Leicester City Council

WARDS AFFECTED: ALL WARDS (CORPORATE ISSUE)

CABINET	**15 MARCH 2004**
COUNCIL	**25 MARCH 2004**

TREASURY STRATEGY 2004/2005

Report of the Chief Financial Officer

1. Purpose of Report

1.1 The report recommends a Treasury Strategy for 2004/2005. The Treasury Strategy governs the way the Council manages its debt (of around £270 million) and investments (of around £60 million).

2. Summary

2.1 Treasury Management is the process by which the Council's borrowing and investments are managed. On 24 November 2003 the Cabinet adopted a policy stating how borrowing and investments should be organised, the responsibilities of officers, and the limits placed on officers' discretion to act without member approval. It should be noted that, as decisions on borrowing individual sums have to be taken very quickly, these are delegated to officers within a framework specified by this policy.

2.2 At the beginning of each year, the Cabinet approves a strategy for treasury management for that year taking into account the Council's need for capital spending, the economic outlook and prospects for interest rates. This can be revised from time to time if circumstances warrant it. At the end of each year, a report is submitted to the Finance, Resources and Equal Opportunities Scrutiny Committee considering the activity undertaken in the year and a progress report is taken to Scrutiny Committee half way through the year.

2.3 The proposed Treasury Strategy for 2004/2005 is detailed in the attached background papers.

2.4 2004/05 is the first year of operation of a new prudential system governing borrowing and investment. Limits on the Council's borrowing were agreed by the e Council on 25th February, and this strategy complies with those limits.

2.5 In summary, the strategy envisages the following: -

i. Short-term interest rates are low but are expected to increase during 2004 and later years.
ii. Long-term interest rates are higher than short-term interest rates although close to their predictedlong-term average.
iii. We will save money by using our cash balances to finance new capital expenditure and maturing debt, instead of borrowing. Most of this cash will come from that which is currently invested by professional fund managers.
iv. Cash not invested with fund managers is expected to be invested ourselves with institutions on our list of approved bodies.
v. We will look for beneficial opportunities to repay our existing debt, either with our investments or cheaper new loans.

2.6 The Council's ability to invest was (until 2004/05) restricted by Government legislation. This legislation has now been repealed, and authorities have greater freedom to determine their own investment policy. This freedom requires us to seek full Council approval to an investment strategy which is included within this report. The key premise of the strategy is to ensure our capital is safe, but to enable us to achieve good returns subject to that overriding requirement. In practice, only minor change is proposed to what we have done in the past.

2.7 This report is being written shortly after the early repayment of £71 million of the Council's loan stock ("bonds"). This stock was issued in 1994 and carried an interest rate of 7%. Whilst this was a good interest rate at the time it is high compared to the current level of long-term interest rates. A further report to FREOPS on this matter will follow.

3. **Recommendations**

3.1 The Cabinet is recommended: -

i. To approve the Strategy in respect of borrowing; investment; use of fund managers; and consultants; leasing; debt rescheduling and repayment described in the supporting information.
ii. To recommend the Council to adopt the investment strategy at Appendix One to the supporting information.

3.2 The Council is recommended to adopt the investment strategy.

4. **Financial and Legal Implications**

4.1 This report is solely concerned with Financial Issues.

4.2 There are no legal implications associated with this report. (Peter Nicholls)

5 **Report Author/Officer to contact:**

5.1 David Janes, Treasury Manager (Financial Services) - extn. 7490

DECISION STATUS

Key Decision	**Yes / No**
Reason	**Part of Budget and Policy Framework**
Appeared in Forward Plan	**No**
Executive or Council Decision	**Council / Executive (Cabinet)**

Leicester City Council

WARDS AFFECTED: ALL WARDS (CORPORATE ISSUE)

CABINET	**15 MARCH 2004**
COUNCIL	**25 MARCH 2004**

TREASURY STRATEGY 2003/2004

Report of the Chief Financial Officer

SUPPORTING INFORMATION

1. **Summary**

1.1 This report describes the proposed Treasury Strategy for the Council for 2004/2005, including its Investment Strategy.

REPORT

2. **Purpose of Report**

2.1 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.

2.2 As at 27 February 2004, the Council's debt was £266 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 2002/2003 at a value of £1,400 million.

2.3 The Council also holds a lot of externally invested cash, which stood at £60 million as at 27 February 2004. 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.

2.4 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. The last such report was approved by the

Cabinet in March 2003. Monitoring of the implementation of the treasury strategy is the responsibility of the Finance Resources and Equal Opportunities Scrutiny Committee, and reports are received twice each year.

2.5 This Treasury Management Strategy details the expected activities of the Treasury function in the financial year 2004/2005. The suggested strategy for 2004/2005 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;

2.6 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 investments 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. When loans are due to be repaid and how much it is likely to cost to refinance them at that time
v. The security of investments.

3. <u>**Changes Since 2003/2004**</u>

3.1 Cabinet agreed the previous Treasury Strategy on 10 March 2003. The main changes, which this report addresses, are:

i. Interest rates for short-term loans fell over the first half of the year, but then started to rise and are expected to rise further in 2004/05, and to peak in 2005/06. Even in 2005/06 it is expected that the peak of short term rates will be lower than the current, and expected future levels, of long term interest rates
ii. Interest rates for long-term loans in 2003/04 averaged around 4.8%, although in the course of the year rates varied as much as 0.4% higher or lower than the average. In 2004/05 and 2005/06 the average of long-term rates is expected to be 5%, subject to similar fluctuations.

4. Current Portfolio Position

4.1 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 £47M of debt managed by the County Council on behalf of the City Council.

4.2 The table reflects the recent premature repayment of £71 million of the Council's stock issue.

Treasury Position As At 27 February 2004	**Amount**	**Average Interest Rate %***
Fixed Rate Funding		
Public Works Loan Board	£152m	6.9
Stock	£9m	7.0
Market Loans	£96m	3.7
Variable Rate Funding/Temporary Loans		
Public Works Loan Board	£3m	4.0
Temporary Loans	£6m	3.5
Total Debt	£266m	5.6
Investments:		
Managed Directly In House	£21m	3.6
Managed By Fund Managers	£39m	2.7
Total Investments	£60m	3.0

* Estimate for 2003/04

4.3 The £60M of investments represents net working capital: i.e. the cash flow benefit that derives from income receipts flowing in faster than payments are made, reserves and funds (e.g. the insurance fund). These items of working capital represent future calls on the cash of the authority over the short to medium term, for example creditors represent payments due in the near future whilst reserves and funds may, potentially, be drawn upon in the medium term. The overall level of such balances has been fairly stable in recent years and it is considered appropriate to adopt a medium term strategy for the use of these funds that assumes a fairly constant balance. These funds are currently invested but the other main options are discussed in section 7 below.

5. **Treasury Limits For 2004/2005**

5.1 By law, the Council has to approve certain prudential limits in respect of borrowing and investment, and the Council approved these on 25th February 2004. These limits include:

- "authorised" and "operational" limits to the amount of borrowing that the Council may have at any time
- the maximum proportion of debt that may be at fixed rate
- the maximum proportion of debt that may be at variable rates
- the maximum and minimum proportion of debt that may mature in specified time bands (up to 1 year, 1 to 2 years, 2 years to 5 years, 5 years to 10 years, 10 years and above)
- the maximum value of investments that may be invested for periods in excess of 364 days

5.2 This strategy has been constructed within these limits.

6. **Prospects for Interest Rates**

6.1 The Council appointed Sector Treasury Services as a treasury adviser to the Council and part of their service is to assist the Council to formulate a view on interest rates. This section discusses the broad economic outlook.

6.2 Short term interest rates are affected by international economic performance, particularly that of the USA. In the first half of 2003 world economic growth was weak because of the Iraq crisis, but this was followed by a strong recovery in the second half of the year.

6.3 World economic growth is expected to pick up further in 2004 and this will put upward pressure on short-term interest rates. This economic growth is, however, expected to remain fragile and the setters of interest rates are unlikely to increase short term interest rates sharply, especially in the USA. The position is expected to be similar in the UK.

6.4 Within the UK short-term interest rates are set by the Bank of England who are required to target inflation. Recent changes Government has made to the target (ie to a new measure of inflation) have reduced the short-term pressure on the Bank of England to raise short-term interest rates in order to curtail inflation.

6.5 There are other factors which it is expected will limit the increases in short term interest rates. Wage inflation and producer price inflation are low and the price of oil is expected to fall. In addition, high levels of consumer debt may mean that small increases in short term interest rates will be sufficient to restrain growth without the need to resort to the large increases seen in earlier economic cycles. Another factor is that the increase in the price of houses seen in recent years viewed by many commentators as excessive, and the Bank of England may avoid sharp increases in short term interest rates that might cause a slump in the housing market. Overall it is expected that short-term rates will rise to 4.5% by early 2005, but are unlikely to rise further.

6.6 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 levels. Longer term-term rates are currently around 5% and are expected to stay at similar levels during 2004/2005.

6.7 There could be other technical factors which affect long-term interest rates from time to time. Government budgetary deficits are forecast to increase over the next few years which could lead to additional Government borrowing (and hence put upward pressure on interest rates). At present the financial markets have bought government debt without any significant impact on interest rates. The expectation in the markets is that the Government would respond to large increases in borrowing by increased taxes and/or by scaling back the level of public expenditure growth (with the result that upward pressure on long term rates would be minimised).

7. Capital Borrowings and Borrowing Strategy

7.1 Capital borrowing strategy is mainly based on a two-year time frame and drawing up a strategy for 2004/2005 requires consideration of the Council's capital financing needs for both 2004/2005 and 2005/2006. The Council needs money to finance its capital programme. However, the calculation of the total borrowing needs of the Council also 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 - in much the same way as a homeowner repays a mortgage over a number of years.

ii. The need to repay maturing loans.

7.2 Taking these factors into account the estimated future borrowing needs of the Council total £40 million in 2004/2005 and £40 million in 2005/2006.

7.3 Based upon the prospects for interest rates outlined above the anticipation is that short-term rates will continue to be cheaper than long fixed rate borrowing during 2004/05 and 2005/06. In addition, variable interest rates will also be cheaper than long-term fixed rate loans (the rate of interest on variable rate loans is closely linked to the short-term rates). There are four main options to meet the Council's capital financing requirement:

i. To use short term loans. The disadvantage with short-term loans is the frequent need to raise new loans when existing short-term loans mature. It is important to ensure that the Council does not place itself in a position where it is unable to access sufficient funds to repay a maturing loan. This risk can be minimised by careful planning, but the greater the amount of short-term loans, the more significant this issue is.

ii. To cash in investments. The bulk of the Council's investments are short-term and the economic effect of repaying a short-term investment is the same as taking a new short-term loan. When adopting such a policy due regard should be had to the need for the Council to maintain adequate access to liquid funds, and the Council's investments form a significant proportion of its liquidity.

iii. To use variable rate loans. Generally such loans are for periods in excess of one year or more, as compared to short-term loans which, typically, will run for a few weeks or months. Accordingly, the risk that the Council is unable to access sufficient funds to repay a maturing loan is less than for a series of short term loans that have to be repaid and refinanced every few weeks or months. The interest rate on variable rate loans is generally about 0.3% to 0.5% higher than short term interest rates.

iv. To use loans that have characteristics of both variable rate loans and long term fixed rate loans. For example one type of long term loan, available from market lenders, provides for an initial loan period or 1 to 5 years at a low rate of interest (reflecting the current low interest rates for short term and medium term loans) and then reverts to a higher rate of interest, in line with long term interest rates, for the remainder of the life of the loan. The interest rates on such loans depend on market conditions, and the availability of such loans at reasonable interest rates is unpredictable. The use of such loans does not form part of the main strategy for 2004/05, but any favourable opportunities will be considered.

7.5 It is considered that option ii should be adopted, with use of the other options being considered when advantageous (see section 11 of this report).

7.6 This proposal runs the risk that interest rate rates increase to higher levels than are anticipated in this report. However the markets will be watched closely. Furthermore, because of our high level of investments, the Council would benefit if we were taken by surprise by an economic event that caused short-term interest rates to rise.

7.7 The bulk of the Council's borrowing will comprise long-term, fixed-rate, loans that were taken in earlier financial years. Such loans enable the Council to forecast its future interest payments with a reasonable degree of certainty, and this is important to its medium term financial plans.

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

8.1 Debt rescheduling is the premature repayment of loans with the repayment being financed by taking out new, cheaper, loans. Members will note from paragraph 4.1 that our debt is held at higher rates of interest than are currently available. Unfortunately, we cannot simply repay these, as a penalty has to be paid. Sometimes it is worth paying such a penalty, sometimes it is not. 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).

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.

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

8.3 All rescheduling and premature repayment of debt will be reported to the Scrutiny committee, at the meeting following the rescheduling.

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

9. **Investments Strategy**

9.1 Investments are governed by statutory guidance issued by the ODPM in conjunction with the new system of "prudential" capital finance, operational from 1 April 2004. This guidance requires the production of an Annual Investment Strategy, and the recommended strategy is appended. This strategy specifies the investments that the authority may use, together with conditions.

9.2 In February the Council had £60M of investments. The borrowing strategy envisages the use of invested funds in lieu of borrowing and this would reduce the investments down to a level of around £20M by the end of 2004/05. Approximately £10-£15M is considered likely to be required at any given moment and should be held on short-term deposit, and so the funds available for longer forms of investment may be limited.

9.3 Currently, cash available for investment is split between that managed in house and that earmarked for longer-term investments that is placed with fund managers. £39M is placed with fund managers at present, but this will reduce substantially when investments are spent.

9.4 The Council uses a fund manager to manage cash balances when it is expected that the balances will not be required within the next 12-18 months. The rationale for the use of fund managers is that on average they should earn 0.5% interest a year more than the Council would earn on short-term deposits. Over periods shorter than 18-24 months fund managers may earn less than would be earned on short-term deposits (for example the performance in the current financial year has been poor).

9.5 The Council will review its continued need for external fund managers as investments deplete.

10. <u>Lending Criteria</u>

10.1 The proposed lending criteria for 2004/2005 are detailed in the appended Annual Investment Strategy. The main change proposed to current arrangements is to permit deposits for periods in excess of one year. The use of such deposits may be appropriate to invest cash returned by the fund manager to fund capital expenditure in 2005/2006 (withdrawals from the fund manager should be made 18-24 months ahead of need).

11. <u>Sensitivity of This Strategy</u>

11.1 The strategy is based on the current economic and political outlook but might need to be reconsidered if early UK participation in Economic Monetary Union (EMU) became a real possibility (currently, the view of most commentators is that early participation is unlikely). At this stage it is difficult to state what an appropriate response to such a development would be. Short-term interest rates are considerably lower in the Eurozone than in the UK. Accordingly raising short-term loans might be financially attractive in such circumstances. At this stage it is probably sufficient to note that such a development would almost certainly require the preparation of a revised Treasury Strategy.

11.2 The attitude of the government towards the transfer of local authority housing stock to social housing landlords remains ambivalent. If the Council were to undertake such a transfer the Council would need to repay its housing debt and this would incur premia. The strategy does not assume this will happen, but decisions will take into account the impact if this did happen. It may, for instance, be beneficial to restructure debt in circumstances where this has no impact on current or forecast future borrowing costs if it increases our flexibility at a future date, and any such opportunities will be taken.

11.3 Consideration needs to be given to the impact of any major international crisis, such as the recent war in Iraq, or a major terrorist incident. History would suggest that the immediate response to such events would be a reduction in both short term and long term interest rates. If, however, the resolution of the crisis were prolonged, the position would be less clear.

11.4 Consideration should be given to the possibility that inflation is higher or lower than expected. Generally it might be expected that higher levels of inflation will lead to higher interest rates and lower than expected inflation levels to lower interest rates. Any large variations in the rate of inflation would, however, require that the Council revises its Treasury Strategy.

11.5 The interest rate assumptions upon which this strategy is based are stated in section 6 above. Given the limitations inherent in any forecast it is appropriate to consider the action to be taken if these forecasts do not come to pass. Small changes in long term or short term rates will not require a major rethink of this strategy but may make long term borrowing attractive, in which case such decisions will be taken. Additionally such changes may create opportunities for debt rescheduling. If, however, such changes were the result of a significant economic or political development it would probably be appropriate to revise the Council's Treasury Strategy.

11.6 Where, exceptionally, immediate action which 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 Finance Resources and Equal Opportunities Scrutiny Committee.

12. Treasury Management Consultants

12.1 The Council employs Sector Treasury Services as treasury management consultants. The service provides advice on our borrowing and investment policies and strategies. The annual fee for this service is £30,000.

13. Leasing

13.1 The Council is likely to acquire equipment, principally vehicles, to the value of approximately £2million that would be suitable for leasing.

13.2 Before leasing is pursued consideration will be given to the options of finance leasing, operational leasing, and prudential borrowing. Under the previous system of capital controls, equipment was acquired by lease as it was the only way equipment could be afforded under the then existing capital controls. The only criteria we now need consider is the method of procurement which provides best value to the Council.

13.3 Equipment will only be acquired where departments can meet the ongoing revenue costs (i.e. we will not use prudential borrowing to increase the Council's revenue expenditure).

14. **Financial Implications**

14.1 This report is solely concerned with Financial Issues

15. **Legal Implications**

15.1 There are no legal implications associated with this report. (Peter Nicholls, Head of Legal Services)

16. **Other Implications**

OTHER IMPLICATIONS	**YES/NO**	**Paragraph References Within Supporting information**
Equal Opportunities	No	**-**
Sustainable and Environmental	No	**-**
Crime and Disorder	No	**-**
Human Rights Act	No	**-**
Elderly/People on Low Income	No	**-**

17. **Consultations**

17.1 None.

18. **Background Papers – Local Government Act 1972**

18.1 None.

19. **Author**

19.1 The author of this report is David Janes of the Town Clerk's & Corporate Resources Department on extension 7490

M Noble
Chief Financial Officer.