EXETER CITY COUNCIL

SCRUTINY COMMITTEE - RESOURCES
23 JANUARY 2013

EXECUTIVE
5 FEBRUARY 2013

COUNCIL
26 FEBRUARY 2013

TREASURY MANAGEMENT STRATEGY REPORT 2013/14

1. PURPOSE OF THE REPORT

1.1 To seek adoption by the Council of the Treasury Management Strategy Report, incorporating the Annual Investment Strategy 2013/14, as required under section 15(1)(a) of the Local Government Act 2003.

2. BACKGROUND

2.1 In February 2011 the Council adopted the *CIPFA Treasury Management in the Public Services: Code of Practice*, which requires the Council to approve a treasury management strategy before the start of each financial year. In November 2011, CIPFA updated the guidance and require the adopted clauses from 2009 to be updated and re-approved.

2.2 In addition, the Department for Communities and Local Government (CLG) issued revised guidance on local authority investments in March 2010 that requires the Council to approve an investment strategy before the start of each financial year.

3. CHANGES TO THE STRATEGY

3.1 The main change to the Strategy is to seek approval to increase the amount of money that can be held with UK banks. Over recent times, UK banks have been downgraded along with many international financial institutions. All, with the exception of HSBC and Standard Chartered (both F1+), are graded at F1 short term. In line with our Strategy we are only able to deposit £1 million with each Group of Banks (Lloyds TSB Group, Barclays, Nationwide and Royal Bank of Scotland). This has meant we are unable to actively manage our cashflow and invest surplus funds in Banks, thus we have used the Debt Management Office for short term investments at a rate of 0.25%. As a result it would be helpful to allow investments of £3 million to be undertaken on a short term basis (up to 3 months) or in a call account with the four banking groups listed above. We will continue with our policy of not using foreign owned banks under F1+ for investment purposes.

4. RISKS INVOLVED

4.1 The economic conditions remain tough and it is important to maintain a hold on the number of counterparties the Council will use. However, there is very little scope in the current strategy to invest any money with UK Banks so an increase in the limit, but not the number of Counterparties would assist the Council in generating additional income, whilst maintaining tight control on the organisations used.

5. CONCLUSIONS

5.1 The Strategy continues to limit the types of institution that the Council will lend money to, in order to minimise risk.

6. RECOMMENDATIONS

6.1 That Scrutiny and Executive support and Executive recommend to Council the adoption of the new Treasury Management Strategy and delegations contained therein.

ASSISTANT DIRECTOR FINANCE

Local Government (Access to Information) Act 1985 (as amended
Background Papers used in compiling this report:

1. Treasury Management Strategy

APPENDIX A

EXETER CITY COUNCIL

TREASURY MANAGEMENT STRATEGY 2013/14

1. Introduction

1.1 The Council's strategy is based on the requirements of 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 Despite some positive economic growth data towards the end of 2012, the overall uncertainty over the economic outlook persists. Consumer Price Inflation has fallen closer to the Bank of England's 2% target, although it is expected to be affected by volatility in energy and commodity prices throughout 2013.

2.2 Having voted to increase quantitative easing by £50bn in July, the Bank's Monetary Policy Committee is waiting to assess the effectiveness of the Funding for Lending Scheme that started in August. Further easing remains a distinct possibility, although there is a developing consensus that it is becoming less effective.

2.3 The US Federal Reserve has responded to the slowdown in growth and employment with large scale asset purchases of $40bn a month until the outlook for the labour market improves substantially. The US public finance 'fiscal cliff' nevertheless remains a serious risk unless a political solution is reached soon.

2.4 Interest rate forecasts
The Council's treasury management adviser, Arlingclose, believes that it could be 2016 before official UK interest rates rise. The US Federal Reserve has signalled it will keep interest rates "at exceptionally low levels" until at least 2015. Together with the UK's safe haven status, the minimal prospect of short-term rate rises means that gilt yields are expected to remain near their current lows.

2.5 *Arlingclose central interest rate forecast – November 2012*

	Bank Rate	3 month LIBID	12 month LIBID	20-year gilt yield*
Current	0.50	0.40	1.09	2.71
Q4 2012	0.50	0.55	1.10	2.80
Q1 2013	0.50	0.55	1.10	2.80
Q2 2013	0.50	0.60	1.25	2.80
Q3 2013	0.50	0.60	1.25	2.80
Q4 2013	0.50	0.60	1.25	2.80
H1 2014	0.50	0.70	1.40	2.90
H2 2014	0.50	0.75	1.40	2.90
H1 2015	0.50	0.75	1.40	3.00
H2 2015	0.50	0.75	1.40	3.00

* The Council can currently borrow from the PWLB at 1% above gilt yields

2.6 *HM Treasury Survey of Forecasts – November 2012*

	Average annual Bank Rate %			
	2013	2014	2015	2016
Highest	0.60	1.60	2.80	3.60
Average	0.50	0.65	1.30	1.80

3. Current and Expected Treasury Portfolios

3.1 <u>Current portfolio</u>

The Council's treasury portfolio as at 31st December 2012 was as follows.

		Principal Amount £m	Interest Rate %
Investments	- maturing 2012/13	0.0	
	- maturing 2013/14	0.0	
	- maturing later	0.0	
Total Investments		0.0	
Debt	- maturing 2012/13	0.0	-
	- maturing 2013/14	5.0	0.55%
	- maturing later	56.9	3.48%
Total Debt		61.9	0.55 – 3.48%
Net Debt		61.9	

3.2 <u>Expected changes</u>

According to current cash flow forecasts, net borrowing is expected to increase by £5 million by 31st March 2013. The future cash flow forecast includes planned borrowing of £4.4 million as part of the 2013/14 capital programme. The decision of whether to take external long-term borrowing will be made in light of current and forecast interest rates.

3.3 <u>Budget implications</u>

The net budget for interest payments in 2013/14 is £139,000 in respect of the General Fund. The HRA covers the interest costs relating to the long term borrowing of £56.9 million. 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 small surplus funds, which represent income received in advance of expenditure plus balances and reserves held. Much of the Council's cash has been used to reduce the amount of debt taken on during the current financial year. 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 limit[1]	Time limit
UK owned banks and building societies holding short-term credit ratings no lower than F1+ and P-1	£3m each	12 months
Foreign owned banks that deal in sterling holding short-term credit ratings no lower than F1+ and P-1	£2m each	6 months
UK owned banks and building societies holding short-term credit ratings no lower than F1 and P-1	£3m each	3 months
Money market funds[2] and similar pooled vehicles holding the highest possible credit ratings (AAA)	£3m each	3 months
UK Central Government	no limit	12 months
UK Local Authorities[3]	£3m each	12 months

[1] banks within the same group ownership are treated as one bank for limit purposes
[2] as defined in the Local Authorities (Capital Finance and Accounting) Regulations 2003
[3] 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 £3 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

4.5 Non specified Investments

- No non specified investments will be made by the Council.

4.6 Foreign countries

Investments in foreign countries will be limited to those that hold a AAA or AA+ sovereign credit rating from all three major credit rating agencies, and to a maximum of £3 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 by 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 2013/14 – 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 three months. 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 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. Although these are essentially cash, a monetary limit in line with the banks credit rating is retained on the accounts. The Council will also make use of the Government's Debt Management Office to ensure the highest possible security for cash. 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. There is no limit on the account, 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. Borrowing Strategy

6.1 The Council's capital financing requirement (CFR, or underlying need to borrow) as at 31st March 2013 is expected to be £89.4 million, and is forecast to rise to £93.8 million by March 2014 as capital expenditure is incurred.

6.2 The maximum expected long-term borrowing requirement for 2013/14 is:

	£m
Not borrowed in previous years	32.5
Long term borrowing	56.9
Forecast increase in CFR	4.4
Loans maturing in 2011/12	0.0
TOTAL	**93.8**

6.3 The Council made a one-off payment on 28 March 2012, to buy itself out of the HRA subsidy system. The final settlement figure of £56.884 million was confirmed in February 2012. The amount was borrowed from the Public Works Loans Board over a 50 year period and is repayable on maturity at the end of the loan term. The interest rate was 3.48% fixed for the term of the loan.

6.4 However, to reduce risk and minimise cost, it has been decided to defer borrowing until later years, and to reduce the size of the Council's investment balance instead.

6.5 In addition, the Council will borrow for short periods of time (normally up to one year) to cover cash flow shortages. Currently the Council has outstanding borrowing of £5 million, which was taken for a period of one year at 0.55%.

6.6 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.

6.7 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.

6.8 Borrowing strategy to be followed

With short-term interest rates currently much lower than long-term rates, it continues 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.

7. Policy on Use of Financial Derivatives

7.1 Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans).

7.2 The Localism Bill 2011 includes a general power competence that removes the uncertain legal position over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment). The latest CIPFA Code requires authorities to clearly detail their policy on the use of derivatives in the annual strategy.

7.3 The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

7.4 Derivative counterparties

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

7.5 In reality, whilst the Council is required to include the above policy, it is highly unlikely that the Council will engage in such activity.

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 Arlingclose, who have taken over 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. 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, and
- training courses.

The quality of the advisory service is monitored by the Assistant Director Finance.

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 Arlingclose 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.

ASSISTANT DIRECTOR FINANCE
JANUARY 2013