, conversely, resulted in a selloff in bonds and some diminution of the UK as a safe haven from more risky assets. However, towards the end of March, the Cyprus crisis partially reversed these general trends, although this is likely to be a temporary phase – at least, until the next Eurozone crisis!

## 6. Economic Forecast

### **UK economy**

- 6.1 The Bank of England February Inflation Report downgraded its forecasts for growth and pushed back the timing of economic recovery. In addition, it also raised its forecasts for inflation (peaking at 3.2% in Q3 this year) and pushed back the timing of when inflation would fall back to the 2% target rate by eighteen months, to Q1 2016. The Bank has, therefore, continued its trend of correcting its repeated over optimism on the speed and strength of recovery and it is now forecasting growth reaching about 1.9% in two years time.
- 6.2 In both the Chancellor's Autumn Statement, and then his March budget, he again extended the timetable for reducing the annual budget deficit and total outstanding debt due to weak growth depressing tax revenues and increasing benefit payments. The one slightly more optimistic area has been the housing market, as the Funding for Lending Scheme looks to be having a positive effect in improving the supply of credit via mortgages.

6.3 In summary, our concerns around a slowdown in prospects for GDP growth in the western world are as follows: -

#### **UK**

- The Bank of England February 2013 Inflation Report again pushed back the timing of a return to trend growth and the rate at which inflation will fall back towards the target rate of 2%. Over the year to Q4 2012, total growth came in at only 0.2%.
- A fair proportion of UK GDP is dependent on overseas trade; the high correlation of UK growth to US and EU GDP growth means that the UK economy is likely to register weak growth over both 2013 and 2014.
- Consumers are likely to remain focused on paying down debt. Weak consumer sentiment and job fears will all act to keep consumer expenditure suppressed; this will be compounded by inflation being higher than increases in average earnings i.e. disposable income will continue to be eroded.
- The Coalition government is hampered in promoting growth by the need to tackle the budget deficit. However, the March budget did contain measures to boost house building and the supply of mortgages, and brought forward, by one year to April 2014, the start of a £10,000 tax free allowance for incomes.
- Little sign of a co-ordinated strategy for the private sector to finance a major expansion of infrastructure investment to boost UK growth.
- There is a limited potential for more Quantitative Easing (QE) in 2013, which would help to keep gilt yields lower than they would be without further QE.
- In February 2013 Moody's downgraded the UK's AAA credit rating one notch to AA+. There was little reaction in financial markets, as this had been widely anticipated. Fitch put its AAA rating on negative watch in March.

#### **Eurozone**

- Most Eurozone countries are now battling against negative economic growth in 2013, although Germany is experiencing a resurgence of business confidence and surveys are pointing towards a resumption of growth. Growth prospects, for many Eurozone countries, are poor due to the need to adopt austerity programmes to bring government deficits under control.
- Although market anxiety about Greece has subsided after the agreement to a further major financial support package amounting to nearly €50bn, in December, concerns still remain that the eventual end game could be that Greece is eventually forced to exit the Eurozone and to return to the drachma.
- There is also increasing concern that the contraction in Spain's economy and the very high level of unemployment of 25%, similar to Greece's level, could mean that both countries could get into a downward deflationary spiral, which makes achieving fiscal correction increasingly difficult and possibly

unachievable. The ECB's pledge to provide unlimited bond buying support for countries that request an official bailout means that market anxiety about Spain and Greece is likely to be subdued in the immediate future. However, the poor economic fundamentals and outlook for both economies could well mean that a storm in financial markets has only been delayed, not cancelled. Spain has resisted asking for an official national bailout, although it has received financial support to recapitalise its four largest banks.

- The general election in Italy created a highly unstable political situation where no party could form a viable coalition to govern without the support of the new Five Star anti-austerity party. Five Star won a blocking vote 25% of seats and has refused to enter a coalition agreement. It looks increasingly likely that there will be another general election.
- A general election is due in Germany in the autumn of 2013. It currently looks likely that this will lead to little change in current policy on the Euro and support for peripheral countries. However, polls are indicating that 25% of the electorate now favour Germany leaving the Euro and stopping the flow of money from Germany to profligate southern countries. Any further disasters in the Eurozone could see this sentiment increase significantly.
- A bailout for Cyprus was eventually agreed in the last week of March after a traumatic first proposal was resoundingly rejected by the Cypriot Parliament. Financial markets remained largely calm after the final agreement and there has been little evidence to date, of potential contagion to other peripheral Eurozone countries. Slovenia, however, looks increasingly likely to be the next in line for a bailout. However, huge damage will be done to the Cypriot economy by the fallout from this bailout and many commentators consider it is only a matter of time before another bailout will be needed – or exit from the Euro.

## US

- There has been a strong resurgence of confidence in US financial markets as the “fiscal cliff” has been largely averted or postponed. Confidence has bolstered recovery in employment and the housing market and has provided the wider economy with a solid base for optimism looking forward. This is reflected by US equities reaching all-time highs.
- The Federal Reserve is unlikely to increase the central rate until 2015, as it has now set a specific target of first reducing unemployment to 6.5% (currently 7.7% at the end of March).
- The housing market is showing signs of having turned a corner, both in price rises and the volume of house sales.

## China

- Efforts to stimulate the economy appear to be succeeding. However, there are still concerns around an unbalanced economy, heavily dependent on new investment expenditure, and for a potential bubble in the property sector to burst, as it did in Japan in the 1990s, with its consequent impact on the financial health of the banking sector. There are also increasing concerns around the potential size, and dubious creditworthiness, of some lending to local government organisations and major corporates during the Government promoted expansion of credit, aimed at protecting the overall rate of growth in the economy since the Lehmans crisis.

## Sector's forward view

- 6.4 Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely during 2013/14 as investor fears and confidence, ebb and flow, between favouring more risky assets i.e., equities, and safer bonds. Equity prices have staged an ongoing rise since mid 2012. Correspondingly, there had been a trend of a fall in bond prices and a rise in bond yields, until the Cyprus crisis reversed this trend in late February. Key areas of uncertainty include:
- The potential for a significant increase in negative reactions of populaces in Eurozone countries against austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
  - Failure of Italian political parties to form a viable coalition after the general election due to the blocking vote of the Five Star anti-austerity party, which has refused co-operation with any major party.
  - The impact of the Eurozone crisis on financial markets and the banking sector.
  - Monetary policy action failing to stimulate growth in western economies.
  - The impact of the UK Government's austerity plan on confidence and growth.
  - Further downgrading by credit rating agencies of the creditworthiness and credit rating of UK Government debt, consequent upon repeated failure to achieve fiscal correction targets and recovery of economic growth.
  - The potential for weak growth or recession in the UK's main trading partners - the EU and US.
- 6.5 The overall balance of risks to economic recovery in the UK remains weighted to the downside. Sector believes that the longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. However, near-term, the prospect of further QE is likely to keep gilt yields lower than they would otherwise be. However, any concerns that central banks are getting to the point where they are likely to view the beneficial effects of further QE as being exhausted, could lead to the reversal of this effect.
- 6.6 Given the weak outlook for economic growth, Sector sees the prospects for any increase in Bank Rate before 2015 as very limited indeed, and the first increase could be even further delayed if growth disappoints.

## 7. Annual Investment Strategy

7.1 The Treasury Management Strategy Statement (TMSS) for 2012/13, which includes the Annual Investment Strategy, was approved by the Council on 27<sup>th</sup> March 2012. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield

7.2 The Council will also aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover short term cash flow needs but also to seek out value available in significantly higher rates in periods up to 12 months with highly credit rated financial institutions, using Sector's suggested creditworthiness approach, including sovereign credit rating and Credit Default Swap (CDS) overlay information provided by Sector.

7.3 Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the year ended 31st March 2013.

7.4 Investment rates available in the market have continued at historically low levels and have fallen further during the year as a result of the Funding for Lending Scheme. The average level of funds available for investment purposes during the year was **£2.75m**. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme.

### Treasury Activity in the Year

7.5 The following table summarises the treasury management transactions undertaken during the 2012/13 financial year:

|             |   | <b>Principal Amount<br/>£000</b> | <b>Average Interest Rate<br/>%</b> |
|-------------|---|----------------------------------|------------------------------------|
| Investments | - as at 31 <sup>st</sup> March 2012 (a) | 1,000                            | 2.1                                |
|             | - matured in year                       | 16,500                           | 1.01                               |
|             | - arranged in year                      | 16,500                           | 0.91                               |
|             | - Instant access accounts *             | 3,440                            | 0.55                               |
|             | - Long-term investments                 | 3                                | 0.01                               |
|             | - as at 31 <sup>st</sup> March 2013 (b) | 4,443                            |                                    |
| Debt        | - as at 31 <sup>st</sup> March 2012 (c) | 6,238                            | 4.81                               |
|             | - matured/repaid in year                | 0                                |                                    |
|             | - arranged in year                      | 0                                |                                    |
|             | - as at 31 <sup>st</sup> March 2013 (d) | 6,238                            | 4.81                               |



|   |       |              |  |
|---|-------|--------------|--|
| <b>Net Debt at 31<sup>st</sup> March 2013</b> | (d-b) | <b>1,795</b> |  |
|   |       |              |  |
| <b>Net Debt at 31<sup>st</sup> March 2012</b> | (c-a) | <b>2,674</b> |  |

\* *Balance held at the end of the year*

## **8. Performance Report**

- 8.1 Fixed term investments were held at £1m as a consequence of maintaining the need to observe security over liquidity over yield.
- 8.2 Surplus short-term cash remains invested in AAA-rated Money Market Funds giving instant access to meet cash outflow requirements.
- 8.3 Debt remained constant with no requirement for short-term borrowing.
- 8.4 Interest on Treasury Activities:

|                   | <b>Actual</b> | <b>Budget</b> | <b>Variance</b> |
|-------------------|---------------|---------------|-----------------|
|                   | <b>£000</b>   | <b>£000</b>   | <b>£000</b>     |
| Investment Income | 69            | 21            | 48              |
| Interest Paid     | 302           | 302           | 0               |

## **9. Risk Management**

- 9.1 As noted in the Treasury Management Policy Statement, the Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. The key treasury risks being managed are:
- credit risk,
  - liquidity risk,
  - interest rate risk,
  - refinancing risk, and
  - operational risk.
- 9.2 The techniques employed to manage these risks are covered in detail in the Council's Treasury Management Practices, and include:
- robust counterparty monitoring and selection criteria,
  - prudent cash flow forecasting,
  - a range of exposure limits and indicators, and
  - procedures designed to prevent fraud and error.
- 9.3 The Council's primary objectives for the management of its investments are to give priority to the security and liquidity of its funds before seeking the best rate of return. All of its surplus cash is therefore held as short-term investments with the UK Government, local authorities, and highly credit-rated banks, building societies and pooled funds.

- 9.4 The Council's primary objective for the management of its debt is to ensure its long-term affordability. The majority of its loans have therefore been borrowed from the Public Works Loan Board at long-term fixed rates of interest.
- 9.5 However, the combination of short-term investments and long-term debt exposes the Council to the risk of falling investment income during periods of low interest rates.

## 10. Treasury Management Indicators

The Council is asked to note the following indicators as at 31<sup>st</sup> March 2013.

### 10.1 Security: Average credit rating

Fixed-term investments were held across a range of counterparties and the average rating achieved, compared to a median target, was:

|                                 | Median | Actual |
|---------------------------------|--------|--------|
| Portfolio average credit rating | BB+    | A-     |

For the purpose of this indicator, unrated building societies are assigned an indicative rating of BBB+.

### 10.2 Liquidity: cash available within three months

The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period.

The use of instant access accounts ensures cash is available on demand. The average holding for the year was:

|                    | Target<br>£000 | Actual<br>£000 |
|--------------------|----------------|----------------|
| NatWest SIBA       | 500            | 367            |
| Santander          | 500            | 0              |
| Bank of Scotland   | 500            | 0              |
| Money Market Funds | 3,000          | 3,127          |
|                    | 4,500          | 3,494          |

### Interest Rate Exposures

- 10.3 Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.
- 10.4 All of the Council's investments are deemed to be variable rate while the whole of its borrowing is at fixed rate. The Council is, therefore, at the mercy of falling or low rate investment returns while remaining tied-in to the cost of fixed term borrowing.

- 10.5 The upper limits on fixed rate exposures therefore match the Council's fixed rate borrowings, and the value of 'Zero' for variable rate exposures enables variable rate borrowing only up to the value of variable rate investments.

|  | Limit<br>£000 | Actual<br>£000 |
|--|---------------|----------------|
| Upper limit on fixed rate exposures    | 6,238         | 6,238          |
| Upper limit on variable rate exposures | 0             | 0              |

#### Maturity Structure of Borrowing

- 10.6 This indicator is set to control the Council's exposure to refinancing risk. The maturity structure of fixed rate borrowing at the 31<sup>st</sup> March 2013 is:

| Maturity Date of Borrowing      | Target Spread | Actual Spread |
|---------------------------------|---------------|---------------|
| Under 12 months                 | 10%           | 20%           |
| 12 months and within 24 months  | 0%            | 0%            |
| 24 months and within five years | 10%           | 0%            |
| Five years and within 10 years  | 10%           | 0%            |
| 10 years and within 25 years    | 10%           | 11%           |
| Over 25 years                   | 50%           | 69%           |

(Note: The maturity date of borrowing is the earliest date on which the lender can demand repayment.)

- 10.7 The target spread is designed to ensure that not all the Council's borrowings become repayable at the same time. An actual percentage greater than target is not necessarily detrimental, but would need to be taken into consideration should further borrowing be contemplated.

## **11. Implications**

### **11.1 Financial Implications**

There are no financial implications associated with this report.

### **11.2 Legal Implications**

There are no legal implications attached to this report..

## **12. Contribution to Corporate Priorities**

The Treasury Management function does not contribute directly to the Council's Corporate Priorities albeit the delivery of the Treasury Management Strategy supports the Council's budget strategy which in turn is a fundamental element of the Council's service and financial planning approach to achievement of the Council Plan.

## **13. Risk Management**

There are no direct risk management implications arising from this report. Regular review provides assurance that treasury management activities are being managed in line with the Treasury Management Strategy.

**14. Equalities Impact Assessment**

Since this report is not seeking to set or amend policy, the Council's Equality Impact Assessment procedure has not been followed.

**15. Consultations with Others**

None

**16. Access to Information : Background Documents**

Working papers held in Financial Services.

**17. Author of the Report**

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Note: Members are invited to contact the author in advance of the meeting with any detailed queries or questions.

**18. Appendices**

None