Appendix 1

ANNUAL TREASURY REPORT

2012-2013

Annual Treasury Management Review 2012/13

Purpose

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

During 2012/13 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 15/03/2012)
- a mid year (minimum) treasury update report (Council 22/11/2012)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

In addition, the Council has received quarterly treasury management update reports on 23/08/2012 and 21/03/2013.

Recent changes in the regulatory environment place a much greater onus on members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Spokesperson for Resources before they were reported to the full Council.

Executive summary

During 2012/13, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Prudential and treasury indicators	**2011/12 Actual £000**	**2012/13 Original £000**	**2012/13 Actual £000**
Actual Capital Expenditure	25,575	42,644	35,140
Total Capital Financing Requirement	256,617	268,830	258,398
Net Borrowing	122,446	130,000	126,584
External Debt	160,408	160,000	160,616
Investments (Under 1 year)	37,962	30,000	34,032

Other prudential and treasury indicators are to be found in the main body of this report. The Head of Strategic Finance also confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit (the authorised limit), was not breached.

The financial year 2012/13 continued the challenging environment of previous years; low investment returns and continuing counterparty risk continued.

Recommendations

The Council is recommended to:

1. Approve the actual 2012/13 prudential and treasury indicators in this report
2. Note the annual treasury management report for 2012/13

1. Introduction and background

This report summarises:

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- Reporting of the required prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity.

2. The Council's Capital Expenditure and Financing 2012/13

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

	2011/12 Actual £000	2012/13 Original £000	2012/13 Actual £000
Capital Expenditure	**25,575**	**42,644**	**35,140**
Total Capital Financing Requirement			
Resourced by:			
Capital Receipts	0	0	94
Capital Grants	11,479	9,656	11,428
Revenue	124	0	1,650
Unfinanced Capital Expenditure	**13,972**	**32,988**	**21,968**

3. The Council's overall borrowing need

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's debt position. The CFR results from the capital activity of the Council and what resources have been used to pay for the capital spend. It represents the 2012/13 unfinanced capital expenditure (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

Reducing the CFR – the Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Scheduled Debt Amortisation or loans repayments, to reduce the CFR. This is effectively a repayment of the borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the revenue charge each year.

The Council's CFR for the year is shown below, and represents a key prudential indicator. This includes PFI and leasing schemes on the balance sheet, which increase the Council's borrowing need, the CFR. No borrowing is actually required against these schemes as a borrowing facility is included in the contract.

CFR	**31 March 2012 Actual £000**	**31 March 2013 Original £000**	**31 March 2013 Actual £000**
Opening Balance	**264,977**	**254,791**	**256,617**
Add Unfinanced capital	13,972	32,988	21,968
Less Debt Repayments	20,584	17,699	18,679
Less Finance Lease Repayments	1,569	1,250	1,449
Less Other	179	0	59
Closing Balance	**256,617**	**268,830**	**258,398**

The borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

Net borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. This essentially means that the Council is not borrowing to support revenue expenditure. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2012/13 plus the expected changes to the CFR over 2013/14 and 2013/14. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2012/13. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

CFR	**31 March 2012 Actual £000**	**31 March 2013 Original £000**	**31 March 2013 Actual £000**
Net Borrowing Position	122,446	130,000	126,584
CFR	256,617	268,830	258,398

The authorised limit - the authorised limit is the maximum borrowing limit and the Council does not have the power to borrow above this level. The table below demonstrates that during 2012/13 the Council has maintained gross borrowing within its authorised limit.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	2012/13 £000
Authorised Limit	**321,000**
Maximum Gross Borrowing Position	243,191
Operational Boundary	315,000
Average Gross Borrowing Position	242,967
Financing Costs as a proportion of net revenue stream	11.70%

4. Treasury Position as at 31 March 2013

The Council's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the beginning and the end of 2012/13 the Council's treasury position was as follows:

	Principal 31 March 2013 £m	£m	Rate/ Return %	Average Life years	Principal 31 March 2012 £m	£m	Rate/ Return %	Average Life years
Fixed Rate Funding:								
- PWLB	108.066				108.066			
- Market	12.551				12.554			
		120.617	**6.718%**	**23.24**		**120.620**	**6.718%**	**24.24**
Variable Rate Funding:								
- PWLB								
- Market	39.255				39.255			
		39.255	**4.430%**	**55.58**		**39.255**	**4.430%**	**56.58**
Temporary Loans		**0.743**	**0.490%**			**0.533**	**0.187%**	
Total Debt		**160.615**	**6.139%**	**31.18**		**160.408**	**6.139%**	**32.18**
Investments		**34.032**	**1.357%**			**37.962**	**1.668%**	

PWLB - Public Works Loan Board

The Council's investments were all for under one year at a variable rate of interest.

The maturity structure of the debt portfolio was as follows:

	2011/12 Actual £000	**2012/13 Actual £000**
Under 12 months	554	743
12 months and within 24 months	1	8,353
24 months and within 5 years	36,786	33,841
5 years and within 10 years	22,911	17,541
10 years and above	100,156	100,137
Total	160,408	160,615

5. The Strategy for 2012/13

The expectation for interest rates within the strategy for 2012/13 anticipated low but rising Bank Rate (starting in quarter 4 of 2014) with similar gradual rises in medium and longer term fixed borrowing rates over 2012/13. Variable or short-term rates were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and reduce counterparty risk.

The actual movement in gilt yields meant that PWLB rates fell during the first quarter of the year to historically low levels. This was caused by a flight to quality into UK gilts from EU sovereign debt, and from shares, as investors became concerned about the potential for a Lehman's type crisis of financial markets, if the Greek debt crisis were to develop into a precipitous default and exit from the Euro. During the second and third quarters, rates rose gradually and agreement of a second bail out for Greece in December saw the flight to quality into gilts reverse somewhat, as confidence rose that the Eurozone crisis was finally subsiding. However, gilt yields then fell back again during February and March as Eurozone concerns returned, with the focus now shifting to Cyprus, and flight to quality flows into gilts resumed. This was a volatile year for PWLB rates, driven by events in the Eurozone which oscillated between crises and remedies.

6. The Economy and Interest Rates

Sovereign debt crisis. The EU sovereign debt crisis was an ongoing saga during the year. However, the ECB statement in July that it would do "whatever it takes" to support struggling Eurozone countries provided a major boost in confidence that the Eurozone was (at last) beginning to get on top of its problems. This was followed by the establishment of the Outright Monetary Transactions Scheme in September. During the summer, a €100bn package of support was given to Spanish banks. The crisis over Greece blew up again as it became apparent that the first bailout package was insufficient. An eventual very protracted agreement of a second bailout for Greece in December was then followed by a second major crisis, this time over Cyprus, towards the end of the year. In addition, the Italian general election in February resulted in the new Five Star anti-austerity party gaining a 25% blocking vote; this has the potential to make Italy almost ungovernable if the grand coalition formed in April proves unable to agree on individual policies. This could then cause a second general election – but one which could yield an equally 'unsatisfactory' result! This result emphasises the dangers of a Eurozone approach heavily focused on imposing austerity, rather than promoting economic growth, reducing unemployment, and addressing the need to win voter support in democracies subject to periodic general elections. This weakness leaves continuing concerns that this approach has merely postponed the ultimate debt crisis, rather than provide a conclusive solution. These problems will, in turn, also affect the financial strength of many already weakened EU banks during the expected economic downturn in the EU. There are also major questions as to whether the Greek Government will be able to deliver on its promises of cuts in expenditure and increasing tax collection rates, given the hostility of much of the population.

The UK coalition Government maintained its tight fiscal policy stance against a background of warnings from two credit rating agencies that the UK could lose its AAA credit rating. Moody's followed up this warning by actually downgrading the rating to AA+ in February 2013 and Fitch then placed their rating on negative watch, after the Budget statement in March. Key to retaining the AAA rating from Fitch and S&P will be a return to strong economic growth in order to reduce the national debt burden to a sustainable level, within a reasonable timeframe.

UK growth. 2012/13 started the first quarter with negative growth of -0.4%. This was followed by an Olympics boosted +0.9% in the next quarter, then by a return to negative growth of -0.3% in the third quarter and finally a positive figure of +0.3% in the last quarter. This weak UK growth resulted in the Monetary Policy Committee increasing quantitative easing (QE) by £50bn in July to a total of £375bn on concerns of a downturn in growth and a forecast for inflation to fall below the 2% target. QE was targeted at further gilt purchases. In the March 2013 Budget, the Office of Budget Responsibility yet again slashed its previously over optimistic growth forecasts, for both calendar years 2013 and 2014, to 0.6% and 1.8% respectively.

UK CPI inflation has remained stubbornly high and above the 2% target, starting the year at 3.0% and still being at 2.8% in March; however, it is forecast to fall to 2% in three years time. The MPC has continued its stance of looking through temporary spikes in inflation by placing more importance on the need to promote economic growth.

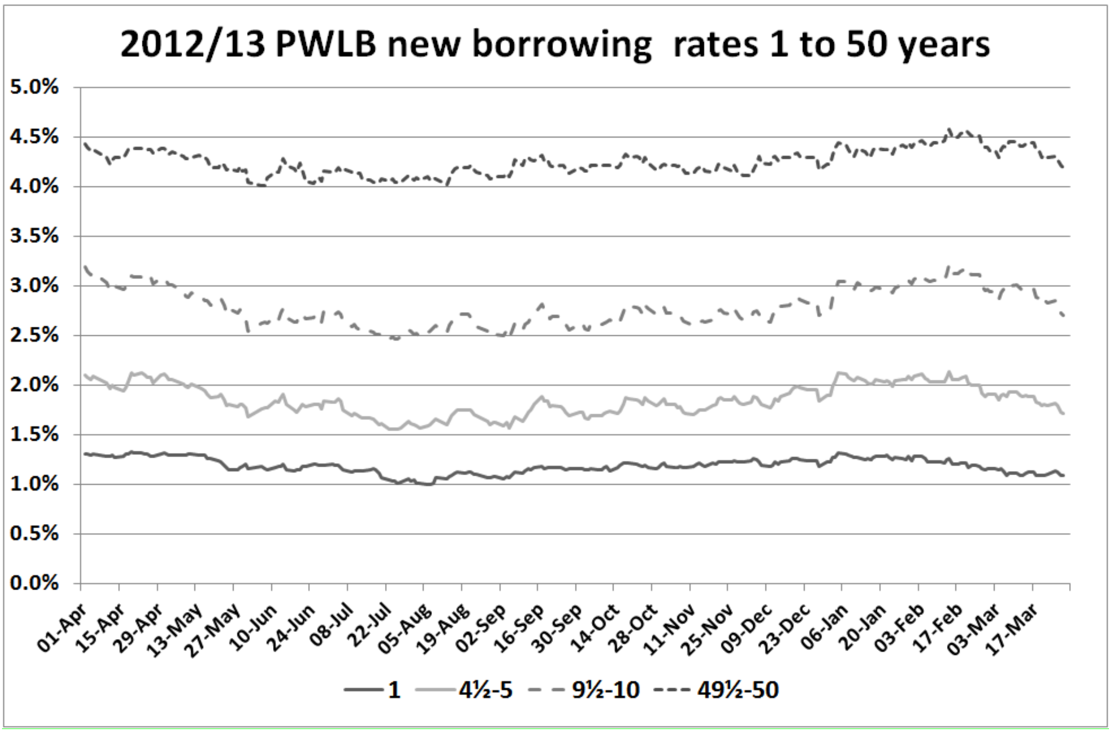
Gilt yields oscillated during the year as events in the ongoing Eurozone debt crisis ebbed and flowed, causing corresponding fluctuations in safe haven flows into / out of UK gilts. This, together with a further £50bn of QE in July and widely expected further QE still to come, combined to keep PWLB rates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

Bank Rate was unchanged at 0.5% throughout the year, while expectations of when the first increase would occur were pushed back to quarter 1 2015 at the earliest.

Deposit rates. The Funding for Lending Scheme, announced in July, resulted in a flood of cheap credit being made available to banks and this has resulted in money market investment rates falling sharply in the second half of the year. However, perceptions of counterparty risk have improved after the ECB statement in July that it would do "whatever it takes" to support struggling Eurozone countries. This has resulted in some return of confidence to move away from only very short term investing.

7. Borrowing Rates in 2012/13

PWLB borrowing rates - the graphs and table for PWLB maturity rates below show, for a selection of maturity periods, the high and low points in rates, the average rates, spreads and individual rates at the start and the end of the financial year.



8. Borrowing Outturn for 2012/13

Treasury Borrowing

There was £274k of new temporary borrowing in 2012/13 at an average rate of 0.490%.

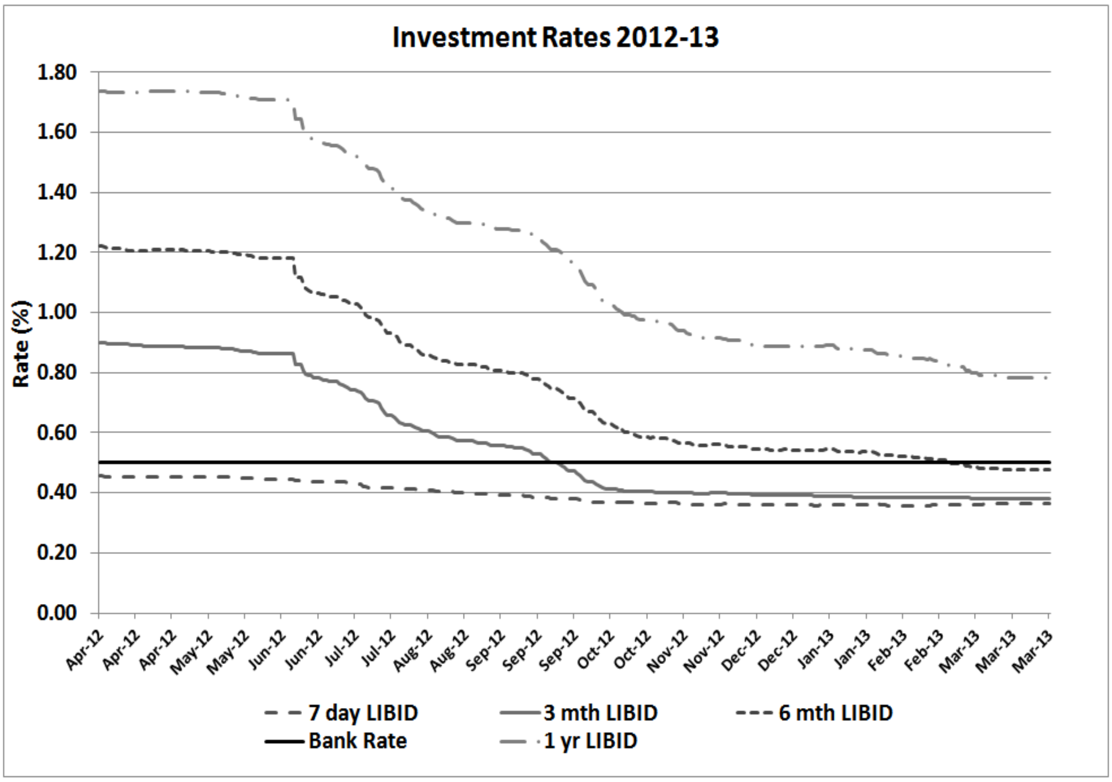
Repayment

There was £165k of temporary borrowing repaid in 2012/13.

There was £3k of special loans repaid in 2012/13.

9. Investment Rates in 2012/13

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



10. Investment Outturn for 2012/13

Investment Policy – the Council's investment policy is governed by Scottish Government Investment Regulations, which was been implemented in the annual investment strategy approved by the Council on 15/3/2012. This policy sets out the approach for choosing investment categories and counterparties, and is based on credit ratings provided by the three main credit rating agencies supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

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

Resources – the Council's longer term cash balances comprise, primarily, revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources comprised as follows, and met the expectations of the budget:

Balance Sheet Resources	**31 March 2012 £m**	**31 March 2013 £m**
General Fund Balance	34,572	45,914
Repairs and Renewals Fund	532	850
Provisions	419	382
Total	**35,523**	**47,146**

Investments held by the Council - the Council maintained an average balance of £52m of internally managed funds. The internally managed funds earned an average rate of return of 1.303%. The comparable performance indicator is the average 7-day LIBID rate, which was 0.394%.

Appendix 1

1. PRUDENTIAL INDICATORS	2011/12	2012/13	2012/13
	£ p	£ p	£ p
	actual	estimate	actual
Capital Expenditure	£'000	£'000	£'000
Non - HRA	25,575	42,644	35,140
TOTAL	25,575	42,644	35,140
Ratio of financing costs to net revenue stream			
Non - HRA	11.00%	11.90%	11.70%
Net borrowing requirment			
brought forward 1 April *	264,977	254,791	256,617
carried forward 31 March *	256,617	268,830	258,398
in year borrowing requirement	(8,360)	14,039	1,781
In year Capital Financing Requirement			
Non - HRA	(8,360)	14,039	1,781
TOTAL	(8,360)	14,039	1,781
Capital Financing Requirement as at 31 March			
Non - HRA	256,617	268,830	258,398
TOTAL	256,617	268,830	258,398
Incremental impact of capital investment decisions	£ p	£ p	£ p
Increase in Council Tax (band D) per annum	(14.77)	70.71	46.57

2. TREASURY MANAGEMENT PRUDENTIAL INDICATORS	2011/12	2012/12	2013/12
	actual	original	actual
	£'000	£'000	£'000
Authorised limit for external debt -			
borrowing	239,000	231,000	231,000
other long term liabilities	91,500	90,000	90,000
TOTAL	330,500	321,000	321,000
Operational boundary for external debt -			
borrowing	234,000	226,000	226,000
other long term liabilities	88,500	89,000	89,000
TOTAL	322,500	315,000	315,000
Actual external debt	160,408	160,408	160,616
Upper limit for fixed interest rate exposure			
Principal re fixed rate borrowing	100%	180%	180%
Upper limit for variable rate exposure			
Principal re variable rate borrowing	30%	90%	90%
Upper limit for total principal sums invested for over 364 days (per maturity date)	£10m	£10m	£10m

Maturity structure of new fixed rate borrowing during 2012/13	upper limit	lower limit
under 12 months	30%	0%
12 months and within 24 months	30%	0%
24 months and within 5 years	30%	0%
5 years and within 10 years	40%	0%
10 years and above	80%	0%