EXETER CITY COUNCIL

SCRUTINY COMMITTEE - RESOURCES
26 JANUARY 2011

EXECUTIVE
8 FEBRUARY 2011

COUNCIL
22 FEBRUARY 2011

TREASURY MANAGEMENT STRATEGY REPORT 2011/12

1. PURPOSE OF THE REPORT

1.1 To seek adoption by the Council of the Treasury Management Strategy Report, incorporating the Annual Investment Strategy 2011/12, as required under section 15(1)(a) of the Local Government Act 2003 and to seek adoption of revised clauses in respect of Treasury Management as part of the Council's Financial Regulations.

2. BACKGROUND

2.1 In February 2004 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 2009, CIPFA updated the guidance and require the adopted clauses from 2004 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 Strategy has been extended to form an overall Treasury Management Strategy as required by the CIPFA Treasury Management Code of Practice. The Council has taken the decision to disinvest the Externally Managed Fund and to use the investments to reduce overall borrowing. This has been reflected in the new strategy. Investments with the highest rated UK banks and local authorities have been increased to £3m per institution (or group of institutions).

4. CLAUSES TO BE FORMALLY ADOPTED

4.1 The following clauses to be adopted and replace section 13 of Financial Regulations:

1. The Council will create and maintain, as the cornerstones for effective treasury management :
   - a treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities
   - suitable treasury management practices (TMPs), setting out the manner in which the Council will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

   The content of the treasury management policy statement and TMPs will follow the recommendations contained in Sections 6 and 7 of the Code, subject only to amendment where necessary to reflect the particular circumstances of Exeter City

Council. Such amendments will not result in a material deviation from the Code's key principles.

2. The Council's Executive will receive reports on its treasury management policies, practices and activities, including, as a minimum:

   - An annual treasury management strategy including as a minimum an annual strategy and plan in advance of the year
   - A mid-year review
   - An annual report after the end of the financial year in the form prescribed in the TMPs.

3 The Council delegates responsibility for the implementation and monitoring of its treasury management policies and practices to the Executive, and for the execution and administration of treasury management decisions to the Head of Treasury Services, who will act in accordance with the Council's policy statement and TMPs and, if a CIPFA member, with CIPFA's Standard of Professional Practice on Treasury Management.

4. The Council designates Scrutiny Committee – Resources to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

5. RISKS INVOLVED

5.1 The economic conditions of the past 18 months have demonstrated the risks involved in treasury management. The Council is still awaiting the final outcome of the winding up process of the Icelandic Banks and has strengthened our lending criteria substantially since then.

6. CONCLUSIONS

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

7. RECOMMENDATIONS

7.1 That Scrutiny and Executive support and Executive recommend to Council the adoption of the new Treasury Management clauses for inclusion in Financial Regulations and the Treasury Management Strategy and delegations contained therein.

HEAD OF TREASURY SERVICES

CORPORATE SERVICES DIRECTORATE

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 2011/12

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 The strength of the UK economy's recovery from recession has surprised analysts and policymakers alike. A 2.0% increase in the six months to September left gross domestic product 2.8% higher than a year ago. Economic activity has been boosted by three main factors: the exceptionally loose stance of monetary policy, the lower value of sterling and the recovery in international trade. With exports cheaper because of the depreciation of sterling, the recovery in global trade has primarily benefited the manufacturing sector.

2.2 Despite the recession, inflation has remained high. The annual change in the consumer price index increased to 3.2% in October, and has been above the 2% target for 36 of the past 45 months. A number of factors have boosted consumer price inflation. The resumption of the 17.5% VAT rate, a rise in commodity prices and higher import prices due to the past depreciation of sterling have acted to offset the effect from weaker domestic demand.

2.3 The current factors boosting inflation are considered temporary by members of the Bank of England's Monetary Policy Committee (MPC) and not representative of the underlying demand and supply situation. Inflation is expected to remain above target throughout 2011, but fall below target in 2012 as the effect of these temporary factors wanes. This outlook is driven by the expectation that potential supply comfortably exceeds demand, and that this significant margin of spare capacity will bear down on pricing pressure. The continuing poor availability of credit and forthcoming fiscal tightening are expected to weigh on domestic demand throughout the forecast period.

2.4 The outlook suggests the MPC will look to maintain the current level of monetary policy to support demand in the face of potential difficulties. Our advisor's central forecast is for Bank Rate to remain at 0.5% for most of 2011, and although rising thereafter, remaining below "normal" levels until 2013. Longer-term interest rates are likely to rise slowly as the economic situation improves and government borrowing increases, but the rate of increase will be tempered by the coalition government's austerity measures and the fact that UK government debt is still considered to be a safe investment.

2.5 The high level of uncertainty surrounding the economic and political outlook means there are substantial risks on both sides of the economy. The speed of interest rate rises depends on the recovery in domestic demand, which in turn depends on private sector confidence and the strength of the global economy. Long-term rates may rise more significantly if investors risk appetite increases due to faster economic growth or, if planned spending cuts undershoot expectations, the government loses investor confidence. Equally rates could fall in the event of a sovereign default or non-financial event, as long as the UK retains its safe haven status.

2.6 *Sterling Consultancy Services central interest rate forecast – November 2010*

	Bank Rate	1 month LIBOR	3 month LIBOR	12 month LIBOR	25 year PWLB
Current	0.50	0.57	0.74	1.47	5.26
Q1 2011	0.50	0.60	0.80	1.60	5.45
Q2 2011	0.50	0.60	0.90	2.00	5.55
Q3 2011	0.50	0.60	1.00	2.50	5.65
Q4 2011	1.00	1.10	1.50	2.75	5.75
H1 2012	2.00	2.10	2.50	3.50	5.85
H2 2012	3.00	3.10	3.50	4.25	5.95
H1 2013	4.00	4.10	4.50	5.00	6.05

2.7 *HM Treasury Survey of Forecasts – November 2010*

	Average annual Bank Rate %			
	2011	2012	2013	2014
Highest	1.8	3.1	3.6	4.5
Average	0.7	1.5	2.5	3.1
Lowest	0.5	0.5	0.6	1.2

3. Current and Expected Treasury Portfolios

3.1 Current portfolio

The Council's treasury portfolio as at 31st December 2010 was as follows.

		Principal Amount £m	Interest Rate %
Investments	- maturing 2010/11	1.9	0.71 - 0.73%
	- maturing 2011/12	6.1	0.95 -1.45%
	- maturing later	0	-
Total Investments		8.0	0.71 – 1.45%
Debt	- maturing 2010/11	0	-
	- maturing 2011/12	10.0	0.75 – 0.80%
	- maturing later	0	-
Total Debt		10.0	0.75 – 0.80%
Net Debt		2.0	

3.2 Expected changes

According to current cash flow forecasts, net investments are expected to reduce by £8 million by 31st March 2011 and remain very low by 31st March 2011, as a result of capital expenditure using up the money withdrawn from Investec.

The cash flow forecast includes planned borrowing of £7 million as part of the 2011/12 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 interest payments in 2011/12 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 small surplus funds, which represent income received in advance of expenditure plus balances and reserves held. Much of the Council's reserves have 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, or with a major UK subsidiary[2] banks and building societies holding short-term credit ratings no lower than F1+ and P-1	£3m 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)	£3m each	1 week
UK Central Government	no limit	12 months
UK Local Authorities[4]	£3m each	12 months

[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 £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 2011/12 – 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. Although these are essentially cash, a limit of £3 million is retained on the accounts. 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 currently holds no long-term loans. The Council's capital financing requirement (CFR, or underlying need to borrow) as at 31st March 2010 is expected to be £19.4 million, and is forecast to rise to £26.5 million by March 2011 as capital expenditure is incurred.

6.2 The maximum expected long-term borrowing requirement for 2011/12 is:

	£m
Not borrowed in previous years	19.4
Forecast increase in CFR	7.1
Loans maturing in 2010/11	0.0
TOTAL	**26.5**

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

6.4 In addition, the Council may borrow for short periods of time (normally up to one month) to cover unexpected cash flow shortages.

6.5 <u>Sources of borrowing</u>
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.

6.6 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.

6.7 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. Treasury Management Prudential Indicators

7.1 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.

8. Other Matters

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

8.2 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. 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 Head of Treasury Services.

8.3 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.

8.4 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.

9. Investment Reports

9.1 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 2011