Leicester
City Council

WARDS AFFECTED:
ALL WARDS (CORPORATE ISSUE)

OVERVIEW SELECT COMMITTEE **21st June 2018**

REVIEW OF TREASURY MANAGEMENT ACTIVITIES 2017/18

Report of the Director of Finance

1. Purpose of Report

1.1 This report reviews how the Council conducted its borrowing and investments during 2017/18.

1.2 2017/18 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 already shown in the budget report and accounts.

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 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.

3. Recommendations

3.1 Members of the Overview Select Committee are recommended to note the report and make any 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 this prohibitively expensive.

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 negligible 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 reserves position is described in the budget report.

4.6 There is a budget for interest earned on investments as part of the Council's revenue budget.

Treasury Management Policy and Monitoring

4.7 The activities to which this report relates were primarily governed by the Treasury Strategy for 2017/18 which was approved by the Council on 2nd February 2017 and amended on 5th October 2017. The last few weeks of 2017/18 were governed by the Treasury Strategy for 2018/19 which was approved by the Council on 21st February 2018. The Treasury Strategy establishes an outline plan for borrowing and investment. The 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.

4.8 A twice-yearly report is submitted to your Committee reviewing the treasury activity undertaken in the year. This report is the full-year report for 2017/18

Loans and Investments at Key Dates

4.9 Table 1 below shows the loans (money borrowed by the Council) and investments (money invested by the Council) as at 7/11/2017 and 31/03/2018. The rates shown are the averages paid and received during 2017/18.

4.10 It can be seen that the level of gross debt (total loans borrowed) is unchanged at a level of £239m. No new loans have been borrowed and no debt restructuring has taken place. At the time of drafting this report the premature repayment of some loans is under active consideration and this is referred to later in this report.

4.11 Investments have decreased by £1m from £253m to £252m. Typically we might expect cash balances to have declined by a greater amount over this period. The position will be clearer once the Council's accounts for 2017/18 are finalised but it appears likely that government grants have been received which were unspent as at 31st March.

Table 1- Loans & Investments

	Position at 07/11/2017 Principal £M	**Position at 31/03/2018 Principal £M**	**Average Rate**
Long Term Fixed Rate Loans			
Public Works Loan Board (PWLB)	134	134	4.2%
Market & Stock	34	34	4.9%
Variable Rate Loans			
Bank Loans	71	71	4.5%
Gross Debt	**239**	**239**	**4.4%**
Treasury Investments			
Banks and Build Soc	67	33	
Other Local Authorities	159	189	
Government Debt Management Office	4	-	
Money Market Funds	23	30	
Total Treasury Investments	**253**	**252**	**0.5%**
Local Investment Fund			
Loans	5	5	
Total Local Investment Fund Investments	**5**	5	9.3%
Total Investments	**258**	257	0.7%
NET BORROWING /(INVESTMENT)	**(6)**	(5)	

5. **Credit Worthiness of Investments**

5.1 2017/18 showed continued economic recovery within the UK economy and within the world economy. Within the Eurozone, economic and financial tensions have eased but significant underlying issues remain. The impact of the UK's exit from the EU on the economy remains to be seen.

5.2 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.

5.3 These developments were reflected in the Council's approach to managing credit risk in its Treasury Strategy for 2017/18. 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. Lending to other local authorities has been a key element of our strategy and is one of the very safest forms of investment. Other lending has been part of pooled funds (see 5.5 below).

5.4 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 matter kept under review is the measures that will be put in place to require banks to "ring fence" bank deposits from other more risky activities. Banks have to complete this by 1st January 2019 but some banks plan to complete this earlier. The transition to these new arrangements creates some uncertainties and until these are resolved the maximum period for which we will lend to some UK banks are shorter than might otherwise be the case.

5.5 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.

5.6 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 1 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.

5.7 Most commentators believe interest rates will remain at low levels for a long time, although it is unclear whether the recent increase in base lending rates will be followed by some further small increases. At the time of writing this report, market interest rates indicate an expectation that short-term interest rates will average about 1.6% for an extended period of time.

5.8 The Treasury Strategy 2017/18 permits investment in a property fund. An investment of £1.7M has been made in the Lothbury Property Trust in April 2018 and will be considered in the next review report.

6. Implementation of Borrowing & Investment Strategy

6.1 The strategy approved by Council for 2017/18 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. At the time of writing this report we are actively working towards the premature repayment of some bank loans and hope to conclude this soon. This matter will be reported upon in the next review of treasury management activities.

6.3 The premature repayment of debt is not straightforward as debt repayment usually involves the payment of a premium. Generally the level of such premiums payable is too high.

6.4 We hold £70m of debt which is described as variable rate loans in table 1. These are technically "LOBOs" which 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.

6.5 Lenders would face large losses on these loans if they did request a rate rise which we then declined by repaying the money. Accordingly they are unlikely to request such a rate rise. There are indications that some lenders may be open to negotiated repayments and we will explore such options.

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. However, no new loans have been borrowed and no existing loans have been prematurely repaid.

7.2 The Council benchmarks its investments and the latest data is as at 31st March 2018.

7.3 Treasury investments comprise internally managed investments, longer maturity externally managed funds and in the case of Leicester its 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 2018. No comparative data is held for the local investment fund. The data is for income received but excludes fluctuations in the capital value of investments held in externally managed funds.

Investment	**Leicester City Council Revenue return**	**All Authorities Revenue return**
Internally managed	0.73%	0.63%
Externally Managed Funds		3.22%
Local Investment Fund	9.2%	n/a
Total	**0.89%**	**0.89%**

7.5 The average rate of interest on internally managed investments for participating authorities at 31st March is 0.63% whilst the Council's own rate is higher: 0.73%

7.6 Higher investment returns are available if higher credit risk is accepted. However, the trade-off between risk and reward was considered when investment strategies were set for 2017/18 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.

8. <u>Use of Treasury Advisors</u>

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. <u>Compliance with the Council's Treasury Strategy</u>

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 In July 2017, loans were made to local authorities which resulted in the aggregate level of loans to all local authorities exceeding the limit set in the treasury strategy. This did not create a significant credit risk given the high level of credit worthiness of local government (second only to the UK Government itself). Monitoring processes were tightened in response to this event.

9.5 In February 2018 the level of money deposited overnight with Barclays exceeded the set limit. This happened in respect of our day to day banking and was due to a large receipt from a third party received late in the working day. Our day to day banking and treasury operations are informed by detailed cashflow forecasts. Such occurrences do not happen often, and generally do not involve large sums of money. When they do happen we seek to get better information to improve our cashflow forecasts. This is a risk which cannot be wholly eliminated and the financial risk involved is low as the excess balance will be removed the next banking day.

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 2017/18" (Council 22nd February 2017), "Treasury Strategy 2017/18" (Council 5th October 2017) and "Treasury Management Strategy 2018/19" (Council 21st February 2018). The Council's Treasury Policy Document – "Framework for Treasury Decisions" – Council 29 March 2012.

13. **Consultation**

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

14. **Author**

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

Alison Greenhill
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