Leicester
City Council

WARDS AFFECTED:
ALL WARDS (CORPORATE ISSUE)

OVERVIEW SELECT COMMITTEE **20th June 2019**

REVIEW OF TREASURY MANAGEMENT ACTIVITIES 2018/19

Report of the Director of Finance

1. **Purpose of Report**

1.1 This report reviews how the Council conducted its borrowing and investments during 2018/19.

1.2 2018/19 has seen continued economic growth in the UK and elsewhere. However, there are risks and these are discussed further in section 5.

1.3 We continue to monitor the impact of the “bail in” requirements whereby major depositors could be forced to inject funds into banks which are running into trouble, introduced earlier in the year. This is further discussed below.

2. **Summary**

2.1 Treasury management is the process by which our borrowing is managed, and our cash balances are invested. Whilst there are links to the budget, the sums in this report do not form part of the budget. To the extent that the Council has money it can spend, this is reflected in the annual budget report. Cash balances reported here cannot be spent, except to the extent shown in the budget report and accounts and revenue outturn report (elsewhere on your agenda).

2.2 The Council has incurred debt to pay for past capital expenditure

2.3 The Council also has cash balances. These are needed for day to day expenditure (e.g. to pay wages when they are due). A substantial proportion can only be used to repay debt but (because of Government rules) we have been unable to use them to repay debt. Thus, they are held in investments.

2.4 The report commences with an overview of treasury management, including loans and investments at key dates. It then reviews the credit worthiness of investments and implementation of our strategy, provides outcomes on key performance measures and concludes by reviewing compliance against limits set by the Council.

2.5 Reports reviewing treasury management activities are submitted twice a year. The previous report was presented to your committee on 13th December 2018.

3. Recommendations

3.1 Members of the Overview Select Committee are recommended to note the report and make comments to the Director of Finance and the Executive as they wish.

4. Overview of Treasury Management

Main elements of Treasury Management

4.1 There are two main elements to treasury management. The first is managing our borrowings which have been taken out to finance capital expenditure. Most capital schemes are now financed by grant, and only a limited number of schemes are financed by borrowing (generally those which pay for themselves). In the past the Government expected us to borrow but allowed for the cost of borrowing in our grant settlement, and we still have a lot of debt which was taken to meet this capital expenditure.

4.2 Historic debt can sometimes be restructured to save money, i.e. repaying one loan and replacing it with another and this is always given active consideration. In recent years, Government rule changes have normally made it prohibitively expensive to repay loans borrowed from the Public Works Loans Board. We have, however, prematurely repaid £51m of market loans having been offered favourable terms by the lender (this was reported in the previous, mid-year, report).

4.3 The revenue budget approved by the Council for each financial year includes provision for the interest payable on this borrowing. It also includes a provision for repaying the borrowing over a number of years (broadly speaking over the economic life of the assets acquired).

4.4 The second element is cash management which involves managing the Council's investments to ensure the optimum amount of money is in the bank account on a day-to-day basis – so that there is enough money in the account to cover the payments made on the day but no more (cash held in the bank account earns neglible interest).

4.5 The Council has substantial investments but this is not "spare cash". There are three reasons for the level of investments:-

(a) Whilst the Government no longer supports capital spending with borrowing allocations, we are still required to raise money in the budget each year to repay debt. Because of the punitive rules described above, we are not usually able to repay any debt, and therefore have to invest the cash;

(b) We have working balances arising from our day to day business (e.g. council tax received before we have to pay wages, and capital grants received in advance of capital spending);

(c) We have reserves, which are held in cash until we need to spend them. We expect reserves to fall over the next few years. The annual accounts for 2018/19 have been prepared and will detail the reserves of the Council.

Treasury Management Policy and Monitoring

4.6 The activities to which this report relates were governed by the Treasury Strategy for 2018/19 which was approved by the Council on 21st February 2018. This establishes an outline plan for borrowing and investment. The strategy for 2019/20 was approved by the Council on 20th February 2019 and governs treasury strategy from that point. The Treasury Strategy is drawn up in the light of the Council's expected borrowing requirements, its expected cash balances, the outlook for interest rates and the credit worthiness of the banks with whom the Council might invest its cash balances.

4.7 A twice-yearly report is submitted to your Committee reviewing the treasury activity undertaken in the year. This report is the final report for 2018/19

Loans and Investments at Key Dates

4.8 Table 1 below shows the loans (money borrowed by the Council) and investments (money invested by the Council) as at 29/10/2018 and at 31/03/2019. The rates shown are the averages paid and received during 2018/19.

4.9 The level of gross debt (total loans borrowed) has reduced from £188M to £179M because market debt (loan stock) has matured. No new loans have been borrowed and no debt restructuring has taken place in the second half of the year.

4.10 Investments have decreased by £43M from £273M to £230M. £9M of this movement reflects the repayment of the loan stock. The balance of £34M is within the range of what is normal (for example if grant income has been spent).

Table 1- Loans & Investments

	Position at 29/10/2018 Principal £M	Position at 29/10/2018 Principal £M	Average Rate
Long Term Fixed Rate Loans			
Public Works Loan Board (PWLB)	134	134	4.2%
Market & Stock	34	25	4.7%
Variable Rate Loans			
Bank Loans	20	20	4.5%
Gross Debt	**188**	**179**	**4.3%**
Treasury Investments			
Banks and Build Soc	33	63	
Other Local Authorities	172	128	
Government Debt Management Office	4	-	
Money Market Funds	55	29	
Property Funds	8	8	
Total Treasury Investments	**272**	**228**	**0.8%**
Local Investment Fund			
Loans	1	2	
Total Local Investment Fund Investments	**1**	**2**	4.3%
Total Investments	**273**	**230**	0.9%
NET INVESTMENTS	**85**	**51**	

4.11 The investments include £8m in property unit trusts. These are unit trusts which invest in property (as opposed to more traditional unit trusts that invest in shares). At present political and economic uncertainties are impacting on the property markets and if we had surrendered the units to the fund managers at 31st March 2019 then we would have made a loss of £267K on the principal sum invested. This is not reflected in the table above because our strategy is to hold the investments long term. It should be noted also that there is a secondary market in which units can be sold and that generally this achieves a higher price, although this did not apply at 31st March.

4.12 The dividends received on the units in the year totalled £238K and are £170K more than would have been earned on cash investments.

4.13 The treasury strategy permits investments in property funds up to a total value of £30M but no further such investments will be made whilst the current uncertainty around Brexit persists.

5. **Credit Worthiness of Investments & Interest Rate Outlook**

5.1 2018/19 showed steady growth within the world economy and the UK - albeit at relatively low levels in the UK. Within the Eurozone many of the economic and financial tensions that followed the crisis of 2008 have eased but significant underlying issues remain. Tensions between the USA and trading partners remain a source of uncertainty. The impact of the UK's exit from the EU on the economy remains to be seen.

5.2 The core expectations of the Council's treasury advisors, Arlingclose, is for Bank Rate is to remain at 0.75% in 2019 before rising twice to a rate of 1.25% in 2020. Inflationary pressures, possibly following future devaluations in the value of the pound, could carry the risk of higher interest rates. On the other hand economic risks around Brexit could argue for bank rate increases to be moderated in order to support the UK economy.

5.3 The governments of the largest world economies, including the UK, have implemented measures to make banks less likely to fail but also to reduce the impact on the financial system and on tax payers if they do fail. The measures for dealing with a failing bank see investors who have lent or deposited money (which includes us) taking significant losses before there is any tax payer support ("bail in"). Our assessment of risk is based both on the risk that banks fail (as measured by credit ratings) and also on the level of losses that we might face should the banks require capital support to prevent failure.

5.4 These developments are reflected in the Council's approach to managing credit risk in its Treasury Strategies for 2018/19 and 2019/20. It has adopted a cautious stance over the whole period covered by this report and has only directly lent to strong UK banks, other local authorities and the UK Government. Other lending has been part of pooled funds (see 5.5 below).

5.5 The position is continually under review. One factor is that other regulatory developments are continuing to require or push banks towards greater financial robustness. One change has been that banks are now required to "ring fence" bank deposits from other more risky activities.

5.6 The Council has an indirect exposure to non-UK banks through its investment in money market funds. Money market funds are like "unit trusts" but rather than investing in company shares these funds invest in interest bearing investments such as bank deposits. When we open such funds they are vetted to ensure that they have strong investment and risk management processes to ensure a high level of credit worthiness in the underlying investments, and we receive advice from our treasury advisor, Arlingclose. Investing in this way helps manage credit risk by having a high level of diversification amongst the underlying banks and institutions to whom money is lent. Interest rates on these funds are low, because we have immediate access to the funds. Some of our money needs to be immediate access (like individuals will usually keep some money in a current account). Rates are, however, better than alternatives such as the DMO.

5.7 The Council has a "Local Investment Fund" which invests in local commercial opportunities. This fund is managed within the Council's framework for managing capital expenditure and it is not considered in detail within this report. However, investments within this fund are included at table 2 below because the rationale of this fund is that it puts to work cash balances which would otherwise be invested in low interest paying deposits. The fund has now ceased to exist following approval of the Council's new investment strategy in February 2019. This strategy will govern similar investments in the future.

5.8 The Treasury Strategy for 2018/19 and 2019/20 permits investment in property funds. Investments of £8m are held in two funds, the Lothbury Property Trust and the Threadneedle Property Unit Trust.

6. Implementation of Borrowing & Investment Strategy

6.1 The strategy approved by Council for 2018/19 envisaged using cash balances instead of borrowing, and this strategy has been adhered to.

6.2 Given that the Council continues to have a high level of investments, active consideration is given to the possible early redemption of a limited amount of debt. This, however, is not straightforward as debt repayment usually involves the payment of a premium. The level of such premiums payable is generally high and premature debt redemption is usually not financially viable.

6.3 As at 31/03/2018 we held £71m of "LOBOs" loans. These are fixed rate but on which the lender may ask for a rate rise. We have the option to repay if they do. Members may be aware of some criticism of LOBOs nationally, principally in respect of authorities which have complex mechanisms for calculating interest rates. We do not: we would be pleased to receive a request for a rate rise as we would then take the opportunity to repay. To all intents and purposes they are simply fixed rate loans.

6.4 In the previous review of treasury activities we reported that on 25th May 2018 we had prematurely repaid three of these loans with a total face value of £51m. After this redemption, LOBO loans with a face value of £20m remain (these are reported in the table above as variable rate bank loans).

7. Key Performance Measures

7.1 The most important performance measures are the rate of interest on the Council's borrowings, the timing of borrowing decisions, the timing of decisions to prematurely repay debt and the return on investments. No new loans have been borrowed and no further loans have been prematurely repaid.

7.2 The Council benchmarks its investments and the latest data for the investment portfolio as at 31st March 2019.

7.3 Treasury investments comprise internally managed investments, longer maturity externally managed funds and in 2018/19 our local investment fund.

7.4 The following table compares our performance against that of participating authorities. This information is available for internally managed investments (including money market funds) and externally managed funds. It is a "snapshot" of investments held at 31st March 2019. No comparative data is held for the local investment fund.

Table 2 – Key Performance Data

Investment	Leicester City Council Revenue return	All Authorities' Revenue return
Internally managed	0.98%	0.85%
Longer term investments*	1.12%	4.14%
Local Investment Fund	4.5%	n/a
Total	**1.02%**	**1.43%**

* total return -income received less capital losses

7.5 The average rate of interest on all investments for participating authorities at 30th September is 1.43% whilst the Council's own rate is 1.02%. This is mainly explained by differences on income from longer term investments.

7.6 There are two factors to consider with regard to longer term investments. Firstly, the Council has a lower proportion of longer-term investments than the average authority. Secondly the longer-term investments that it holds yield less but are less risky (higher yields are achieved at the expense of higher risk).

7.7 As at 31st March the Council's own investments comprised units in property unit trusts. These carry less risk than some other investment types and the lower risk equates to a lower investment return. In addition we selected property fund managers that invested in good quality properties with reliable tenants and such funds have a lower rate of return than more adventurous property funds or (for example) funds that invest in the shares of companies.

7.8 Higher investment returns are always available if higher risk is accepted. Risk can take the form of credit risk (money due is not paid) or market risk (the value of investments fall). However, the trade-off between risk and reward was considered when investment strategies were set for 2018/19 and in the current economic climate continues to be a most important consideration. The "return of the principal" is more important than the "return on the principal": our primary concern is to ensure that the funds invested will be repaid on time and in full. This remains our approach during the current financial year.

7.9 In practice, there is no such thing as a representative "average" authority. The benchmarking data report shows a division between the authorities that use longer term and more risky assets (about half of all authorities) and those adopting a more cautious approach. We fall on the cusp between the two as we have only a small proportion of longer-term assets.

8. Use of Treasury Advisors

8.1 The Council are advised by Arlingclose Ltd. They advise on all aspects of treasury management but their main focus is on providing advice on the following matters:

- the creditworthiness of banks
- the most cost effective ways of borrowing
- appropriate responses to Government initiatives
- technical and accounting matters.

9. **Compliance with the Council's Treasury Strategy**

9.1 As required by the statutory borrowing framework, the Council is required to set a number of prudential limits and indicators. These limits are set annually and can be found within the budget and Treasury Strategy.

9.2 For the operational implementation of the Council's Treasury Management Strategy the most important limits and indicators that need to be monitored throughout the year are:

- The authorised limit – the maximum amount of borrowing that the Council permits itself to have outstanding at any one time
- The operational limit – a lower limit to trigger management action if borrowing is higher than expected.
- The maximum proportion of debt that is fixed rate.
- The maximum proportion of debt that is variable rate.
- Limits on the proportion of debt maturing in a number of specified time bands
- Limits on sums to be invested for more than 364 days

9.3 These limits are monitored and have been complied with.

9.4 Some of the indicators for 2019/20 have been modified with effect from 20th February 2019. The changes are marginal and the revised indicators have been complied with.

10. **Financial and Legal Implications**

10.1 This report is solely concerned with financial issues. Kamal Adatia, Legal Services, has been consulted as Legal Advisor and there are no legal issues.

11. **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	

12. **Background Papers**

12.1 The Council's Treasury Management Strategy - "Treasury Strategy 2018/19" (Council 21st February 2018), "Treasury Strategy 2019/20" (Council 20th February 2019) and The Council's Treasury Policy Document – "Framework for Treasury Decisions" – Council 20th February 2019.

13. <u>Consultation</u>

13.1 Arlingclose Ltd (the Council's Treasury Management advisers).

14. <u>Author</u>

14.1 The author of this report is David Janes, Treasury Manager, on extension 37 4058.

Alison Greenhill
Director of Finance.