FLINTSHIRE COUNTY COUNCIL

TREASURY MANAGEMENT

DRAFT ANNUAL REPORT 2012/13

1.00 INTRODUCTION

1.01 The Council approved the Treasury Management Policy and Strategy Statement (Policy Statement) 2012/13 including key indicators, limits and an annual investment strategy on 1st March 2012.

1.02 The Policy Statement was produced based on the 2011 edition of the CIPFA Treasury Management in the Public Services: Code of Practice.

1.03 The purpose of this report is to review the outcomes from 2012/13 treasury management operations and compare with the Policy Statement.

1.04 Treasury management comprises the management of the local authority's 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.

2.00 ECONOMIC & INTEREST RATE REVIEW 2012/13

Provided by Arlingclose Ltd the Council's Treasury Management advisors.

The global outlook stabilised mainly due to central banks maintaining low interest rates and expansionary monetary policy for an extended period. Equity market assets recovered sharply with the FTSE 100 registering a 9.1% increase over the year. This was despite economic growth in G-7 nations being either muted or disappointing.

In the UK the economy shrank in the first, second and fourth quarters of calendar 2012. It was the impressive 0.9% growth in the third quarter, aided by the summer Olympic Games, which allowed growth to register 0.2% over the calendar year 2012. The expected boost to net trade from the fall in the value of sterling did not materialise, but raised the price of imports, especially low margin goods such as food and energy. Avoiding a 'triple-dip' recession became contingent on upbeat services sector surveys translating into sufficient economic activity to overhaul contractions in the struggling manufacturing and construction sectors.

Household financial conditions and purchasing power were constrained as wage growth remained subdued at 1.2% and was outstripped by inflation. Annual CPI dipped below 3%, falling to 2.4% in June before ticking up to 2.8% in February 2013. Higher food and energy prices and higher transport costs were some of the principal contributors to inflation remaining above the Bank of England's 2% CPI target.

The lack of growth and the fall in inflation were persuasive enough for the Bank of

England to maintain the Bank Rate at 0.5% and also sanction additional £50 billion asset purchases (QE) in July, taking total QE to £375 billion. The possibility of a rate cut was discussed at some of Bank's Monetary Policy Committee meetings, but was not implemented as the potential drawbacks outweighed the benefits of a reduction in the Bank Rate. In the March Budget the Bank's policy was revised to include the 2% CPI inflation remit alongside the flexibility to commit to intermediate targets.

The resilience of the labour market, with the ILO unemployment rate falling to 7.8%, was the main surprise given the challenging economic backdrop. Many of the gains in employment were through an increase in self-employment and part time working.

The Chancellor largely stuck to his fiscal plans with the austerity drive extending into 2018. In March the Office for Budgetary Responsibility (OBR) halved its forecast growth in 2013 to 0.6% which then resulted in the lowering of the forecast for tax revenues and an increase in the budget deficit. The government is now expected to borrow an additional £146bn and sees gross debt rising above 100% of GDP by 2015-16. The fall in debt as a percentage of GDP, which the coalition had targeted for 2015-16, was pushed two years beyond this horizon. With the national debt metrics out of kilter with a triple-A rating, it was not surprising that the UK's sovereign rating was downgraded by Moody's to Aa1. The AAA status was maintained by Fitch and S&P, albeit with a Rating Watch Negative and with a Negative Outlook respectively.

The government's Funding for Lending (FLS) initiative commenced in August which gave banks access to cheaper funding on the basis that it would then result in them passing this advantage to the wider economy. There was an improvement in the flow of credit to mortgagees, but was still below expectation for SMEs.

The big four banks in the UK – Barclays, RBS, Lloyds and HSBC – and several other global institutions including JP Morgan, Citibank, Rabobank, UBS, Credit Suisse and Deutsche came under investigation in the Libor rigging scandal which led to fines by and settlements with UK and US regulators. Banks' share prices recovered after the initial setback when the news first hit the headlines.

3.00 BORROWING REQUIREMENTS AND DEBT MANAGEMENT

3.01 PWLB (Public Works Loans Board) Certainty Rate

The Certainty Rate was introduced by the PWLB in November 2012, allowing the authority to borrow at a reduction of 20bps on the Standard Rate.

3.02 Borrowing Activity in 2012/13

The total long term borrowing outstanding, brought forward into 2012/13 totalled £173.6 million. Loans with the Public Works Loans Board were in the form of fixed rate (£144.66m) and variable rate (£10m). The remaining £18.95m was variable in the form of Lobo's (Lender's Option, Borrower's Option). The Council's average borrowing rate throughout the year was 5.43%.

	Balance 1/04/2012 £m	**Debt Maturing £m**	**New Debt £m**	**Balance 31/03/2013 £m**
Capital Financing Requirement	**180.4**			**183.2**
Short Term Borrowing[1]	0.00	0.00	0.00	0.00
Long Term Borrowing	173.6	1.5	0.00	172.1
TOTAL BORROWING	**173.6**	**1.5**	**0.00**	**172.1**
Other Long Term Liabilities	6.0	0.5	2.6	8.1
TOTAL EXTERNAL DEBT	**179.6**	**2.0**	**2.6**	**180.2**
Increase/ (Decrease) in Borrowing £m				**0.6**

3.03 The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31/3/2013 was £183.2m. The Council's total external debt was £180.2m.

3.04 No new long term Public Works Loan Board (PWLB)/financial institution borrowing was undertaken during 2012/13 - the Council continues to use cash reserves to fund capital expenditure in place of new borrowing. New finance leases of £2.6m were signed to fund, in the main, the Redevelopment works at the Jade Jones Pavilion, Flint.

3.05 Loans at Variable Rates

The extent of variable rate borrowing the Council can potentially undertake is influenced by the level of Reserves and Balances. The interest rate on the Council's £10m variable rate loans averaged 0.54%.

The uncertain interest rate outlook further supported the case for maintaining variable rate debt. As the economy still appeared susceptible to economic shocks, growth remained insipid and official interest rates were forecast to remain low for much longer, the Council determined that exposure to variable rates was warranted. It also made sense from an affordability and budgetary perspective in the short-to-medium term.

Any upward move in interest rates and interest paid on variable rate debt would be 'hedged' by a corresponding increase in interest earned on the Council's variable rate investments. The interest rate risk associated with the Council's strategic exposure of £10m is regularly reviewed with our treasury advisor against clear reference points, this being a narrowing in the gap between short and longer term interest rates by 0.5%. When appropriate this exposure will be reduced by replacing the variable rate loans with fixed rate loans.

3.05 Internal Borrowing

Given the significant cuts to local government funding putting pressure on Council finances, the strategy followed was to minimise debt interest payments without compromising the longer-term stability of the portfolio. The differential between the cost of new longer-term debt and the return generated on the Council's temporary investment returns was significant at around 3%. The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding £1.4m of capital expenditure. This has, for the time being, lowered overall treasury risk by reducing both external debt and temporary investments. Whilst this position is expected to continue in 2013/14, it will not be sustainable over the medium term. The Council expects it will need to borrow for capital purposes from 2014/15 onwards.

3.06 Lender's Option Borrower's Option Loans (LOBOs)

The option to change the terms on £18.95m of the Council's LOBOs was not exercised by the lender.

The 2011 revision to the CIPFA Treasury Management Code now requires the prudential indicator relating to Maturity of Fixed Rate Borrowing to reference the maturity of LOBO loans to the earliest date on which the lender can require payment, i.e. the next call date. This change is reflected in Appendix 1, paragraph (c).

3.07 Debt Rescheduling

No debt-restructuring opportunities arose. However, The Head of Finance, along with its Treasury Management Advisors, keeps under review any opportunities which may arise for restructuring the Council's debt in order to take advantage of potential savings as interest rates change and to enhance the balance of the long term portfolio (amend the maturity profile and/or the balance of volatility). At a late stage in the year a proposal was being considered and assessed for suitability. Any actions carried out under delegated powers will be reported to the Audit Committee, Cabinet and County Council as appropriate.

4.00 INVESTMENT ACTIVITY

4.01 The Welsh Assembly Government's Investment Guidance requires local authorities to focus on security and liquidity, rather than yield.

4.02 Investment Activity in 2012/13

Summary of investments as at 31st March 2013.

Country	Total		<1 month	1 –12 months	>12 months	Iceland
	£m	%	£m	£m	£m	£m
UK BANKS	7.0	12		7.0		
UK BUILDING SOCIETIES	22.4	39	7.1	15.3		
OVERSEAS	3.7	6	2.0	1.7		
LANDSBANKI	1.9	3				1.9
MMF'S						
LOCAL AUTHORITIES	2.0	4	2.0			
DMO	21.0	36	21.0			
TOTAL	**58.0**	**100**	**32.1**	**24**	**0.00**	**1.9**
% OF PORTFOLIO			55%	42%	0.0%	3%
TARGET 2012			35%	55%	10%	

4.03 Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Policy and Strategy Statement for 2012/13. Investments during the year included:

- Deposits with the Debt Management Office
- Deposits with other Local Authorities
- Investments in AAA-rated Constant Net Asset Value Money Market Funds
- Call accounts and deposits with Banks and Building Societies

4.04 The start of 2012/13 saw the continuation of the self imposed low risk policy of only making short term investments (maximum term of 3 months), or investing in instant access call accounts and money market funds, which was put in place during 2011/12 in response to the Euro zone sovereign debt crisis.

In January 2013, following discussions with Arlingclose, the financial environment had stabilised sufficiently for the self imposed restriction of only making short term investments to be lifted, and subsequently a number of longer term investments ranging from 3 to 12 months being made.

4.05 Credit Risk

Counterparty credit quality was assessed and monitored with reference to credit ratings; credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; any potential support mechanisms and share price. The minimum long-term counterparty credit rating determined for the 2012/13 treasury strategy was A/A/A2 across rating agencies Fitch, S&P and Moody's.

In June Moody's downgraded a swathe of banks with global capital market operations, including the UK banks on the Council's lending list - Barclays, HSBC, Royal Bank of Scotland/Natwest, Lloyds TSB Bank/Bank of Scotland - as well as several non UK banks.

4.06 Liquidity

In keeping with the WAG's Government's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds and call accounts.

4.07 Yield

The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate was maintained at 0.5% through the year.

The Council considered an appropriate risk management response to uncertain and deteriorating credit conditions in Europe was to shorten maturities for new investments. Short term money market rates also remained at very low levels which had a significant impact on investment income.

Income earned on £9m of longer-dated investments made in 2012/13 at an average rate of 1.9% provided some cushion against the low interest rate environment.

The Council's budgeted investment income for the year had been estimated at £537k. The average cash balances were £70m during the period and interest earned was £508k.

5.00 UPDATE ON INVESTMENTS WITH ICELANDIC BANKS

5.01 The Winding up board of Landsbanki (now LBI hf) made distributions to priority creditors in February, May and October of 2012, totalling £1.76m.

The Winding Up Board published details of LBI's financial position as at 31 December 2012 on its website. This showed that LBI's assets, including partial payments already made in respect of priority claims were greater than the sum of the priority claims. It is therefore still considered likely that UK local authorities will recover 100% of their deposits, subject to potential future exchange rate fluctuations.

There is an on-going dispute over whether the total claims should be valued at the 22 April 2009 exchange rates or at spot rates. This is being trialled in the Icelandic Courts shortly and is likely to be the subject of appeal to the Icelandic Supreme Court whatever the verdict.

The future pattern of distributions by the Landsbanki Winding Up Board is not known, but based on the above information and an estimate that the distribution made in October 2012 represented 49.65% of the total due (based on the 22 April 2009 exchange rates), Local Authority Accounting Panel recommends that the estimate of the recoverable amount is based on a total repayment of 100% and that the future payment schedule should be estimated as follows:

December 2013 7.50%
December 2014 7.50%
December 2015 7.50%
December 2016 7.50%
December 2017 7.50%
December 2018 7.50%
December 2019 5.35%

Issues remain around foreign exchange risks, as payments have been and will continue to be received in Euros, US Dollars, GBP and Icelandic Krona. The

Council has discussed these foreign exchange transactions with its bank and suitable arrangements have been put in place to accept the payments. There are still uncertainties regarding funds currently held in Krona, as they cannot currently be converted into GBP. The LGA in conjunction with those authorities affected, are working on practical solution for all.

6.00 COMPLIANCE

6.01 The Council can confirm that it has complied with its Prudential Indicators for 2012/13, which were approved on 1st March 2012 as part of the Council's Treasury Management Policy and Strategy Statement.

6.02 In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2012/13. None of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

6.03 The treasury function operated within the limits detailed in the Treasury Management Policy and Strategy Statement 2012/13 with one exception; an investment was made with a counterparty that had recently been placed at risk of falling below the Council's criteria because it was on review for possible downgrade. The error was identified the next day and immediate action was taken to recover the investment. The investment has now been returned, and internal controls have been improved to ensure that such an error will not happen again.

7.00 OTHER ITEMS

7.01 The following were the main treasury activities during 2012/13:

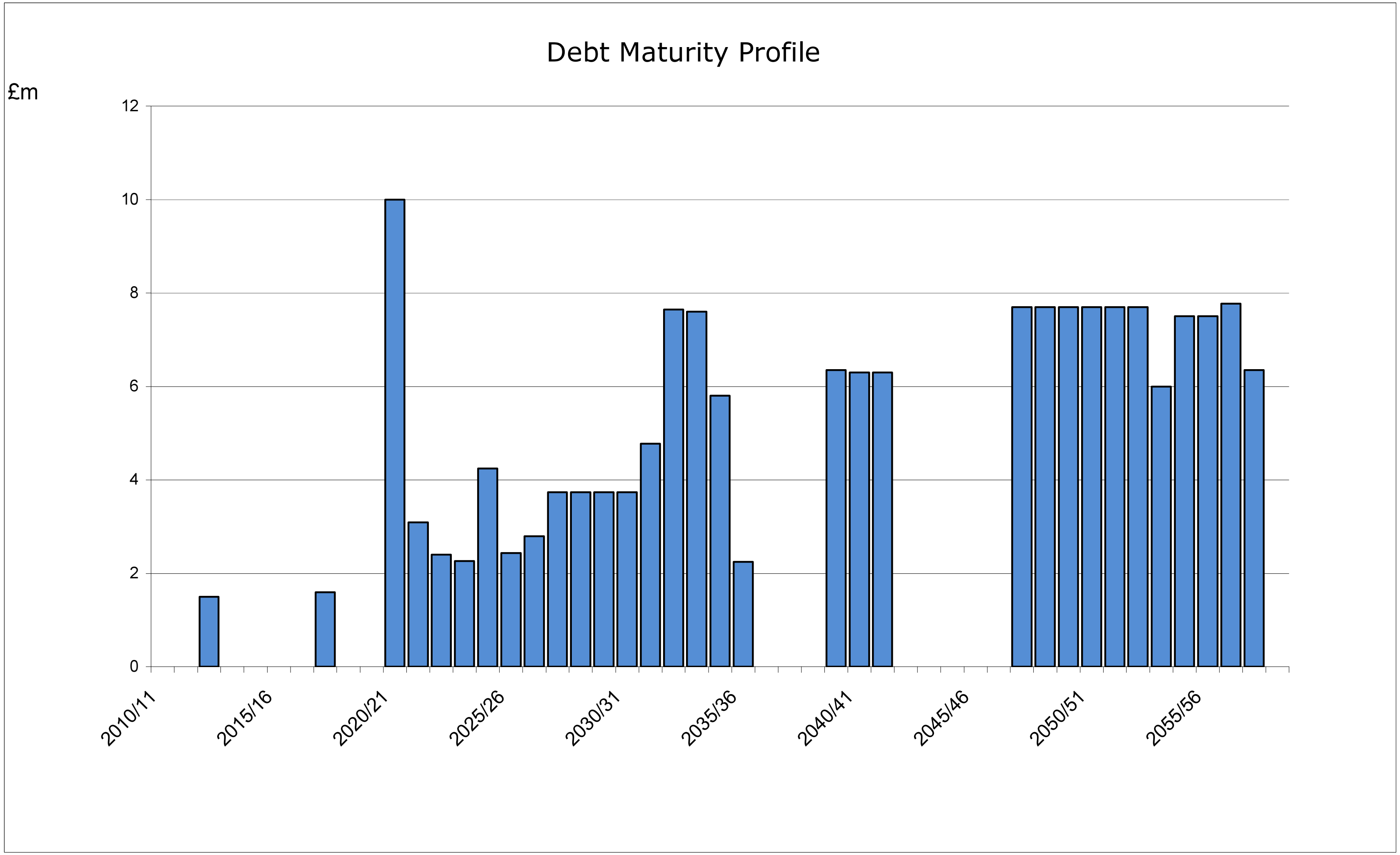
- The Head of Finance received a monthly update on treasury activities.
- The Council received a Mid Year Report on 13th November 2012.
- Quarterly updates reports were presented to the Audit Committee including the Icelandic monies at risk
- All Members were invited to a training session undertaken by Arlingclose Ltd on 29th January 2013, which was hosted by Audit Committee.
- The new Policy and Strategy Statement 2013/14 was approved by Council on 1st March 2013.
- The Council continues to be an active member of both the CIPFA Treasury Management Forum and the CIPFA Benchmarking Club.
- The Council's cash flow was managed on a daily basis. During the year the Authority acted both as a borrower and as a lender and was a net borrower over the year in question. The maximum investments the Authority had on deposit at any one time was £82.1m and the maximum long-term borrowing at any one time was £172.1m.

8.00 CONCLUSION

8.01 The treasury management function has operated within the statutory and local limits detailed in the 2012/13 Treasury Management Policy and Strategy Statement with one exception.

8.02 A new Policy Statement 2013/14 – 2015/16 and Treasury Management Strategy 2013/14 has been adopted which were revised from the 2012/13 statement, with the view of continuing to improve performance by managing the various treasury risks.

8.03 The Policy was implemented in a pro-active manner with security and liquidity as the focus.


Debt Maturity Profile
£m
12
10
8
6
4
2
0
2010/11
2015/16
2020/21
2025/26
2030/31
2035/36
2040/41
2045/46
2050/51
2055/56