

EXETER CITY COUNCIL

REPORT TO: SCRUTINY COMMITTEE – RESOURCES
EXECUTIVE
COUNCIL

DATE OF MEETING: RESOURCES – 27 JANUARY 2016
EXECUTIVE – 19 FEBRUARY 2016
COUNCIL – 23 FEBRUARY 2016

REPORT OF: ASSISTANT DIRECTOR FINANCE
TITLE: TREASURY MANAGEMENT STRATEGY REPORT 2016/17

Is this a Key Decision?

No

Is this an Executive or Council Function?

Council

1. What is the report about?

To seek adoption by the Council of the Treasury Management Strategy Report, incorporating the Annual Investment Strategy 2016/17, as required under section 15(1)(a) of the Local Government Act 2003.

2. Recommendations:

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

3. Reasons for the recommendation:

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 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.

The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

4. What are the resource implications including non financial resources

There are no financial or non financial resource implications.

5. Section 151 Officer comments:

The Treasury Management Strategy forms an integral part of the Council's financial management. The request to add property funds to the list of approved investments would enable the Council to further diversify its portfolio and deliver a long term income to the Council.

6. What are the legal aspects?

In February 2012 the Council adopted the updated *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. Adoption of the Code is required by regulations laid under the Local Government Act 2003.

7. Monitoring Officer's comments:

The Monitoring Officer comments have not been obtained.

8. Report Details:

8.1 Key issues to be considered

8.2 This is a statutory Strategy recommended for adoption by full Council. The key issues to be considered are:

- An amendment to the In-house investment strategy (Section 5) which is authorising to invest in property funds. Section 5.3 provides a background to property funds and the potential rate of return.
- 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 2015/16 strategy increased the amount the Council can lend to UK owned banks or building societies from £3 million to £4 million and increased amount that can be lent to foreign owned banks that deal in sterling from £2 million to £3 million.
- The changes enabled the Council to access a higher interest rate on the investments, which is generally the case with larger value investments.
- There are no proposed amendments to the lending limits for UK owned banks or building societies or foreign owned banks that deal in sterling in the 2016/17 strategy.
- 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.

9. How does the decision contribute to the Council's Corporate Plan?

Treasury Management supports the Council in generating additional funds for investing in Services, whilst minimising the amount of interest paid on borrowings. It does not in itself contribute to the Council's Corporate Plan.

10. What risks are there and how can they be reduced?

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.

11. What is the impact of the decision on equality and diversity; health and wellbeing; safeguarding children, young people and vulnerable adults, Economy safety and the environment?

No impact.

12. Are there any other options?

No.

Paul Matravers, Principal Accountant
Dave Hodgson, Assistant Director Finance

Local Government (Access to Information) Act 1972 (as amended)
Background papers used in compiling this report: None

APPENDIX A

EXETER CITY COUNCIL

TREASURY MANAGEMENT STRATEGY 2015/16

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 Domestic demand has grown robustly, supported by sustained real income growth and a gradual decline in private sector savings. Low oil and commodity prices were a notable feature of 2015, and contributed to annual CPI inflation falling to 0.1% in October. Wages are growing at 3% a year, and the unemployment rate has dropped to 5.4%. Mortgage approvals have risen to over 70,000 a month and annual house price growth is around 3.5%. These factors have boosted consumer confidence, helping to underpin retail spending and hence GDP growth, which was an encouraging 2.3% a year in the third quarter of 2015. Although speeches by the Bank of England's Monetary Policy Committee (MPC) members sent signals that some were willing to countenance higher interest rates, the MPC held policy rates at 0.5% for the 81st consecutive month at its meeting in November 2015.

2.2 Interest rate forecasts

The Authority's treasury advisor Arlingclose projects the first 0.25% increase in UK Bank Rate in the third quarter of 2016, rising by 0.5% a year thereafter, finally settling between 2% and 3% in several years' time. Persistently low inflation, subdued global growth and potential concerns over the UK's position in Europe mean that the risks to this forecast are weighted towards the downside.

2.3 *Arlingclose central interest rate forecast – December 2015*

| Period | Bank Rate | 20-year PWLB rate |
|-----------|-----------|-------------------|
| Dec 2015 | 0.50 | 3.25 |
| Mar 2016 | 0.50 | 3.30 |
| June 2016 | 0.50 | 3.35 |
| Sept 2016 | 0.75 | 3.35 |
| Dec 2016 | 0.75 | 3.40 |
| Mar 2017 | 1.00 | 3.45 |
| June 2017 | 1.00 | 3.50 |
| Sept 2017 | 1.25 | 3.55 |
| Dec 2017 | 1.25 | 3.60 |
| Mar 2018 | 1.50 | 3.65 |
| Jun 2018 | 1.50 | 3.70 |
| Sept 2018 | 1.75 | 3.75 |
| Dec 2018 | 1.75 | 3.75 |

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

Current and Expected Treasury Portfolios

3.

3.1 Investments

3.2 The Council's current investments as at 31st December 2015 was as follows:

UK Owned Banks

| Amount | Investment | Interest rate |
|------------|------------|---------------|
| £3,000,000 | Barclays | 0.30% |

Foreign Owned Banks

| Amount | Investment | Interest rate |
|------------|---------------|---------------|
| £2,000,000 | Handelsbanken | 0.35% |

Money Market Funds

| Amount | Investment | Interest rate |
|------------|--|---------------|
| £3,000,000 | Amundi Asset Management | 0.48% |
| £2,000,000 | Blackrock | 0.38% |
| £5,000,000 | Standard Life Liquidity Funds (formerly Ignis) | 0.44% |

Fixed Term Deposits

| Amount | Investment | Interest rate |
|------------|--------------------------------|---------------|
| £2,000,000 | Commonwealth Bank of Australia | 0.53% |

Borrowings

3.3

The Council's short term borrowing is currently £5m, this will increase to £10m with effect from 1 February 2016. Long term borrowing remains at £56.884m. Details of the loans are set out below.

Existing Loans

| Amount | Lender | Interest rate | Date of repayment |
|------------|---|---------------|-------------------|
| £5,000,000 | Police & Crime Commissioner for West Midlands | 0.65% | 25/02/2016 |
| 56,884,000 | PWLB | 3.48% | 28/03/2062 |

Future Loan

| Amount | Lender | Interest rate | Date of repayment |
|-------------|----------------------------|---------------|-------------------|
| £10,000,000 | Oxfordshire County Council | 0.98% | 01/02/2018 |

3.4 Expected changes

According to current cash flow forecasts, net borrowing is expected to remain at £10 million on 31st March 2016. The future cash flow forecast includes planned borrowing of £4 million as part of the 2016/17 capital programme. The decision of whether to take external long-term borrowing will be made in light of current and forecast interest rates.

3.5 Budget implications

The net budget for interest payments in 2016/17 is £300,000 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.

| In-house investment | Monetary limit¹ | Time limit |
|---|-----------------------------------|-------------------|
| UK owned banks and building societies holding short-term credit ratings no lower than F1+ and P-1 | £4m each | 12 months |
| Foreign owned banks that deal in sterling holding short-term credit ratings no lower than F1+ and P-1 | £3m 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) | £5m each | 3 months |
| UK Central Government | no limit | 12 months |
| UK Local Authorities ³ | | |
| Upper Tier | £5m each | 12 months |
| Lower Tier | £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 £5 million. For an individual bank, the limit is £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

- 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 2016/17 – 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 (Standard Life, Blackrock, Federated, Amundi 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 will hold a balance on its general account to cover any payments due. On occasion, where significant payments are to be made, there may be in excess of £3 million in this account.
- 5.4 The 2016/17 strategy is requesting approval to allow investments to be made in property funds. Such funds are pooled investment products and are accessed on a traded share basis rather than a fixed cash deposit sum. The investment in the property fund would be a long term commitment which will mean that there will be fluctuations in the return over the period of the investment.

The council would be looking to place investments of up to £5m with the Local Authorities Property Fund, (managed by the CCLA). The CCLA provide a range of pooled money market funds, some of which are created specifically for the public sector and cover asset classes such as Equities, Bond, Property or Cash. The property related asset class of the CCLA property fund has achieved a rate of return of approximately 7-8% over recent years.

Members will be assured that although the CCLA does not have any form of rating or financial support criteria awarded to it, something which is currently required for all other investments, the organisation was established in 1958 and has a strong approach to stewardship and ethics.

The council's treasury advisers, Arlingclose Ltd are entirely comfortable with, and recommend, the CCLA property fund and currently have numerous other clients who invest with the organisation.

6. Borrowing Strategy

6.1 The Council's capital financing requirement (CFR, or underlying need to borrow) as at 31st March 2016 is expected to be £97.4 million, and is forecast to rise to £101.4 million by March 2017 as capital expenditure is incurred.

6.2 The maximum expected long-term borrowing requirement for 2016/17 is:

| | £m |
|--------------------------------|--------------|
| Not borrowed in previous years | 40.6 |
| Long term borrowing (HRA) | 56.9 |
| Forecast increase in CFR | 3.9 |
| Loans maturing in 2015/16 | 0.0 |
| TOTAL | 101.4 |

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 two years) to cover cash flow shortages.

Currently the Council has outstanding borrowing of £5 million, which was taken for a period of one year at a rate of 0.65%. A loan of £10 million has been agreed and will replace the current £5 million. The £10 million has been borrowed for a period of 2 years at a rate of 0.98%.

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, or to borrow short-term loans. 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.

If required, the council may arrange forward starting loans during 2016/17, where the interest rate is fixed in advance, but the cash is received in a later period.

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 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 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.

Paul Matravers, Principal Accountant
Dave Hodgson, Assistant Director Finance

Local Government (Access to Information) Act 1972 (as amended)
Background papers used in compiling this report:

None

Contact for enquiries:
Democratic Services (Committees), Room 2.3, (01392) 265275