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AUDIT COMMITTEE - 20 JUNE 2014 **PORTFOLIO: FINANCE AND EFFICIENCY/ALL**

CABINET - 2 JULY 2014

COUNCIL - 14 JULY 2014

TREASURY MANAGEMENT ANNUAL OUTTURN REPORT 2013/14

1 PURPOSE

1.1 New Forest District Council (NFDC) adopts the key recommendations of the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice, which includes an annual report on the treasury management strategy after the end of each financial year.

2 SUMMARY

2.1 Treasury management in the context of this report is defined as:

"The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2.2 This annual report sets out the performance of the treasury management function during 2013/14, to include the effects of the decisions taken and the transactions executed in the past year.

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

2.4 All treasury activity has complied with the NFDC's Treasury Management Strategy and Investment Strategy for 2013/14, and all relevant statute, guidance and accounting standards. In addition the Authority's treasury advisers, Arlingclose, provide support in undertaking treasury management activities.

2.5 # The Authority has complied with all of the prudential indicators set in its Treasury Management Strategy, these are detailed fully in Appendix 1.

2.6 From March 2014 the delivery of the Treasury Management function for NFDC transferred to the Finance Service of Hampshire County Council (HCC), following agreement between both authorities. This report provides a brief update on activity since the transfer.

2.7 At this time it is also recommended to make two changes to the Authority's investment strategy for 2014/15. This will enable NFDC to respond most effectively to the opportunities and risks in the investment market. The recommended changes are as follows and explained fully in Section 8 of this report:

- Adding investments in bonds with banks and other organisations as a secure alternative to cash investments.
- Setting a limit of £4m for investments in pooled property funds as an alternative to longer term investments with other local authorities, for which there are a reducing number of opportunities.

3 ECONOMIC BACKGROUND

3.1 The following Section outlines the key economic themes against which investment and borrowing decisions have been made in the past financial year. At the beginning of the 2013-14 financial year markets were concerned about lacklustre growth in the Eurozone, the UK and Japan. Lack of growth in the UK economy, the threat of a 'triple-dip' recession alongside falling real wages (i.e. after inflation) and the paucity of business investment were a concern for the Bank of England's Monetary Policy Committee. However, the recovery in the UK surprised with strong economic activity and growth. The first quarter of 2014's year-on-year growth estimate was an increase of 3.1%. Much of the improvement was down to the dominant service sector, and an increase in household consumption buoyed by the pick-up in housing transactions which were driven by higher consumer confidence, greater availability of credit and strengthening house prices which were partly boosted by government initiatives such as Help-to-Buy.

3.2 With new Governor Mark Carney at the helm, the Bank of England unveiled forward guidance in August 2013 pledging to not consider raising interest rates until the International Labour Organisation (ILO) measure of unemployment fell below the 7% threshold. In the Bank's initial forecast, this level was only expected to be reached in 2016. Although the Bank stressed that this level was a threshold for consideration of rate increase rather an automatic trigger, markets began pricing in a much earlier rise than was warranted and, as a result, gilt yields rose aggressively.

3.3 CPI fell from 2.8% in March 2013 to 1.6% in March 2014, the lowest rate since October 2009, helped largely by the easing commodity prices and discounting by retailers, reducing the pressure on the Bank to raise rates. Although the fall in unemployment (down from 7.8% in March 2013 to 6.9% in February 2014) to below the Bank`s initial threshold was faster than the Bank of England or indeed many analysts had forecast, it hid a stubbornly high level of underemployment. Importantly, average earnings growth remained muted and real wage growth was negative.

3.4 In February the Bank stepped back from forward guidance relying on a single indicator – the unemployment rate – to more complex measures which included spare capacity within the economy. The Bank also implied that when official interest rates were raised, the increases would be gradual – this helped underpin the 'low for longer' interest rate outlook despite the momentum in the economy.

4 THE BORROWING REQUIREMENT AND DEBT MANAGEMENT

	Balance on 31/03/2013 £m	Net new borrowing £m	Balance on 31/03/2014 £m
Long Term Borrowing	142.7	2.0	144.7
Temporary borrowing	0.0	0.0	0.0
Other Long Term Liabilities	0.0	0.0	0.0
Total External Debt	142.7	2.0	144.7

4.1 NFDC`s underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31/3/2014 is estimated at £147.7m. The Authority`s portfolio of long term debt is in the form of loans from the Public Works Loan Board (PWLB). The only new long-term borrowing that has taken place is a loan of £2m that was taken from the PWLB in March 2014, on behalf of the Lymington Harbour Commissioners, and an agreement is in place for the Harbour Commissioners to repay NFDC. A cautious approach has been applied in terms of take-up of new borrowing to minimise debt interest payments without compromising the long-term stability of the portfolio. Internal resources in lieu of external borrowing have been used in order to lower overall treasury risk by reducing both external debt and temporary investments.

4.2 The indicator for total external debt is obtained directly from the Authority's balance sheet. It is the closing balance for actual gross borrowing plus other long-term liabilities. This Indicator is measured in a manner consistent for comparison with the Operational Boundary and Authorised Limit.

5 INVESTMENT ACTIVITY

5.1 NFDC has invested according to a low risk, high quality lending list as outlined in the Investment Strategy for 2013/14.

	Balance on 31/03/2013 £m	Balance on 31/03/2014 £m	Average Rate on 31/03/2014	Average Life on 31/03/2014
Instant access monies	4.1	16.0	0.42%	0
Short term investments	21.0	25.0	0.83%	0.45 years
Long term investments	0.0	0.0	0	0
Total investments	25.1	41.0	0.67%	0.27 years

5.2 Security of capital remained the Authority's main investment objective. This was maintained by following the Authority's counterparty policy as set out in its Treasury Management Strategy Statement for 2013/14. Investments during the year included:

- call accounts and deposits with banks and building societies.
- money market funds.

5.3 Counterparty credit quality was assessed and monitored with reference to:

- credit ratings
- credit default swaps
- any potential support mechanisms
- share prices.

5.4 The minimum long-term counterparty credit rating determined for the 2013/14 treasury strategy was A-/A3 across rating agencies Fitch, S&P and Moody's. Based on the factors above and advice from the Treasury Management advisors, Arlingclose, the Chief Finance Officer has varied investment duration limits for new investments according to the assessment of credit risk and will suspend investing with individual counterparties at any time if this is felt to be necessary to protect the Authority's capital.

5.5 Throughout 2013/14 NFDC`s banker, the Co-operative, has been rated well below the Authority's minimum investment criteria. As outlined in the Strategy the Authority`s banker is slightly different to all other investment counterparties and although new investments have been suspended, the Co-op will continue to hold small amounts of the Authority`s cash balances as a result of its banking services. The Authority and its advisors, Arlingclose, are maintaining a careful watch on the Co-op and can take further action to protect the Authority`s funds if there are additional negative indicators. In November 2013 the Co-op announced it would no longer provide services to Local Authorities, as part of a restructure of its business. NFDC is currently retendering for banking services in partnership with a number of other local Councils.

5.6 NFDC has maintained a sufficient level of liquidity through the use of call accounts and money market funds. The Authority sought to optimise returns commensurate with its objectives of security and liquidity. The UK base rate was maintained at 0.5% through the year and short term money market rates remained at very low levels which had a significant impact on cash investment income. The Authority's average cash investment balance was £45m during 2013/14, and interest earned was £302,000 giving a yield of 0.66%.

6 COMPLIANCE WITH PRUDENTIAL INDICATORS

6.1 NFDC can confirm that it has complied with its Prudential Indicators for 2013/14 set in February 2013 as part of the Authority's Treasury Management Strategy. Performance against each of the indicators is shown in Appendix 1.

7 DELIVERY OF TREASURY MANAGEMENT SERVICES BY HCC

7.1 Following Member approval the delivery of treasury management services transferred to Hampshire County Council on 1 March 2013. This followed detailed planning and the agreement of a service level agreement by officers. The transfer of the service went smoothly, thanks to the planning that had been done by officers at both Councils and the good communication and strong relationships that had been built in the preceding months.

7.2 Since the transfer a number of small improvements have been made to NFDC`s investment portfolio. HCC was able to use the size of the existing investments it manages to negotiate improved terms with three of the four money market funds that NDFC uses. The following improved rates were achieved.

Money market fund	Previous rate	New rate
Ignis	0.44%	0.44%
Deutsche	0.35%	0.42%
Insight	0.30%	0.40%
Federated Investors	0.38%	0.40%

7.3 HCC has also been able to use the scale of the investments that it manages and relationships with investment counterparties to open accounts with new banks for NFDC. In March and April accounts were opened with Close Brothers and HSBC, and certificates of deposit have been placed with Standard Chartered and Deutsche Bank through a custodian bank. This greater diversification of investment counterparties is enabling the implementation of NFDCs investment strategy for 2014/15 that reduced the individual counterparty limit to £5m, reducing the exposure to credit risk from any single investment counterparty.

7.4 As part of the implementation of NFDC`s investment strategy it is planned to make longer term investments, of up to three years, with other local authorities. This is intended to diversify investments from banks and money market funds, and increase the return earned on investments by investing for longer terms. Since March 2014 there have not been any suitable opportunities to invest with other local authorities, but this continues to be monitored and if suitable opportunities do present themselves they will be taken.

8 RECOMMENDED UPDATES TO THE 2014/15 INVESTMENT STRATEGY

Bond investments

8.1 Regulatory changes have taken place in the UK (Banking Reform Act 2014), and Europe (EU Bank Recovery and Resolution Directive) to move away from the bank ‘bail-outs’ of previous years to bank resolution regimes in which institutional investors, like the Council, are ‘bailed in’ to participate in any recovery process. In the event of a ‘bail in’ investors funds would be top-sliced to meet the losses of the failing bank and restore it to an acceptable level of financial health, resulting in a capital loss to those investors. This has already been seen in Cyprus, to a limited extent with investors in the Co-op Bank and a small number of other examples across Europe.

8.2 In part as a response to this increased risk to the security of its investments the 2014/15 Treasury Management Strategy reduced the individual counterparty limit for investments, thereby limiting the Authority`s exposure to any single institution. Based on Arlingclose`s advice to further diversify the Authority`s investments it is recommended it considers investing in high credit quality bonds issued by banks and other private companies, which offer two advantages. By not being limited to banks this will increase the number of counterparties the Authority can invest in, further diversifying the level of overall counterparty risk. In addition bond investments that are issued by banks are treated differently to cash investments and are not subject to 'bail-in' risk.

8.3 Bond investments issued by companies and multilateral development banks are already specified in the Council`s investment strategy. It is recommended that bond investments issued by any organisation are added to the Authority`s investment strategy and with the duration limit linked to the bond`s credit rating as follows:

Counterparty		Cash limit	Time limit
Banks and other organisations issuing bonds whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's is:	AAA	£5m per counterparty (including other types of invest)	5 years
	AA+		5 years
	AA		4 years
	AA-		3 years
	A+		2 years
	A		1 year

8.4 Any bond investment of more than 1 year`s duration will count as a non-specified investment under the Department of Communities and Local Government's guidance and be limited by the £10m limit on investments greater than one year specified in the Authority`s investment strategy.

Pooled property investments

8.5 As referenced in Section 7 part of the planned implementation of NFDC`s investment strategy was to invest an element of its core balances for longer terms (up to three years) with other local authorities. This is a reflection that in cash terms the Authority can be certain that these amounts are available for longer term investment and therefore use them to earn higher rates of interest, if it can find secure counterparties to invest with over the longer term, such as other local authorities.

8.6 It has so far not been possible for NFDC to find other local authorities that are looking to borrow and therefore other options for longer term investments have been considered. As an alternative it is recommended that the Authority sets a limit of £4m for investments in pooled property funds.

8.7 Investments in pooled property funds offer the opportunity to earn higher rates of return from both rental returns and capital appreciation. They also offer the security of being backed by physical assets. Property investments do however carry the risk that their value is subject to market fluctuations and can suffer significant falls in value, as seen in 2008. Due to this fact, that values will vary over time, investments in pooled property funds need to be seen as long term investments that can be held for at least 5 years, which is why a limit of £4m, a small amount of the total cash balance, is being proposed.

8.8 Although property prices are currently rising, their value is still considered reasonable in comparison to other assets and there are opportunities for investors. The Authority will select investments in pooled property funds in conjunction with its advisors Arlingclose.

9. CRIME AND DISORDER AND ENVIRONMENTAL IMPLICATIONS

9.1 None arising directly from this report.

10. RECOMMENDATIONS

Members are recommended to:

10.1 refer the proposed change in the Treasury strategy outlined at paragraph 8 to Council for approval,

10.2 consider the performance of the treasury function detailed in this report.

Further Information	Background Papers
Please contact Andrew Boutflower (HCC), or Bob Jackson (Executive Director)	The Prudential Code, CIPFA Guidance Notes and ODPM Investment Guidance
	Local Government Act 2003
e-mail: andrew.boutflower@hants.gov.uk bob.jackson@nfdc.gov.uk	SI 2003/3146 - Local Authorities (Capital Finance and Accounting) (England) Regulations 2003
	Council 25 February 2013 – Audit Committee -Treasury Management Strategy Report 2013/14 Council 24 February 2014 – Audit Committee – Treasury Management Strategy Report 2014/15
	Published Papers

APPENDIX 1

COMPLIANCE WITH PRUDENTIAL INDICATORS

NFDC approved the adoption of the CIPFA Treasury Management Code at its meeting on 25 February 2002. In compliance with the requirements of the Code this section of the report provides Members with a summary of actual performance against each of the Prudential Indicators.

1. Capital Financing Requirement (CFR)

Estimates of the Authority's cumulative maximum external borrowing requirement for 2013/14 to 2015/16 are shown in the table below:

	31/03/14 Approved £m	31/03/14 Revised £m	**31/03/14 Actual £m**	31/03/15 Latest Estimate £m	31/03/16 Estimate £m
CFR Non-housing	5.7	4.0	**3.1**	3.5	6.0
CFR Housing	1.9	1.9	**1.9**	1.9	1.9
HRA Settlement	142.7	142.7	**142.7**	142.7	142.7
Total CFR	150.3	148.6	**147.7**	148.1	150.6

2. Gross Debt and the Capital Financing Requirement

In order to ensure that over the medium term debt will only be for a capital purpose, the Authority should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Debt	31/03/14 Approved £m	31/03/14 Revised £m	**31/03/14 Actual £m**	31/03/15 Estimate £m	31/03/16 Estimate £m
Borrowing	142.7	142.7	**144.7**	144.7	144.7
Finance leases	0	0	**0**	0	0
Total Debt	142.7	142.7	**144.7**	145.9	145.9
Borrowing in excess of CFR?	No	No	**No**	No	No

Total debt is expected to remain below the CFR during the forecast period.

3. Authorised Limit and Operational Boundary for External Debt

The Operational Boundary for External Debt is based on the Authority's estimate of most likely, i.e. prudent, but not worst case scenario for external debt. It links directly to the Authority's estimates of capital expenditure, the capital financing requirement and cash flow requirements and is a key management tool for in-year monitoring.

The Authorised Limit for External Debt is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Authority can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

The new borrowing in 2013/14, a £2m loan taken out on behalf of the Lymington Harbour Commissioners, took NFDC's total borrowing above the Operational Boundary but not the Authorised Limit. There is agreement in place with the Harbour Commissioners to repay this debt.

	Operational Boundary	Authorised Limit	**Actual External Debt 31/03/2014**
	(Approved) 31/03/2014		
Total Borrowing	£143.0m	£173.0m	**£144.7m**

4. Maturity Structure of Fixed Rate Borrowing

This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

Maturity Structure of Fixed Rate Borrowing	Lower Limit	Upper Limit	Actual Fixed Rate Borrowing at 31/03/2014		Compliance with Set Limits?
	%	%	£m	%	
under 12 months	0	25	0.2	0	Yes
12 months and within 2 years	0	25	0.2	0	Yes
2 years and within 5 years	0	25	8.8	6	Yes
5 years and within 10 years	0	25	21.5	15	Yes
10 years and above	0	100	114.0	79	Yes

5. Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed.

	Approved Limits for 2013/14	Maximum during 2013/14	Compliance with Limits:
Upper Limit for Fixed Rate Borrowing	100%	100%	Yes
Upper Limit for Variable Rate Borrowing	50%	0%	Yes
Upper Limit for Fixed Rate Investments	100%	83%	Yes
Upper Limit for Variable Rate Investments	100%	60%	Yes

6. Capital Expenditure

This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits and, in particular, to consider the impact on Council tax. Capital expenditure has been and will be financed or funded as follows:

Capital Expenditure and Financing	31/03/14 Approved £m	31/03/14 Revised £m	**31/03/14 Actual £m**	31/03/15 Estimate £m	31/03/16 Estimate £m
Non-HRA	8.2	6.3	**4.0**	6.7	6.1
HRA	13.0	11.7	**10.7**	13.3	11.5
Total Expenditure	**21.2**	**18.0**	**14.7**	**20.0**	**17.6**
Capital Receipts	1.3	0.4	**2.4**	1.1	0.7
Capital Grants	4.3	1.3	**1.7**	1.2	3.0
Capital Reserves	0.5	0.6	**0.0**	0.7	0.4
Revenue	0.6	11.7	**7.7**	12.6	0
Developers Contributions	12.4	2.4	**2.3**	2.4	11.5
Borrowing	2.1	1.6	**0.6**	2.0	2.0
Total Financing	**21.2**	**18.0**	**14.7**	**20.0**	**17.6**

7. Ratio of Financing Costs to Net Revenue Stream

This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	31/03/14 Approved	31/03/14 Revised	**31/03/14 Actual**	31/03/15 Estimate	31/03/16 Estimate
Non-HRA	0.9%	-4.2%	**-10.9%**	-0.1%	0.1%
HRA (inclusive of settlement)	0.0%	0.0%	**0.0%**	0.0%	0.0%

8. Adoption of the CIPFA Treasury Management Code

This indicator demonstrates that the Authority adopted the principles of best practice.

The Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* on 25 February 2002 and complies with all revisions to the Code.

9. Upper Limit for Total Principal Sums Invested Over 364 Days

The purpose of this limit is to contain exposure to the possibility of loss that may arise as a result of the Authority having to seek early repayment of the sums invested.

	31/03/14 Approved £m	31/03/14 Revised £m	**31/03/14 Actual £m**	31/03/15 Estimate £m	31/03/16 Estimate £m
Sums Invested Over 364 Days	10	10	**0**	10	10

10. Estimates of the incremental impact of capital investment decisions on the Band D Council Tax

This indicator shows the impact on the Council Tax of the revenue implications of the capital programme in isolation from any other expenditure that may generate a revenue charge. The Actual reduction in 2013/14 was mainly because of a policy change in 2012/13 which significantly reduced the annual charge to revenue in the following year.

	Approved 2013/14	**Actual 2013/14**	**Forward Projection 2014/17**
Change to Council Tax-Band D	1.5%	-19.73%	-0.24%
Change to Council Tax cost year on year	£2.30	-£31.19	-£0.37

11. Estimates of the incremental impact of capital investment decisions on housing rent levels

The Council has adopted the Government's rent restructuring policy. As such the capital programme has no impact on rent levels. The indicator below shows the cost of proposed changes in the housing capital programme, as recommended elsewhere on this agenda expressed as a change in weekly rent levels if the Government's rent restructuring policy had not been adopted. The variation for 2013/14 is mainly because of the financing of capital expenditure for the HRA undertaken from developers' contributions and capital receipts rather than the HRA revenue account as initially anticipated.

	Approved 2013/14	**Actual 2013/14**	**Forward Projection 2014/15**
Change to Weekly Housing Rent levels	£0.31	-£17.72	-£3.37