

**EXETER CITY COUNCIL**  
**SCRUTINY COMMITTEE - RESOURCES**  
**22 JANUARY 2014**

**EXECUTIVE**  
**4 FEBRUARY 2014**

**COUNCIL**  
**25 FEBRUARY 2014**

**TREASURY MANAGEMENT STRATEGY REPORT 2014/15**

**1. PURPOSE OF THE REPORT**

- 1.1 To seek adoption by the Council of the Treasury Management Strategy Report, incorporating the Annual Investment Strategy 2014/15, 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. KEY ISSUES TO BE CONSIDERED**

- 3.1 This is a statutory Strategy to be adopted and the key issues to be considered are:
- Section 4.3 sets the limits on the value of investments to be held by any one institution and the type of institution that can be used. The only change from the current strategy is a proposal to increase the amount held in a money market fund and that lent to an Upper Tier Local Authority from £3 million to £5 million. This reflects the fact that in a Money Market Fund, the funds are spread across a range of institutions and therefore risk is spread. It will also allow the Council to access a higher interest rate on the investments. In respect of Upper Tier Local Authorities, the risk of default is considered to be very low.
  - Section 3 sets out the current levels of borrowing and investments, along with the estimated changes and the financial impact for the year on both the General Fund and HRA.
  - Sections 5 and 6 set out the planned strategy for the year, which Council must be satisfied meets their objectives and is in line with the level of risk they are comfortable to take.

#### **4. RISKS INVOLVED**

- 4.1 The investment limits are designed to reduce risk as far as possible, however with any investments there is a risk of default. The Council minimises this risk by keeping borrowing as low as possible and therefore the amount available for investment low. Investments tend to be in immediate access accounts, or short term (less than three months). The risk of keeping borrowing short term is that rates will rise causing the Council to lock into higher interest rates over the long term.

#### **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

## EXETER CITY COUNCIL

## TREASURY MANAGEMENT STRATEGY 2014/15

**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 past year has seen an improvement in growth in the UK economy, alongside a reduction in inflation back towards the target of 2%. However, the Bank of England has also stated that it will not consider raising interest rates until unemployment levels fall below 7% (currently 7.4%). The Bank is forecasting that this may not occur until 2016.

- 2.2 Although the credit risk in respect of banks has reduced, the plight of the Co-op is a timely reminder that risks remain within the financial services sector.

**2.3 Interest rate forecasts**

The Council's treasury management adviser, Arlingclose, believes that it could be late 2016 before official UK interest rates rise. However they also forecast that gilt yields (which PWLB rates are linked to) will rise by between 0.7 and 1.1% over that period.

**2.4 *Arlingclose central interest rate forecast – December 2013***

	Bank Rate	20-year gilt yield*
Q1 2014	0.50	3.25
Q2 2014	0.50	3.30
Q3 2014	0.50	3.35
Q4 2014	0.50	3.40
H1 2015	0.50	3.50
H2 2015	0.50	3.65
H1 2016	0.50	3.85
H2 2016	0.50	4.15

\* The Council can currently borrow from the PWLB at 0.80% above gilt yields

### 3. Current and Expected Treasury Portfolios

#### 3.1 Current portfolio

The Council's treasury portfolio as at 31<sup>st</sup> December 2013 was as follows.

	Principal Amount £m	Interest Rate %
Investments - maturing 2013/14	7.0	Approx 0.40%
- maturing 2014/15	0.0	
- maturing later	0.0	
<b>Total Investments</b>	<b>7.0</b>	
Debt - maturing 2013/14	5.0	-
- maturing 2014/15	10.0	0.45% - 0.55%
- maturing later	56.9	3.48%
<b>Total Debt</b>	<b>71.9</b>	<b>0.45% – 3.48%</b>
<b>Net Debt</b>	<b>64.9</b>	

#### 3.2 Expected changes

According to current cash flow forecasts, net borrowing is expected to increase by £5 million by 31<sup>st</sup> March 2014. The future cash flow forecast includes planned borrowing of £4.4 million as part of the 2014/15 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 Budget implications

The net budget for interest payments in 2014/15 is £125,000 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 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 the 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.

<b>In-house investment</b>	<b>Monetary limit<sup>1</sup></b>	<b>Time limit</b>
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 <sup>2</sup> and similar pooled vehicles holding the highest possible credit ratings (AAA)	£5m each	3 months
UK Central Government	no limit	12 months
UK Local Authorities <sup>3</sup> Upper Tier Lower Tier	£5m each £3m each	12 months 12 months

<sup>1</sup> banks within the same group ownership are treated as one bank for limit purposes

<sup>2</sup> as defined in the Local Authorities (Capital Finance and Accounting) Regulations 2003

<sup>3</sup> 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 £5 million. For an individual bank, the limit is £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 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 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 minimised. 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), money market funds (Ignis and CCLA) 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, operate an immediate access call 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. On occasion, where significant payments are to be made, there may be in excess of £3 million in this account.

## 6. Borrowing Strategy

6.1 The Council's capital financing requirement (CFR, or underlying need to borrow) as at 31<sup>st</sup> March 2014 is expected to be £92.7 million, and is forecast to rise to £95.5 million by March 2015 as capital expenditure is incurred.

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

	£m
Not borrowed in previous years	34.2
Long term borrowing (HRA)	56.9
Forecast increase in CFR	4.4
Loans maturing in 2012/13	0.0
<b>TOTAL</b>	<b>95.5</b>

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 on the General Fund, 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 £15 million, which was taken in three tranches for a period of one year at 0.45%, 0.50% and 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, the only type of transaction used is the forward deal, which means the Council agrees to borrow funds at a set price for a set period, in advance of the date the loan is actually taken. This is done to ensure the availability of funds at the time that they are needed.



## **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.