Leicester City Council

WARDS AFFECTED: ALL WARDS (CORPORATE ISSUE)

PERFORMANCE AND VALUE FOR MONEY SELECT COMMITTEE **2 MARCH 2011**
CABINET **7 MARCH 2011**

TREASURY STRATEGY 2011/12

Report of the Chief Financial Officer

1. Background

1.1 Treasury management is the process by which the Council's borrowing and investments are managed. This is a vital activity because of the sums involved.

1.2 As at 14th January 2011, the Council's debt was £260 million, which has been raised to pay for capital projects over many years. This level of indebtedness should, however, be seen in the light of the value of the Council's assets which were recorded at the end of 2010/2011 at a value of £2,266 million (ie £2 billion).

1.3 The Council also holds a lot of externally invested cash, which stood at £78million as at 14th January 2011. These investments represent working cash balances (the extent to which the Council receives income before it has to pay bills) and the Council's reserves.

1.4 It is the responsibility of the Cabinet to approve the treasury strategy and it receives a report at the beginning of each year identifying how it is proposed to borrow and invest in the light of capital spending requirements, interest rate forecasts and economic conditions. Monitoring of the implementation of the treasury strategy is the responsibility of the Performance and Value for Money Select Committee, and reports are received twice each year together with a monthly briefing on investments.

1.5 This treasury management strategy details the expected activities of the treasury function in the financial year 2011/2012. The suggested strategy for 2011/2012 is based upon my views of interest rates, which are supported by the use of leading market forecasts. The strategy covers the matters listed below:

i. the Council's current debt and investments;
ii. prospects for interest rates;

iii. capital borrowing required;
iv. investment strategy;
v. the balance between holding investments and using them to repay debt (or as a substitute for new borrowing);
vi. debt rescheduling opportunities;

1.6 The key factors to consider are:

i. How much new borrowing will cost. Members are asked to note that interest rates for borrowing over a long period of time are different from rates for borrowing over a short period.
ii. Ensuring the Council has an appropriate balance of debt at fixed and variable interest rates, so we are protected against market changes.
iii. How much interest the Council can get on its investments.
iv. Ensuring the security of investments.
v. When loans are due to be repaid and how much it is likely to cost to refinance them at that time.
vi. Government initiatives which impact on borrowing and investment decisions.

2. **Recommendations**

2.1 PVFM Select Committee is recommended:-

* Note the proposed treasury strategy and to make any comments or recommendations to the Cabinet.

2.2 Cabinet is recommended:-

* To approve this treasury strategy.

3. **Current Portfolio Position**

3.1 The Council's current debt and investment position is shown in the table below. Members are asked to note that the figures shown represent a snapshot at a single moment in time. The table excludes £34M of debt managed by the County Council on behalf of the City Council.

Treasury Position As At 14th January 2011	**Amount**
Fixed Rate Funding	
Public Works Loan Board	£155m
Stock	£9m
Market Loans	£96m
Total Debt	£260m

Investments	£78m
Net Debt	£182M

4. **Treasury Limits For 2011/2012**

4.1 The Treasury Strategy includes a number of prudential indicators required by CIPFA's Prudential Code for capital finance, the purpose of which is to ensure that treasury management decisions are affordable and prudent. The recommended indicators and limits are shown below. One of these indicators, the "authorised limit" (para 4.3 below) is a statutory limit under the Local Government Act 2008 and will be set by the full Council as part of the budget. The other indicators are part of this treasury strategy which is approved by the Cabinet.

4.2 The first indicator is that over the medium-term net borrowing will only be for capital purposes – ie net borrowing should not, except in the short-term, exceed the underlying need to borrow for capital purposes (the "capital financing requirement"). Authorities may, however, borrow to pre-fund capital requirements up to two years ahead. We do not anticipate any difficulties in complying with this requirement.

4.3 The Council is required to set an "authorised limit" on borrowing which cannot be exceeded. The proposed limits are:

	2011/12 £m	2012/13 £m	2013/14 £m
Borrowing	400	400	400
Other forms of liability	35	35	35
Total	435	435	435

4.4 The Council is also required to set an "operational boundary" on borrowing and other forms of long-term liability, which requires a subsequent report to scrutiny committee if exceeded:

2011/12 £370m
2012/13 £400m
2013/14 £400m

4.5 Limits have also to be set on the Council's interest rate exposure and recommended upper limits on fixed and variable rate debt exposures are shown in the table below. Variable rate loans includes all loans where the lender has an option to vary the interest rate chargeable.

	2011/12 £m	2012/13 £m	2013/14 £m

Fixed interest rate	280	300	300
Variable interest rate	145	145	145

4.6 The Council has also to set upper and lower limits for the remaining length of outstanding loans that are fixed rate as a percentage of the total of all such loans. Recommended limits are:

Upper Limit

	%
Under 12 months	30
12 months and within 24 months	40
24 months and within 5 years	60
5 years and within 10 years	60
10 years and within 25 years	100
25 years and within 50 years	100
Above 50 years	20

Lower Limit

	%
Less than 5 years	5
Over 5 years	60

4.7 The upper limit for principal sums invested for more than 364 days is £50m for 2011/12 and subsequent years. In the present investment climate, such investments would only be made in Government backed securities.

4.8 These indicators exclude Private Finance Initiative (PFI) schemes.

5. Prospects for Interest Rates

5.1 The Council retains Arlingclose as a treasury adviser to the Council and part of their service is to assist the Council to formulate a view on interest rates and these underpin the strategy.

5.2 The economic background to this report is the recovery of the UK and the world economy after the recession that followed the “credit crunch”, although there are risks that could yet derail this recovery.

5.3 Because of the recession, the Bank of England has left short-term interest rates at a record low of 0.5% for over a year. Arlingclose see rates starting to rise again in late 2011 and increasing to 3% by March 2014

5.4 The outlook for long-term interest rates is more uncertain. The Council’s primary source of long-term loans is the Public Works Loans Board (PWLB); a government body that lends money to local authorities at rates below normal market levels. Longer term-term rates are currently around 5.25%.

Arlingclose forecast that long-term rates will fluctuate over a range of 4.5% to 5.25% over the next three years. Borrowing is more expensive than it used to be, because the Government added a 1% premium to PWLB borrowing in the June budget.

5.5 There is a lot of uncertainty and a number of scenarios are considered in section 10 of this report.

6. <u>Capital Borrowings and Borrowing Strategy</u>

6.1 At the time of preparing this strategy the Council's capital programme has not been agreed. As capital will now be entirely grant funded this is not a major consideration and the treasury strategy is in any event based on known capital resources. Capital borrowing strategy is mainly based on a two-year time frame and drawing up a strategy for 2011/2012 requires consideration of the Council's capital financing needs for 2011/2012 and 2012/2013. The calculation of the total borrowing needs of the Council takes into account the following factors:

i. The sums the Council is required by law to "set aside" from revenue each year to repay its borrowings (or in lieu of new borrowings) - in much the same way as a homeowner repays a mortgage over a number of years;

ii. The need to repay maturing loans.

iii. Borrowing to support capital expenditure (unsupported borrowing).

6.2 The capital borrowing requirements of the Council can be met from the "set aside" sums and are not expected to generate a borrowing requirement.

6.3 One long-term loan of £13 million matures in 2013, but can be financed from existing cash balances.

6.4 The event most likely to trigger borrowing would be an a large outflow of funds over the financial planning period as grant streams come to an end and existing balances are spent.

6.5 If such an outflow of funds exceeded the existing level of cash balances then the Council would need to borrow (the balances have been used as an alternative to borrowing, and our actual borrowing is less than our underlying need to borrow).

6.6 This strategy envisages a borrowing requirement of £20 million in 2011/12 and a further £20 million in 2012/13 but it's possible that the run down of grant balances and reserves will not proceed as fast as expected.

6.7 If we borrowed in 2011/12 the rate of interest on any new loans is expected to be higher than short-term interest rates and hence we would be slow to borrow in advance of need, and would only do so when we expected a clear long-term benefit that justified the short-term cost.

7. **Debt Rescheduling & Premature Repayment of Debt**

7.1 Debt rescheduling is the premature repayment of loans with the repayment being financed by taking out new, cheaper, loans. Sometime we have to pay a penalty to repay a debt early but this may be worth paying if the interest rate on the new loan is sufficiently low. At other times we may be able to repay a loan at a discount. It is proposed that we undertake debt rescheduling if financially advantageous. The reasons for any rescheduling to take place will include:

i. the generation of savings at minimum risk; or

ii. in order to enhance the balance of the long-term portfolio (i.e. the dates of repayment and balance between fixed and variable interest rates).

7.2 When making decisions we will be guided by our expectation of future movements in interest rates but the situation will be continually monitored in order to take advantage of any perceived “tremors” in the market. To maximise the savings from debt rescheduling, replacement loans should be taken at low interest rates and when interest rates are expected to fall we would delay taking the replacement loan until this happened. In the interim, temporary finance would be found by raising a temporary loan or by using cash balances. Recent changes in PWLB rules mean rescheduling opportunities are far less common than they used to be.

7.3 The premature repayment of existing debt utilising cash investments may also be considered where financially attractive.

7.4 When considering the options for rescheduling, all the Council’s debts will be periodically examined in the light of current market conditions.

7.5 The Council also has market loans totalling £96 million and we may reschedule these if opportunities present.

7.6 At present it seems likely that any rescheduling in 2011/12 will be done as a risk reduction measure but, otherwise, favourable opportunities for cost reductions are unlikely to present in 2011/2012

8. **Investments**

8.1 This report outlines the investment strategy. Further details are given in the appendix, which sets the criteria that we apply to ensure that we only invest with borrowers of high credit worthiness. It also deals with measures to manage other key issues, for example ensuring access to liquid funds.

8.2 On 14th January the Council had investments of £78M. As previously stated we are expecting these funds to be drawn down as the Council spends the balances and uses them in lieu of borrowing.

8.3 In 2010/11 our lending was confined to the UK Government's Debt Management Office, other local authorities and the large UK Banks which were eligible for capital injections from the UK government during the "credit crunch". The latter factor is increasingly less significant as these support arrangements have now lapsed. and we need a new basis for our lending arrangements.

8.4 The proposed strategy raises the minimum long-term credit rating requirement from A to A+ (whilst maintaining the minimum short term rating requirement at F1). We also need to recognise that credit conditions have improved but are still far from normal. Thus we propose a slight relaxation of the criteria applied in 2010/11, but still intend to operate a stricter policy than we used to.

8.5 Under the 2011/12 strategy we willl take published credit ratings into account, but shall consider these alongside other considerations (where applicable) such as share price, the cost to investors of buying insurance against default and political and economic developments (especially those to do with the Eurozone). We propose to maintain a relatively small list of strong investment counterparties which it is practical for us to monitor regularly and in depth.

8.6 The lending list shall be maintained by the Treasury Manager taking into consideration advice and information from the Council's Treasury Advisors, Arlingclose, as well as on the basis of his own research. New counterparties shall not be added to the lending list until the CFO or his deputy has reviewed the proposed changes.

8.7 The general direction in which our lending list is moving is that our existing counterparties will remain but that we shall add a small number of strong banks, most likely those in the stronger European states.

8.8 We shall continue to report on this matter to the Performance and Value for Money Select Committee via six-monthly review reports and monthly briefing reports.

9.0 Credit Rating the City Council

9.1 Lenders are now being far more cautious in their lending decisions and whilst UK local authorities are seen as being highly credit worthy some will be seen as more credit worthy than others, and local authorities can no longer count on being automatically perceived as having the coveted AAA credit rating.

9.2 The credit rating of a local authority is unlikely to ever exceed that of the Government. Commentators generally think that its unlikely that the UK would lose its AAA credit rating but there are risks which can not be wholly discounted.

9.3 For these reasons it is possible that the Council might need to seek a credit rating during 2011/12 (including where this was done to faciliate borrowing in 2012/13). If a credit rating was sought the rationale would be that it would lower the cost of borrowing. We are confident that we would get a high credit rating, but it's not possible to assess whether we would get a AAA rating. Any decision to seek a credit rating would be taken by the CFO in consultation with members.

10. **Sensitivity of This Strategy**

10.1 This strategy is based on the view that the economic outlook for 2011/2012 and later years carries a number of significant risks.

10.2 Short-term interest rates are expected to rise and the main risk is that they rise faster and/or sooner than expected. Any borrowing decision made during 2011/12 will be a careful balancing act - at present long-term interest rates are significantly higher than short-term rates but long-term borrowing offers certainty. The key considerations are the medium term outlook for long-term and short-term interest rates (and the difference between the two) and the degree of uncertainty surrounding those projections.

10.3 There is uncertainty as to how fast we will use up earmarked grants and earmarked funds which are currently unspent. So long as such expenditure can be met from existing cash balances the revenue impact will be relatively low because of the very low interest rates paid on deposits.

10.4 The position will be monitored and if there were a need to borrow then we would seek to do this in the most cost effective way.

10.5 The Council has £96 million of market loans at favourable interest rates on which the lender has the right to periodically propose an interest rate increase. We have the option to refuse and to repay the loans, but would then have to borrow new loans at the prevailing interest rates. In a "reasonable but not extreme" worst case scenario the impact to the General Fund would be of the order of £350,000 but would be unlikely to impact on 2011/12 nor to impact substantially on 2012/13.

10.6 The funding of the Housing Revenue Account (HRA) will change in 2012/13 and details were recently announced of our proposed settlement. The main changes are that we will no longer receive Housing Subsidy grant but that £30 million of housing debt will be repaid by the Government (and this will reduce interest payments by the HRA). From 2012/13 the HRA will have its own pool of loans separate from those of the rest of the Council. We are still evaluating what implications, if any, these changes will have for borrowing decisions in 2011/12 and what impact they will have on the viability of any options that may present for the premature repayment of debt. The initial indications are that these changes will not impact substantially on borrowing and investment decisions during 2011/12 but we shall be exploring the implications further over the next few months.

10.7 Where, exceptionally, immediate action that does not comply with this strategy will benefit the Council such action will be taken, and will be reported to the next meeting of the Performance and Value for Money Select Committee.

11. Treasury Management Consultants

11.1 Since January 2008 the Council has employed Arlingclose as treasury advisors. The service provides advice on our borrowing and investment policies and strategies. The annual fee for this service is £20,000.

11.2 Whilst 2010/11 has been less turbulent than the preceding years there have been many challenges and Arlingclose's performance has been good.

12. Leasing

12.1 The Council is likely to acquire equipment, principally vehicles, to the value of approximately £2-3 million that would be suitable for leasing, though budget reductions could see that figure scaled back.

12.2 Before leasing is pursued consideration will be given to the options of finance leasing, operational leasing, and prudential borrowing. At present the difference between these forms of funding is marginal, and, generally, prudential borrowing is more cost effective. This judgement takes into account the costs of the two forms of finance over the expected economic life of the asset. In addition, because of lease termination charges it is more expensive to dispose of a leased vehicle than an owned vehicle, and this is important because the Council is reviewing the utilisation of the existing fleet.

13. Financial and Legal Implications

13.1 This report is solely concerned with financial issues. Peter Nicholls, Legal Services has been consulted as Legal Advisor and has confirmed that there are no legal issues arising from this report.

14. Climate Change Implications

14.1 This report does not contain any significant climate change implications and therefore should not have a detrimental effect on the Council's climate change targets - Helen Lansdown, Senior Environmental Consultant.

15. Other Issues

OTHER IMPLICATIONS	YES/NO	Paragraph References Within Supporting information
Equal Opportunities	No	
Policy	No	
Sustainable and Environmental	No	

Crime and Disorder	No	
Human Rights Act	No	
Elderly/People on Low Income	No	
Corporate Parenting	No	
Health Inequalities Impact	No	

16. **Background Papers**

16.1 Background information is available on the files of the Chief Financial Officer.

17. **Consultation**

17.1 Arlingclose Ltd.

18. **Author**

18.1 The author of this report is David Janes of the Resources Department on extension 7490

Mark Noble
Chief Finance Officer.

Key Decision	Yes
Reason	Is significant in terms of its effect on communities living or working in an area comprising more than one ward
Appeared in Forward Plan	Yes
Executive or Council Decision	Executive (Cabinet)

ANNUAL INVESTMENT STRATEGY 2011/2012

1. Introduction

1.1 This investment strategy complies with the DCLG's Guidance on Local Government Investments and CIPFA's Code of Practice.

1.2 The Investment Strategy states which investments the Council may use for the prudent management of its treasury balances during the remainder of the current financial year and in 2011/2012. It also identifies other measures to ensure the prudent management of investments.

2. Investment Objectives & Authorised Investments

2.1 All investments will be in sterling, although bank deposits in euros will be permitted when placed with our bankers for operational reasons such as the receipt and disbursement of grants receivable and payable in euros.

2.2 The overriding policy objective for the Council is the prudent investment of its balances. The Council's investment priorities are
(a) the **security** of capital and
(b) **liquidity** of its investments.

2.3 The council will aim to achieve the **optimum return** on its investments commensurate with the proper levels of security and liquidity.

2.4 The Council will not borrow monies purely to invest or on-lend.

2.5 The list of authorised investments is as follows: -

Short Term Investments

i. Deposits for periods up to one year with credit rated deposit takers (banks and building societies);
ii. Deposits for periods up to one year with other local authorities;
iii. Money Market Funds;
iv. Any deposit, bond, bill or other loan instrument with a maturity of up to one year which is issued by, or explicitly guaranteed by, the UK Government (including the Debt Management Office) or by a UK local authority.

Longer Term Investments

v. Deposits for periods in excess of one year with UK local authorities or which are explicitly guaranteed by the UK Government;

2.6 The Council will impose upper limits on the total amount of money, which shall be invested with each of these types of investments (in aggregate, not per institution) and these are: -

i. £60 million;
ii. Unlimited;
iii. £50 million;
iv. Unlimited;
v. Unlimited.

2.7 The following factors apply to both short-term and longer-term deposits.

i. Deposits may be for fixed terms or may be repayable at the option of the borrower and/or the lender and may or may not be negotiable
ii. Deposits may be agreed in advance that run from an agreed future date.
iii. For the purposes of applying the credit rating criteria laid down in this AIS, deposits agreed in advance shall be treated as running from the date they are agreed. However, where a deposit is agreed 10 or fewer working days in advance it shall be treated as running from the date the cash is deposited.
iv. Interest rates may be fixed at the outset or may be varied by agreement. They may also be varied by reference to market rates or benchmarks, provided that such rates or benchmarks are capable of independent verification.
v. A deposit to an organisation with an unconditional financial guarantee from a parent organisation shall be treated as if it were as a deposit with that parent organisation.
vi. Where an institution is part of a group then limits shall be set both at group level and at the level of the individual institution.

3. Security of Capital: The use of Credit Ratings

3.1 The CFO will maintain a list of approved counterparties, selected in line with the following criteria.

3.2 The Council utilises credit ratings published by Fitch Ratings. This section of the strategy proposes minimum credit rating requirements. In practice, only investments of the highest security will be made. Minimum credit rating criteria shall be as shown below: -.

i. For term deposits and callable deposits for periods of 1 year or less, a long-term rating of A+, a short term rating of F1
ii. For money market funds, and other commercial secured deposit facilities, a rating for the fund of AAA and a volatility rating of V1+

For (i) there is an additional requirement that there shall be a good prospect of support from a strong government (the government having an AA+ long-term rating) or well-resourced parent institution (minimum A+ credit rating). In addition for all categories of investments regard will be had to other sources of information including (where applicable) the price of Credit Default Swaps, share prices, developments, news, economic data and market sentiment.

3.3 No credit rating is required for investments issued by or subject to an explicit guarantee from the UK government.

3.4 The maximum sum to be deposited with individual counterparties shall be as shown below:

i. For money market funds and commercially secured deposit facilities - £10 million. We shall not normally take account of the underlying exposures to individual banks etc when considering our exposure against the other limits specified below unless such an approach materially improves the control of our credit exposure;
ii. For investments with, or explicitly guaranteed by the UK Government – unlimited;
iii. For deposits with UK local authorities £10 million;
iv. For deposits in banks and other institutions not guaranteed by the UK Government - £10 million.

3.5 Investments are also permitted on the basis of equivalent ratings issued by Moody's Investors Services or Standard and Poor's. In the absence of strong reasons to the contrary, decisions will be based on the lowest rating.

3.6 When applying these criteria it shall be assumed that investments shall be held to maturity. Where, however, the Council has an unqualified option to require the investment to be fully repaid at an earlier date, then for the purposes of applying these criteria it shall be assumed that the investment shall run until the earliest repayment date.

3.7 Credit ratings will be monitored:

i. All credit ratings for investments being actively used will be monitored monthly and credit rating alerts will be acted on as soon as practicable (the next working day or sooner);
ii. If a body is downgraded with the result that it no longer meets the Council's minimum criteria, the further use of that body will cease;
iii. A deterioratation in credit ratings will not automatically lead to a decision to terminate the investment prematurely (and in many cases there will be no contractual provision to permit this).
iv. If a counterparty is upgraded so that it fulfils the Council's criteria, its inclusion will be considered and put to the CFO for approval;
v. If other market intelligence suggests that credit ratings give an over-optimistic view of credit-worthiness, this will be taken into account.

3.8 The criteria specified above control the credit exposure to individual investments. We have procedures in place to monitor the country regulating the banks in which we invest - we monitor credit data at least once a month and take account of information in the financial press.At the time of writing this we are only directly investing in UK based and regulated banks but are considering extending the lending list to include some large, strong well capitalised banks regulated and/or domiciled in other countries. Investments in money market funds will also create an exposure to non-UK banks but this will only be monitored lightly because money market funds invest in a well diversified pool of investments.

4. <u>Investment balances / Liquidity of investments</u>

4.1 The minimum percentage of its overall investments that the Council will hold in short-term investments is 40% and the Council will maintain liquidity by having a minimum of £30m of deposits maturing within 2 months (subject to the availability of funds to invest). There is a regular monthly cycle to the Council's cashflow and these limits apply to the peak cash balance just ahead of the payday. These liquidity targets are guidelines and occasional and temporary deviations from these limits will be permitted on a planned basis where there are good reasons.

4.2 The Council is required to specify the maximum amount which can be prudently committed to longer-term investments (i.e. those with a maturity exceeding a year). On the current level of investments an appropriate limit would be £25m but a higher limit of £50m is being proposed in order to allow for the possibility that we borrow new long-term fixed rate loans in order to prefund future years' borrowing requirements.

5. <u>Investment Reports</u>

5.1 Reports will be prepared twice yearly as part of the reports on treasury management activity, and a monthly note is prepared for Select Committee members and the Cabinet lead for Finance.