Appendix 1

FLINTSHIRE COUNTY COUNCIL

TREASURY MANAGEMENT

ANNUAL REPORT 2013/14

1.00 INTRODUCTION

1.01 The Council approved the Treasury Management Strategy (Strategy) 2013/14 including key indicators, limits and an annual investment strategy on 1st March 2013.

1.02 The Strategy 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 2013/14 treasury management operations and compare with the Strategy.

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 2013/14

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

Economic background: 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' 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. Only two major economies – the US and Germany – had growth above pre financial crisis levels, albeit these were still below trend. The Eurozone had navigated through a turbulent period for its disparate sovereigns and the likelihood of a near-term disorderly collapse had significantly diminished. The US government had just managed to avoid the fiscal cliff and a technical default in early 2013, only for the problem to re-emerge later in the year.

With new Governor Mark Carney at the helm, the Bank of England unveiled forward guidance in August pledging to not consider raising interest rates until the ILO unemployment rate 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.

The recovery in the UK surprised with strong economic activity and growth. Q4 2014 GDP showed year-on-year growth of 2.7%. 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. However, business investment had yet to recover convincingly and the recovery was not accompanied by meaningful productivity growth. Worries of a housing bubble were tempered by evidence that net mortgage lending was up by only around 1% annually.

CPI fell from 2.8% in March 2013 to 1.7% in February 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 7.2% in January 2014) 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 (i.e. after inflation) was negative. 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.

The Office of Budget Responsibility's 2.7% forecast for economic growth in 2014 forecast a quicker fall in public borrowing over the next few years. However, the Chancellor resisted the temptation to spend some of the proceeds of higher economic growth. In his 2013 Autumn Statement and the 2014 Budget, apart from the rise in the personal tax allowance and pension changes, there were no significant giveaways and the coalition's austerity measures remained on track.

The Federal Reserve's then Chairman Ben Bernanke's announcement in May that the Fed's quantitative easing (QE) programme may be 'tapered' caught markets by surprise. Investors began to factor in not just an end to QE but also rapid rises in interest rates. 'Tapering' (a slowing in the rate of QE) began in December 2013. By March 2014, asset purchases had been cut from $75bn to $55bn per month with expectation that QE would end by October 2014. This had particular implications for global markets which had hitherto benefited from, and got very accustomed to, the high levels of global liquidity afforded by QE. The impact went further than a rise in the dollar and higher US treasury bond yields. Gilt yields also rose as a consequence and emerging markets, which had previously benefited as investors searched for yield through riskier asset, suffered large capital outflows in December and January.

With the Eurozone struggling to show sustainable growth, the European Central Bank cut main policy interest rates by 0.25% to 0.25% and the deposit rate to zero. Markets were disappointed by the lack of action by the ECB despite CPI inflation below 1% and a looming threat of deflation. Data pointed to an economic slowdown in China which, alongside a weakening property market and a highly leveraged shadow banking sector, could prove challenging for its authorities.

Russia’s annexation of the Ukraine in March heightened geopolitical tensions and risk. The response from the West which began with sanctions against Russia which is the second largest gas producer in the world and which supplies nearly 30% of European natural gas needs and is also a significant supplier of crude oil – any major disruption to their supply would have serious ramifications for energy prices.

3.00 BORROWING REQUIREMENTS AND DEBT MANAGEMENT

3.01 PWLB (Public Works Loans Board) Certainty Rate

The Council again qualified for the PWLB Certainty Rate, allowing the authority to borrow at a reduction of 20bps on the Standard Rate.

3.02 Borrowing Activity in 2013/14

The total long term borrowing outstanding, brought forward into 2013/14 totalled £172.1 million. Loans with the Public Works Loans Board were in the form of fixed rate (£143.2m) 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 5.41%.

	Balance 01/04/2013 £m	**Debt Maturing £m**	**New Debt £m**	**Balance 31/03/2014 £m**
Capital Financing Requirements	**184.6**			**186.7**
Short Term Borrowing	0.00	0.00	0.00	0.00
Long Term Borrowing	172.1	0.00	0.00	172.1
TOTAL BORROWING	**172.1**	**0.00**	**0.00**	**172.1**
Other Long Term Liabilities	8.1	0.5	0.00	7.6
TOTAL EXTERNAL DEBT	**180.2**	**0.5**	**0.00**	**179.7**
Increase/ (Decrease) in Borrowing £m				**(0.5)**

3.03 The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31/3/2014 was £186.7m. The Council's total external debt was £179.7m.

3.04 No new long term Public Works Loan Board (PWLB)/financial institution borrowing was undertaken during 2013/14 - the Council continues to use cash reserves to fund capital expenditure in place of new borrowing.

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 0.56%.

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.

3.06 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 3.9%. The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding £10.23m 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 2014/15, it will not be sustainable over the medium term. The Council expects it will need to borrow for capital purposes from 2015/16 onwards.

3.07 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.

3.08 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).

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 2013/14

Summary of investments as at 31st March 2014.

Country	Total	<1 month	1 –12 months	>12 months
	£m	%	£m	£m
UK BANKS	12.1	6.4	5.7	
UK BUILDING SOCIETIES	3.0	3.0		
OVERSEAS	4.6	4.6		
MMF's				
LOCAL AUTHORITIES	13.5	6.5	5.0	2.0
DMO	14.6	14.6		
TOTAL	**47.8**	**35.1**	**10.7**	**2.0**
% OF PORTFOLIO		73.4%	22.4%	4.2%
TARGET 2013		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 Strategy for 2013/14. 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 Credit Risk

The Authority assessed and monitored counterparty credit quality 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 and share price. The minimum long-term counterparty credit rating determined by the Authority for the 2013/14 treasury strategy was A-/A-/A3 across rating agencies Fitch, S&P and Moody's.

The material changes to UK banks' creditworthiness were (a) the strong progress made by the Lloyds Banking Group in strengthening its balance sheet, profitability and funding positions and the government reducing its shareholding in the Group to under 25%, (b) the announcement by Royal Bank of Scotland of the creation of an internal bad bank to house its riskiest assets (this amounted to a material extension of RBS' long-running restructuring, further delaying the bank's return to profitability) and (c) substantial losses at Co-op Bank which forced the bank to undertake a liability management exercise to raise further capital and a debt restructure which entailed junior bondholders being bailed-in as part of the restructuring.

In July Moody's placed the A3 long-term ratings of Royal Bank of Scotland and NatWest Bank and the D+ standalone financial strength rating of RBS on review for downgrade amid concerns about the impact of any potential breakup of the bank on creditors. As a precautionary measure the Council reduced its duration to overnight for new investments with the bank(s). In March Moody's downgraded the long-term ratings of both banks to Baa1. As this rating is below the Council's minimum credit criterion of A-, the banks were withdrawn from the counterparty list for further investment. NatWest is the Council's banker and will continue to be used for operational and liquidity purposes.

4.05 Liquidity

In keeping with the WG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds and call accounts. The Authority uses purpose-built cash flow forecasting software to determine the maximum period for which funds may prudently be committed.

4.06 Yield

The UK Bank Rate was maintained at 0.5% through the year. Short term money market rates also remained at very low levels which continued to have a significant impact on investment income. The low rates of return on the Council's short-dated money market investments reflect prevailing market conditions and the Council's objective of optimising returns commensurate with the principles of security and liquidity.

Income earned on £2m of longer-dated investments made in 2013/14 at a rate of 0.95% provided some cushion against the low interest rate environment.

The Council's budgeted investment income for the year had been estimated at £382k. The average cash balances were £69.4m during the period and interest earned was £455k, at an average interest rate of 0.58%.

5.00 UPDATE ON INVESTMENTS WITH ICELANDIC BANKS

5.01 On the 3rd February 2014, the Council sold its claims against the insolvent estate of LBI (Landsbanki). All Members were notified of the sale by letter on 4th February 2014.

The claims were sold through a competitive auction process. The price at which the claims were sold was based on a reserve price set by the Council on the basis of legal advice received from Bevan Brittan, financial advice procured by the Local Government Association (LGA) and our own analysis of the financial position.

A number of other priority creditors/UK local authorities sold their claims though the same auction process. Each creditor who participated in that process achieved exactly the same auction price.

The Council had £3.7m invested with LBI when the bank became insolvent in 2008, and that £1.947m had already been returned. The proceeds of the sale were paid in cash in Pounds Sterling and the sale means that the Council recovered 92% of the amounts that were originally deposited, representing a very large portion of the LBI deposits.

The sale of the claims represents a clean break and with the administration of the insolvent estate of LBI likely to continue for several years, removes the uncertainty around the timing of future recoveries. Future distributions could have been made in a number of currencies, including Icelandic Krona, which would have been less advantageous to the Council. As a result of the sale of the claims the Council is now no longer a creditor of LBI.

In order to maximise the position of those creditors taking part in the auction, the arrangements were made, with advice as set out above, by the Head of Finance and the Monitoring Officer. The sale of the claims was undertaken under delegated powers by the Head of Finance under Financial Procedure Rule 9.5, which is to agree the arrangements for the collection of all income due to the Council.

6.00 COMPLIANCE

6.01 The Council can confirm that it has complied with its Prudential Indicators for 2013/14, which were approved on 1st March 2013 as part of the Council's Treasury Management Strategy.

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 2013/14. 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 Strategy 2013/14 with one exception; the 2013/14 strategy permitted investments with counterparties rated A- or above for a maximum period of 6 months and a limit of £5m per counterparty (in 2012/13 the strategy was to invest with counterparties rated A or above with a limit of £7m). On the 3rd April 2013 an 'on-call account' investment of £7m was made with a counterparty (the Council's own bank) rated at A-, which therefore breached the investment criteria. This was a procedural issue and no loss was incurred by the Council as a consequence. Once the error was discovered action was taken immediately to reduce the investment to the agreed limit of £5m.

7.00 OTHER ITEMS

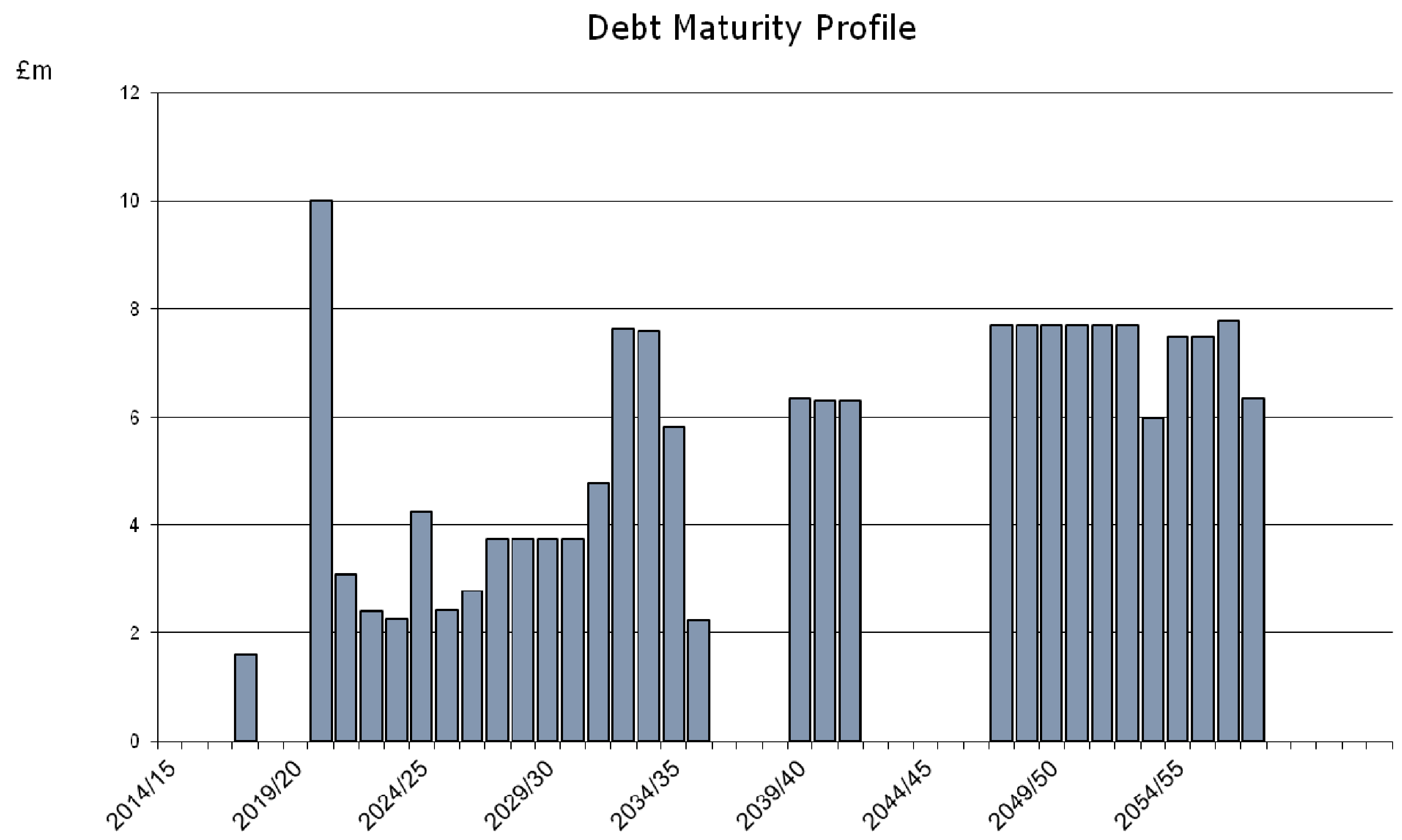
7.01 The following were the main treasury activities during 2013/14:

- The Head of Finance received a monthly update on treasury activities.
- The Council received a Mid Year Report on 18th December 2013.
- Quarterly updates reports were presented to the Audit Committee.
- All Members were invited to a training session undertaken by Arlingclose Ltd on 27th January 2014, which was hosted by Audit Committee.
- The 2014/15 Statement was approved by Council on 18th February 2014.
- The Council continues to be an active member of the CIPFA Treasury Management Network.
- 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 £83.3m 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 2013/14 Treasury Management Strategy with one exception.

8.02 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
2014/15
2019/20
2024/25
2029/30
2034/35
2039/40
2044/45
2049/50
2054/55