

EXETER CITY COUNCIL

TREASURY MANAGEMENT STRATEGY REPORT 2010/11

1. Introduction

- 1.1 The Council has regard to the DCLG's Guidance on Local Government Investments ("Guidance") and CIPFA's Treasury Management in Public Services: Code of Practice and Cross Sectoral Guidance Notes ("CIPFA TM Code").

2. Economic Context

- 2.1 The UK is currently in the longest, if not the deepest, recession since World War Two. Bank failures, combined with rising energy and commodity prices, caused a sharp reduction in consumer and business spending in 2008, with a resulting negative impact on GDP growth and employment. Financial institutions exacerbated the recession by restricting credit in an effort to repair their own balance sheets, although extensive government and central bank intervention has supported economic activity to an extent.
- 2.2 However, the discretionary fiscal stimulus, bank rescues, increased benefit payments and reduced tax revenues have caused a significant deterioration in the national finances. Public sector net borrowing is expected to exceed £175bn in 2009/10, and remain high in subsequent years, pushing the national debt towards 100% of GDP. Whatever the result of the 2010 general election, the next government is expected to cut spending and raise taxes, slowing the country's economic recovery.
- 2.3 Although the UK economy is expected to have returned to growth in the last quarter of 2009, restricted bank lending and fiscal tightening mean it is unlikely that the absolute level of GDP will return to pre-recession levels in the near term. The resultant spare capacity is likely to keep inflation low in the medium term. The Bank of England recognises that simultaneous fiscal and monetary tightening could endanger the economy's recovery, and it is therefore likely to exercise caution before raising interest rates in the absence of obvious inflationary pressures.
- 2.4 The scope for short-term interest rate rises in 2010/11 is therefore limited. Bank Rate could remain at 0.5% for the whole of 2010, increasing quite rapidly thereafter, but remaining below pre-recession levels into 2012. Money market rates, such as LIBOR, will rise earlier in anticipation of monetary tightening, but they are also likely to remain close to record lows for a considerable period. Long-term PWLB rates are expected to rise slowly due to a large increase in the supply of gilts over the next few years, but this will be mostly offset by the demand created by new liquidity requirements for financial institutions.

2.5 *Sterling Consultancy Services central interest rate forecast – November 2009*

	Bank Rate	1 month LIBOR	3 month LIBOR	12 month LIBOR	25 year PWLB	50 year PWLB
Current	0.50	0.51	0.61	1.21	4.40	4.35
Q1 2010	0.50	0.55	0.70	1.30	4.55	4.55
Q2 2010	0.50	0.55	0.75	1.35	4.60	4.60
Q3 2010	0.50	0.55	0.80	1.40	4.70	4.70
Q4 2010	0.50	0.60	0.90	1.55	4.75	4.75
H1 2011	1.00	1.10	1.50	2.00	4.80	4.80
H2 2011	2.00	2.20	2.50	3.00	4.85	4.85
H1 2012	3.00	3.20	3.50	4.00	4.90	4.90

2.6 *HM Treasury Survey of Forecasts – November 2009*

	Average annual Bank Rate %			
	2010	2011	2012	2013
Highest	1.30	3.30	4.30	4.60
Average	0.70	1.70	3.00	3.80
Lowest	0.50	0.50	1.00	1.40

3. Current and Expected Treasury Portfolios

3.1 Current portfolio

The Council's current treasury portfolio, as at 15th December 2009 is as follows.

	Principal Amount £m	Interest Rate %
Investments - maturing 2009/10	1.20	0.6-0.72
- maturing 2010/11	9.65	0.55 – 2.04
- maturing later	0	-
Total Investments	10.85	-
Debt - maturing 2009/10	5.95	0.32
- maturing 2010/11	0	-
- maturing later	0	-
Total Debt	5.95	-
Net Investments	4.9	-

3.2 Expected changes

According to current cash flow forecasts, net investments are expected to reduce by £8 million by 31st March 2010 and reduce by a further £5 million by 31st March 2011, as a result of capital expenditure.

The cash flow forecast includes planned long-term borrowing of £10 million as part of the 2010/11 capital programme. The decision of whether to take external borrowing will be made in light of current and forecast interest rates.

3.3 Budget implications

The net budget for investment income in 2010/11 is £100,000. If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

4. Investment Strategy

4.1 The Council holds significant surplus funds, which represent income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's investment balance has ranged between £10 million and £26 million. Both the CIPFA Code and the CLG Guidance require to Council to invest its funds prudently, and to have regard to the **security** and **liquidity** of its investments before seeking the highest rate of return, or **yield**.

4.2 Specified Investments

Specified investments are those expected to offer relatively high security and liquidity, and can be entered into with the minimum of formalities. The CLG Guidance defines specified investments as those:

- denominated in pounds sterling,
- due to be repaid within 12 months of arrangement,
- not defined as capital expenditure by legislation, and
- invested with one of:
 - the UK Government,
 - a UK local authority, parish council or community council, or
 - a body or investment scheme of "high credit quality".

4.3 The Council defines the following as being of "high credit quality" for making specified investments, subject to the monetary and time limits shown.

In-house investment	Monetary limit¹	Time limit
UK owned, or with a major UK subsidiary ² banks and building societies holding short-term credit ratings no lower than F1+ and P-1	£2m each	12 months
UK owned banks, or banks with a major UK subsidiary ² and building societies holding short-term credit ratings no lower than F1 and P-1	£1m each	3 months
Money market funds ³ holding the highest possible credit ratings (AAA)	£2m each	1 week
UK Central Government	no limit	12 months
UK Local Authorities ⁴	£2m each	12 months
External Fund Managers		
<i>Banks</i>		
Minimum Fitch Rating F1+ short term	£2m each	
<i>Building Society</i>		
Minimum Fitch Rating F1+ short term	£2m each	

¹ banks within the same group ownership are treated as one bank for limit purposes

² e.g. Santander / National Australia Bank

³ as defined in the Local Authorities (Capital Finance and Accounting) Regulations 2003

⁴ as defined in the Local Government Act 2003

4.4 The maximum that will be lent to any one organisation (other than the UK Government) will be £4 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

4.5 Non specified Investments

- The external Fund Manager may invest in Government fixed interest Securities for more than one year as they are liquid, low risk and allow for good financial planning.
- The external Fund Manager may invest in Certificates of Deposit for more than one year using their professional judgement.
- The above is subject to the requirement that no more than 50% of the external managers Fund may be held in non-specified investments during the year.

4.6 Foreign countries

Investments in foreign countries will be limited to those that hold an AAA or AA+ sovereign credit rating from all three major credit rating agencies, and to a maximum of £2 million per country. Only banks that are domiciled in the UK but are owned in another country will be used and need to meet the rating criteria of and will count against the limit for both countries. There is no limit on investments in the UK.

4.7 Liquidity management

The Council uses purpose-built cash flow forecasting software to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a pessimistic basis, with receipts under-estimated and payments over-estimated to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments.

Limits on long-term investments are set by reference to the Council's medium term financial plan and cash flow forecast.

4.8 Credit ratings

The Council uses credit ratings from two main rating agencies Fitch Ratings Ltd and Moody's Investors Service to assess the risk of loss of investments. The lowest available credit rating will be used to determine credit quality.

Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. Where an institution has its credit rating downgraded so that it fails to meet the above criteria then:

- no new investments will be made,
- any existing investments that can be recalled at no cost will be recalled, and
- full consideration will be given to the recall of any other existing investments

Where a credit rating agency announces that it is actively reviewing an organisation's credit ratings with a view to downgrading it so that it is likely to fall below the above criteria, then no further investments will be made until the outcome of the review is announced.

4.9 Other information on the security of investments

Full regard will be given to other available information on the credit quality of banks and building societies, including credit default swap prices, financial statements and rating agency reports. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the above criteria.

4.10 Investment instruments

Investments may be made using any of the following instruments:

- interest paying bank accounts
- fixed term deposits
- call or notice deposits (where the Council can demand repayment)
- certificates of deposit
- treasury bills and gilts issued by the UK Government
- bonds issued by multilateral development banks
- shares in money market funds

5. Planned investment strategy for 2010/11 – In-house

5.1 The cash flow forecast will be used to divide surplus funds into three categories:

- Short-term – cash required to meet known cash outflows in the next month, plus a contingency to cover unexpected cash flows over the same period.
- Medium-term – cash required to manage the annual seasonal cash flow cycle, including amounts to cover forecast shortages, planned uses of reserves, and a longer-term contingency.
- Long-term – cash not required to meet cash flows, and used primarily to generate investment income.

5.2 The Council's in-house managed funds are based on the likely cash-flow position and rarely exceed one month. Investments will be made to ensure that cash flow is protected and borrowing is not required. However, on occasion, money has been invested for a longer period up to 364 days. These are funds, which are not required for day-to-day cash management purposes.

5.3 The Council will continue to seek to utilise its call accounts (which are linked to base rate) and use short-dated deposits up to 3 months to ensure liquidity of assets for day-to-day cashflow. Additionally, the Council's bankers, the Co-operative Bank operate a Public Sector Reserve Account, which automatically sweeps excess funds from our general bank account into one paying a higher interest rate. The limit on the account is £3 million, with interest varying depending on the amount in the account. However, the credit rating of the Co-operative Bank no longer meets our lending criteria and therefore only minimal funds are kept in this account, where possible.

6. Planned investment strategy for 2010/11 – External Cash Fund Management

6.1 Investec manages the Council's funds on a discretionary basis. The Strategy is in line with the contractually agreed procedures. These have been amended to allow the placement of deposits with the Debt Management Office.

7. Borrowing Strategy

7.1 The Council currently holds no long-term loans. The Council's capital financing requirement (CFR, or underlying need to borrow) as at 31 March 2010 is expected to be £8.4 million, and is forecast to rise to £18.9 million by March 2011 as capital expenditure is incurred.

7.2 The maximum expected long-term borrowing requirement for 2010/11 is:

	£m
Not borrowed in previous years	2.2
Forecast increase in CFR	16.7
Loans maturing in 2010/11	0.0
TOTAL	18.9

7.3 However, depending on the pattern of interest rates during the year, it may be more cost effective to defer borrowing until later years, and to temporarily reduce the size of the Council's investment balance instead.

7.4 In addition, the Council may borrow for short periods of time (normally up to two weeks) to cover unexpected cash flow shortages.

7.5 Sources of borrowing

The approved sources of long-term and short-term borrowing will be:

- Public Works Loan Board
- any institution approved for investments above
- any other bank or building society on the Financial Services Authority list.

7.6 Debt instruments

Loans will be arranged by one of the following debt instruments:

- fixed term loans at fixed or variable rates of interest
- lender's option borrower's option (LOBO) loans.

As an alternative to borrowing loans, the Council may also finance capital expenditure and incur long-term liabilities by means of:

- leases
- Private Finance Initiative.

7.7 Borrowing strategy to be followed

With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to not borrow and reduce the level of investments held instead. However, with long-term rates forecast to rise in the coming years, any such short-term savings will need to be balanced against potential longer-term costs.

The Public Works Loan Board allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. The Council may take advantage of this and replace some higher rate loans with new loans at lower interest rates where this will lead to an overall saving or reduce risk.

8. Treasury Management Prudential Indicators

- 8.1 The Council sets each year, in February, prudential indicators for Treasury Management, to ensure that proper control of borrowing and investing is maintained. These indicators can be found in the Council's budget book.

9. Other Matters

- 9.1 The draft revised CLG Investment Guidance also requires the Council to approve the following matters each year as part of the investment strategy:

9.2 Investment consultants

The Council contracts with Sterling Consultancy Services to provide advice and information relating to its investment and borrowing activities. However, responsibility for final decision making remains with the Council and its officers within the parameters set out in these papers. The services received include:

- advice and guidance on relevant policies, strategies and reports
- advice on investment decisions
- notification of credit ratings and changes
- other information on credit quality
- advice on debt management decisions
- accounting advice
- reports on treasury performance
- forecasts of interest rates
- training courses

The quality of this service is controlled by monitoring of officers of the advice received.

9.3 Investment training

The needs of the Council's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change. Staff regularly attend training courses, seminars and conferences provided by Sterling Consultancy Services and CIPFA.

9.4 Investment of money borrowed in advance of need

The Council may, from time to time, borrow in advance of spending need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks.

The total amount borrowed will not exceed the authorised borrowing limit. The maximum periods between borrowing and expenditure is expected to be two years, although the Council does not link particular loans with particular items of expenditure.

10. Investment Reports

- 10.1 At the end of the financial year, the Council will prepare a report on its investment activity as part of its Annual Treasury Report. Progress will also be reported after six months of the financial year.

HEAD OF TREASURY SERVICES
JANUARY 2010