Appendix C

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1. Background

1.1 The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management. Before the start of every year the Code requires local authorities to produce Prudential Indicators and a Treasury Management Strategy Statement detailing the policies and objectives of the council's treasury management activities for the forthcoming year. After the year end an outturn report is then produced detailing the actual results for the year.

1.2 Treasury management is defined as "the management of the local authority'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."

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

2. Economic Background

2.1 The global outlook stabilised mainly due to central banks maintaining low interest rates and expansionary monetary policy for an extended period.

2.2 The UK economy shrank in the first, second and fourth quarters of calendar year 2012. It was only growth of 0.9% in the third quarter, aided by the summer Olympic Games, which allowed growth to register 0.2% over 2012.

2.3 Household finances and purchasing power were constrained as wage growth remained subdued at 1.2% and was outstripped by inflation. Annual CPI (Consumer Price Index) dipped below 3%, falling to 2.4% in June before increasing 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.

2.4 The lack of growth and fall in inflation meant that the Bank of England maintained the Bank Rate at 0.5% and also sanctioned an additional £50 billion of asset purchases (known as Quantitative Easing (QE)) in July, taking total QE to £375 billion. The possibility of a cut in the Bank Rate was discussed but was not implemented as the potential drawbacks outweighed the benefits.

2.5 The resilience of the labour market, with the 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.

2.6 The Chancellor largely stuck to his fiscal plans with the planned austerity drive extending into 2018. In March the Office for Budgetary Responsibility (OBR) halved its forecast of growth in 2013 to 0.6% which then resulted in the lowering of the forecast for tax revenues and a corresponding increase in the budget deficit. With the deterioration in the national debt position, 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.

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2.7 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 lending to businesses was less than anticipated.

2.8 One direct consequence of the Funding for Lending Scheme, and the availability of cheap cash, was the sharp drop in rates offered by banks for local authority investments. For example, at the start of the year Barclays was paying 0.91% for a three month term deposit compared to 0.45% at the end of the year.

2.9 Gilt yields ended the year lower than at the start in April. 10-year yields fell by nearly 0.5% ending the year at 1.72%. The reduction was less pronounced at the longer end; 30-year yields ended the year at 3.11%, around 0.25% lower than in April. Interest rates on loans from the Public Works Loan Board are set approximately 1% higher than gilt yields and so PWLB interest rates also fell but the cost of carry associated with borrowing longer-term loans, whilst investing the monies temporarily until required for capital financing, remained high.

3. Borrowing

3.1 In November 2012 the Public Works Loan Board (PWLB) introduced the Certainty Rate, allowing local authorities to borrow from the PWLB at a reduction of 0.20% on the Standard Rate. However, given the large differential between short and longer term interest rates, and with PWLB rates forecast to remain low for the foreseeable future, the council funded the 2012/13 capital programme using short-term borrowing from other local authorities.

3.2 Council borrowing as at the year-end is shown in the table below.

Borrowing Activity in 2012/13	**PWLB & LOBO's £m**	**LA's £m**	**Other £m**	**Total 01/04/13 £m**	**Total 31/03/12 £m**
Short Term Borrowing	16.00	16.00	0.13	32.13	15.98
Long Term Borrowing	124.54	-	0.34	124.88	128.53
TOTAL BORROWING	**140.54**	**16.00**	**0.47**	**157.01**	**144.51**
Other Long Term Liabilities	-	-	28.24	28.24	29.19
TOTAL EXTERNAL DEBT	**140.54**	**16.00**	**28.71**	**185.25**	**173.70**

- The above amounts show the principal outstanding. The figures in the council's annual accounts will be higher as they include accrued interest and other accounting adjustments.
- The short-term borrowing includes £12 million of LOBO loans because it is possible (although unlikely) that they could be repaid in 2013/14 (see note 3.6 below).
- The "other" borrowing of 0.47 million is an interest-free loan received by the council under the Salix Energy Efficiency Scheme. The loan is repayable over four years.

3.3 The council took out nineteen short-term loans during the year from other local authorities. The amounts borrowed were between £1 million and £3.97 million and for periods ranging from one week to forty weeks. Interest rates (inclusive of

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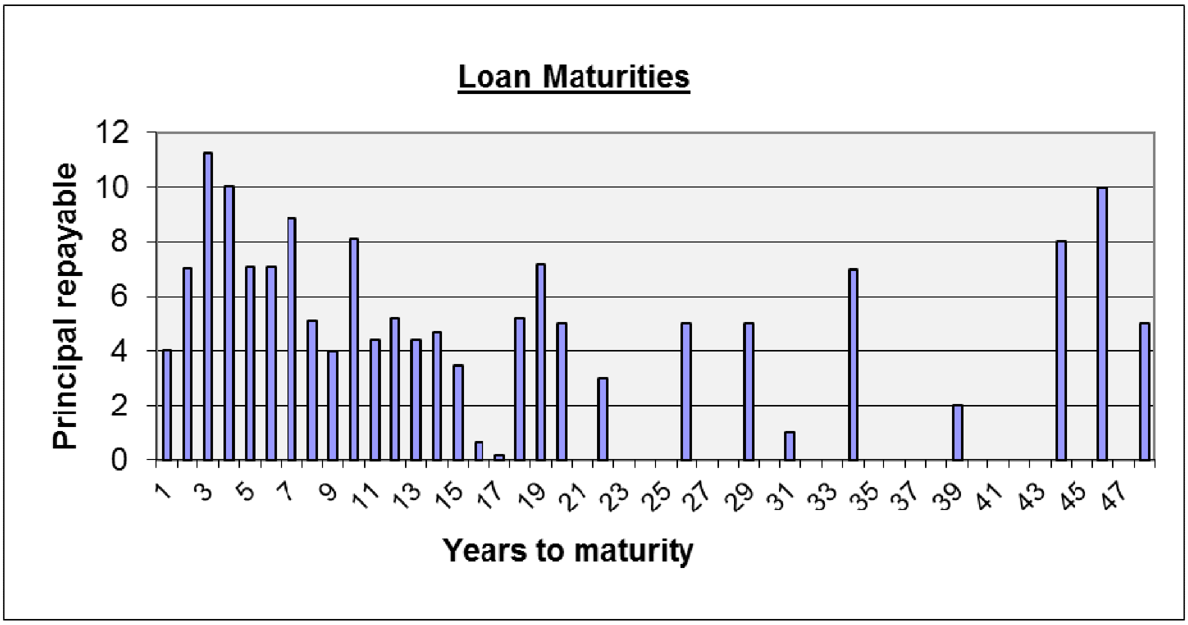
broker's commission) ranged from 0.35% to 0.44% (average 0.39%). This is a very cost effective approach to managing borrowing to fund capital works. It produces interest savings that support the overall general fund position. This is outlined in paragraph 3.9.

3.4 Eight short-term loans, totalling £16 million, were outstanding at the year end, as follows.

Date Borrowed	Local Authority	£m	Period (days)	Date Repayable	Interest Rate – gross including brokers commission
26/11/12	Merseyside Transport	2.00	224	08/07/13	0.40%
30/11/12	South Yorkshire	2.00	255	12/08/13	0.42%
30/11/12	Merseyside Transport	2.00	283	09/09/13	0.44%
04/01/13	City & County of Swansea	2.00	97	11/04/13	0.35%
05/01/13	City & County of Swansea	2.00	92	08/05/13	0.40%
06/02/13	Kent Police Authority	2.00	119	05/06/13	0.40%
26/03/13	Worcestershire	2.00	16	11/04/13	0.40%
28/03/13	Worcestershire	2.00	119	05/06/13	0.40%

3.5 At the year end the borrowing from the PWLB consisted of 40 loans with an average remaining period to maturity of 19.44 years and an average rate of interest of 3.98%. The maturity profile of the principal repayable is shown below.



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3.6 In addition to the PWLB loans, the council also has two LOBO bank loans of £6 million each on which the council pays interest at 4.5% (LOBO being Lenders Option then Borrowers Option). Every six months, when the interest payment becomes due, the lender has the option to increase the interest rate being charged at which point the council can accept the revised terms or reject them and repay the loan. LOBO loans present a potential refinancing risk to the council since the decision to amend the terms is entirely at the lender's discretion. If the lenders do not revise the terms the loans mature in 2053/54 and 2054/55.

3.7 In February the council asked Arlingclose to investigate the possibility of repaying these loans and was advised that the penalty for early repayment would be in the region of £2.2 million for each loan. Therefore this is not considered to be an option at the present time.

3.8 The council's borrowing costs in 2012/13 have been as follows.

Summary of Borrowing Costs for 2012/13	**Budget**	**Actual**	**Saving**
	£m	**£m**	**£m**
Minimum Revenue Provision	9.95	9.78	0.17
Interest on existing loans (January 2012 position)	5.76	5.76	-
Provision for borrowing of £5.50m to be taken out before the end of 2011/12 at 4.00%	0.22	-	0.22
Borrowing requirement for 2012/13 of £6m, included at an interest rate of 4.00%	0.24	-	0.24
Interest payable on short-term borrowing in lieu of longer-term loans	-	0.02	(0.02)
Additional budget towards property disposal costs	0.05	0.05	-
Original budget	**16.22**	**15.61**	**0.61**
Budget adjustment relating to a reduction in capital financing contributions from directorates	**(0.15)**	**-**	**(0.15)**
Capitalised interest	**-**	**(0.39)**	**0.39**
Year end accounting adjustment: Difference between opening and closing interest accruals re longer-term loans	**-**	**(0.02)**	**0.02**
Budget surplus as at 31 March 2013	**16.07**	**15.20**	**0.87**

3.9 As can be seen from the above, the strategy of using short-term loan finance from other local authorities has saved the council interest of £440,000 compared to the budgeted interest on new longer-term PWLB loans.

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4 Investments

4.1 The council follows CLG's Investment Guidance which requires local authorities to focus on security and liquidity, rather than yield.

4.2 Investments held at the start and end of the year were as follows:

Investments	Balance on 01/04/2012 £m	Balance on 31/03/2013 £m
Instant Access Accounts	1.63	0.97
Term Deposits	9.50	8.50
Total	**11.13**	**9.47**
Decrease in investments		**(1.66)**

4.3 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 Strategy Statement for 2012/13. Investments during the year comprised:

– Investments in AAA-rated Money Market Funds
– Call accounts and deposits with UK Banks
– Deposits with the Nationwide Building Society
– A deposit with another Local Authority (Gateshead Council)

4.4 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.

4.5 Interest rates fell during the year, the main reason being the availability of cheap alternative finance for banks through the Funding for Lending Scheme (as noted in 2.8). For example, interest rates on the following investments have been as follows:

Investment		2nd Apr	2nd Jul	28th Sep	27th Dec	31st Mar
Prime Rate Money Market Fund (instant access)		0.87%	0.69%	0.61%	0.46%	0.45%
Ignis Money Market Fund (instant access)		0.82%	0.72%	0.65%	0.50%	0.44%
Nationwide	E.g. 3 month term deposit	0.98%	0.60%	0.51%	0.44%	0.44%
Barclays	E.g. 3 month term deposit	0.91%	0.83%	0.53%	0.46%	0.45%
Lloyds Group	E.g. 3 month term deposit	1.40%	1.40%	1.35%	0.70%	0.70%

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4.6 Investment income received during the year was as follows:

Month	Amount invested		Average rate of interest earned		Amount of interest earned £	Budget £	Short-fall £
	Actual £m	Budget £m	Actual %	Budget %			
Apr	22.11	30	1.15	0.90	20,643	22,500	(1,857)
May	31.94	40	1.09	0.90	29,281	30,000	(719)
Jun	32.57	45	1.07	0.90	29,008	33,750	(4,742)
Jul	32.34	50	0.93	0.90	25,653	37,500	(11,847)
Aug	31.33	45	0.98	0.90	26,123	33,750	(7,627)
Sep	28.82	45	0.99	0.90	23,445	33,750	(10,305)
Oct	28.00	45	0.99	0.90	23,491	33,750	(10,259)
Nov	25.61	40	0.98	0.90	20,506	30,000	(9,494)
Dec	31.17	35	0.92	0.90	24,387	26,250	(1,863)
Jan	32.04	35	0.92	0.90	24,831	26,250	(1,419)
Feb	28.88	30	0.87	0.90	19,265	22,500	(3,235)
Mar	16.82	30	0.91	0.90	13,221	22,070	(9,279)
Interest received in 2012/13					**279,854**	**352,070**	**(72,646)**
Less interest payable to third parties					**(11,353)**		**(11,353)**
Add interest receivable on loans					**14,688**		**14,688**
Add interest receivable on long-term investments					**126**		**126**
Total for year					**283,315**	**352,070**	**(68,755)**

4.7 The interest received has fallen short of the amounts budgeted by £68,755. Whilst the average rates achieved have generally been higher than the budgeted rate of 0.90%, the average amounts invested have been lower.

4.8 The investment budget was set on a consistent basis with the borrowing budget assuming that the council may take out further borrowing totalling £11.5 million at the end of 2011/12 and/or at the beginning of 2012/13. The postponement of this borrowing caused investment income to fall but the reduction in income is outweighed by savings made on the borrowing side. Short-term borrowing from other local authorities reduced the gap between projected and actual investment balances but falling council reserves had the opposite effect.

4.9 The average interest rate received on investments during 2012/13 was 0.98% which was lower than the 1.15% achieved in 2011/12 because of the general fall in the rates offered by banks on term deposits. However, the rate compares favourably with the generally accepted benchmark of the average 7-day London Inter-Bank Bid (LIBID) rate of 0.49%.

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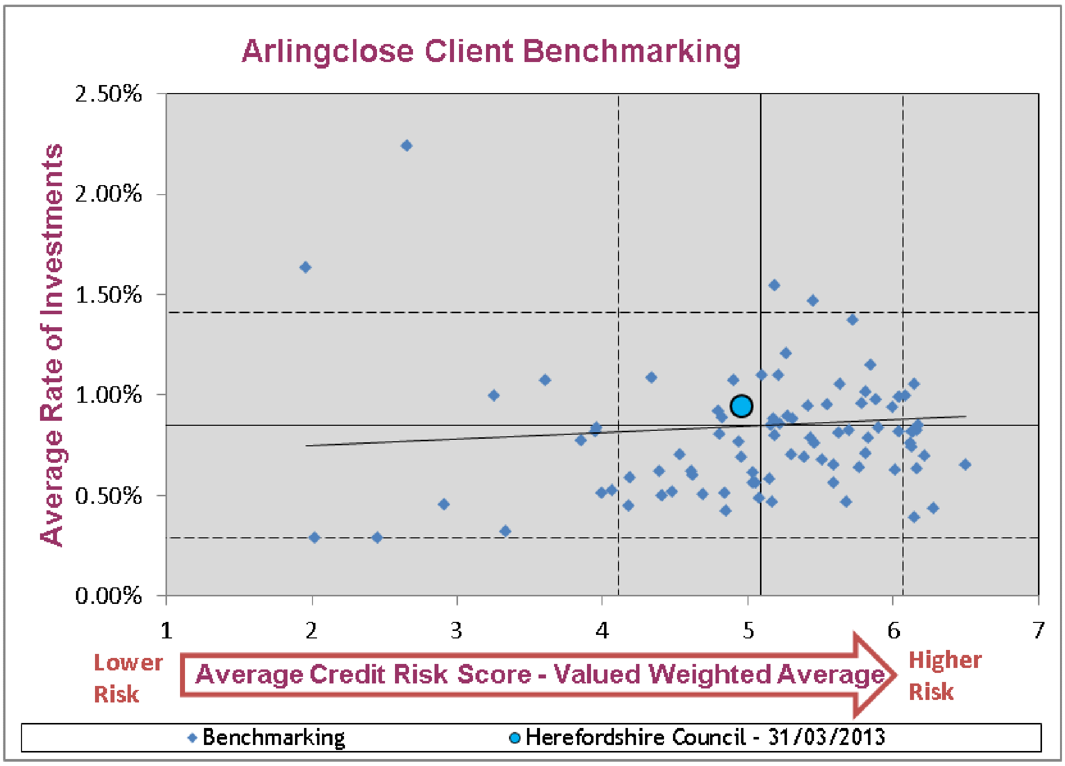
4.10 In addition, Arlingclose have provided the following graph where each dot represents one of their clients and shows the rate of return achieved by each compared to their level of risk. You will see that as at 31st March 2013 Herefordshire Council was earning an above average return with a lower than average level of risk.



4.11 Another graph produced by Arlingclose replicates the above but just shows the sixteen unitary authorities within their client base. This graph has not been reproduced here but shows returns ranging from 0.42% to 1.07% and averaging 0.75%. At the year end the council was earning 0.94% with only one unitary authority exceeding that rate and eight authorities assessed by Arlingclose as being exposed to more credit risk.

5 Compliance with Prudential Indicators

5.1 The Council can confirm that it has complied with its Prudential Indicators for 2012/13, which were approved on 18th February 2013 as part of the Council's Treasury Management Strategy Statement.

Details of Prudential Indicators can be found in Appendix 1.

Appendix C

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Appendix 1

PRUDENTIAL INDICATORS

1. Background

Prudential indicators for 2012/13, and the two following years, formed part of the Treasury Management Strategy for 2012/13 which was approved by full council before the start of the year. This Appendix looks at the indicators that were set for 2012/13 compared to the actual results for the year.

There were no significant deviations from expectations.

2. Authorised Limit and Operational Boundary for External Debt

- The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit. This is a statutory limit which should not be breached.
- The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit.
- The Chief Officer – Finance and Commercial confirms that there were no breaches to the Authorised Limit and the Operational Boundary during the year.

	Approved Operational Boundary for 2012/13 £m	**Approved Authorised Limit for 2012/13 £m**	**Actual External Debt as at 31/03/2013 £m**
Borrowing	175.00	185.00	157.01
Other Long-term Liabilities	35.00	40.00	28.24
Total	**210.00**	**225.00**	**185.25**

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

- These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates.
- The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of investments.

	Approved Limits for 2012/13	**Maximum during 2012/13**
Upper Limit for Fixed Rate Exposure	100%	100%
Compliance with Limits:	Yes	Yes
Upper Limit for Variable Rate Exposure	25%	10.22%
Compliance with Limits:	Yes	Yes

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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	Upper Limit %	Lower Limit %	Actual Fixed Rate Borrowing as at 31/03/13 £m	% Fixed Rate Borrowing as at 31/03/13	Compliance with Set Limits?
Under 12 months (Inc LOBO loans)	0%	20%	16.00	11.38%	Yes
12 months and within 24 months	0%	10%	4.01	2.85%	Yes
24 months and within 5 years	0%	30%	19.34	13.76%	Yes
5 years and within 10 years	0%	30%	18.01	12.82%	Yes
10 years and within 20 years	0%	40%	37.17	26.45%	Yes
20 years and within 30 years	0%	40%	13.00	9.25%	Yes
30 years and within 40 years	0%	40%	10.00	7.12%	Yes
40 years and within 50 years	0%	40%	23.00	16.37%	Yes
Total fixed rate borrowing			140.53	100%	
Short-term borrowing from other local authorities is categorised as variable rate borrowing and not included above. *The two LOBO loans totalling £12 million are shown as being repayable in less than one year as they need to be shown as being repayable on the earliest date on which the lender can require payment, i.e. the next call date.*					

5. Estimates of 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	2012/13 Estimate £'000	2012/13 Actual £'000
Total	**39,362**	**38,563**

- Capital expenditure was financed as follows:

Capital Financing	2012/13 Estimate £'000	2012/13 Actual £'000
Capital receipts	465	2,897
Government Grants	26,992	21,931
Total Financing	**27,457**	**24,828**
Prudential borrowing	11,905	13,735
Total Financing and Funding	**39,362**	**38,563**

Appendix C

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6. 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.
- The ratio is based on costs net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2012/13 Estimate £'000	2012/13 Actual £'000
Net Revenue Stream	143,359	143,359
Financing Costs	18,049	17,148
Percentage	**12.59%**	**11.96%**

- The actual percentage is less than the estimate due to using cheaper short-term borrowing from other local authorities, rather than longer-term finance from the PWLB, and also due to capitalising interest costs of £0.39 million.

7. Capital Financing Requirement

- The Capital Financing Requirement (CFR) measures the council's underlying need to borrow for a capital purpose. The calculation of the CFR is taken from the amounts held in the Balance Sheet relating to capital expenditure and its financing.

Capital Financing Requirement	2012/13 Estimate £'000	2012/13 Actual £'000
Total CFR	**209,189**	**212,212**

8. Actual External Debt

- This indicator 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.

Actual External Debt as at 31/03/2013	£'000
Short-term borrowing (including £12 million of LOBO loans, 16 million of short-term LA loans and £4 million of PWLB borrowing repayable next year)	32,133
Longer-term PWLB borrowing	124,876
Total borrowing	157,009
Other Long-term Liabilities – Finance leases and PFI schemes	28,238
Total external debt	**185,247**