Leicester
City Council

WARDS AFFECTED:
ALL WARDS (CORPORATE ISSUE)

OVERVIEW SELECT COMMITTEE **13th December 2018**

MID-YEAR 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.

1.4 We report upon the premature repayment of £51m market loans. The revenue impact of this repayment is reported in the report "Revenue Budget Monitoring Period 6 2018/19" which is also presented to this meeting of the Overview Select Committee

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 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 We have prematurely repaid £51M of loans which has resulted in one off and an ongoing revenue savings

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.

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 reserves position was described in the budget report.

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 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 mid-year 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 31/03/2018 and 29/10/2018. The rates shown are the averages paid and received during 2018/19.

4.9 £51M of bank loans were repaid and the level of gross debt (total loans borrowed) has been reduced from £239M to £188M. No new loans have been borrowed and no debt restructuring has taken place.

4.10 Investments have increased by £17m from £256m to £273m. .

Table 1- Loans & Investments

	Position at 31/03/2018 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	34	4.9%
Variable Rate Loans			
Bank Loans	71	20	4.5%

Gross Debt	**239**	**188**	**4.4%**
Treasury Investments Banks and Build Soc Other Local Authorities Government Debt Management Office Money Market Funds Property Funds	 33 189 4 23 2	 33 172 4 55 8	
Total Treasury Investments	**251**	**272**	**0.8%**
Local Investment Fund Loans	 5	 1	
Total Local Investment Fund Investments	**5**	**1**	8%
Total Investments	**256**	**273**	0.9%
NET INVESTMENTS	**17**	**85**	

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 share). The returns included in the table above do not include any movements in the value of these investments. This is because these investments are bought and sold in secondary markets but transactions are infrequent and so there is no firm quoted price for these investments as there would be for, say, a FTSE 100 company share or a government bond. However the fund managers regularly assess the value of the underlying investments and this data indicates that value of the underlying investments has increased marginally. When we close the accounts for 2018/19 we will gather information from brokers to form a robust view on the value of the investments as at 31st March 2019 and this will be reflected in the year-end review of treasury management activities for 2018/19.

5. <u>Credit Worthiness of Investments & Interest Rate Outlook</u>

5.1 2018/19 showed steady growth within the world economy whilst growth within the UK was steady - albeit at relatively low levels. 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 rise twice more in 2019 to a rate of 1.25%. Inflationary pressures, possibly following future devaluations in the value of the pound, could carry the risk of higher interest rates. On the other hand 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 were reflected in the Council's approach to managing credit risk in its Treasury Strategy for 2018/19. 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 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.

5.6 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.

5.8 The Treasury Strategy 2018/19 permits investment in property funds. Investments of £8m have been made 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 £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.

6.4 On 25th May 2018 we prematurely repaid three of these loans with a total face value of £51m paying a premium of £21m. (Premiums are always payable in these circumstances, because interest rates are lower now than they were when the loans were taken out).

6.5 Prior to agreeing this repayment the Council received a detailed report from its advisors, Arlingclose, showing that this transaction was favourable to the Council. We were aware also that terminating loan early cost the bank money.

6.6 The amount of the premium was based upon the rates of interest at which the Council was able to borrow from the Public Works Loans Board (PWLB). With premia calculated this way the Council could have repaid the existing loans and borrowed matching new loans from the PWLB had it wished to do so.

6.7 Rather than borrowing from the PWLB the Council simply repaid using cash balances. This option was financially favourable because the interest rate on cash balances was (and remains) lower than the interest paid on new PWLB loans.

6.8 This funding decision can be revisited in the future if borrowing from the PWLB becomes more favourable. However the interest rates on cash balances appears likely to remain lower than interest rates payable on new borrowing for a number of years. The overall effect of the repayment is a revenue budget saving which is discussed in the revenue budget monitoring report for period 6.

6.9 After the redemption LOBO loans with a face value of £20m remain. We will explore any viable options to repay these which present themselves

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. The timing of the premature repayment of the loans reported above was driven by negotiations with the lender.

7.2 The Council benchmarks its investments and the latest data for the investment portfolio as at 30th September 2018.

7.3 Treasury investments comprise internally managed investments, longer maturity externally managed funds and 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 30th September 2018. 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	0.86%	0.76%

Longer term investments	3.64%	4.32%
Local Investment Fund	5.0%	n/a
Total	**0.96%**	**1.25%**

7.5 The average rate of interest on internally managed investments for participating authorities at 30th September is 0.76% whilst the Council's own rate is higher: 0.86%

7.6 The average rate of interest on all investments for participating authorities at 30th September is 1.25% whilst the Council's own rate is 0.96%. This is mainly explained by differences on income from longer term investments.

7.7 The average rate of return on longer term investments for participating authorities at 30th September is 4.32% whilst the Council's own rate is 3.64%. This category will cover a wide range of investments and there an unavoidable element of "comparing apples with orange". As at 30th September 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 funds.

7.8 Higher investment returns are always available if higher credit risk is accepted. 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 The benchmarking data also indicated that other authorities, on average, held more longer term investments and that this contributed to the higher return achieved by the average authority. Under normal circumstance the Council would have more longer term investments than it does but such investments were run down in order to ensure the availability of cash (£71m) to fund the premature repayment of LOBO loans that is reported above. It is likely that we will build up investments in longer term assets over the remainder of the year but the uncertainties created by Brexit mean that we will be more cautious than usual.

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.

10. Current Regulatory Developments

10.1 During 2017 and 2018 revised guidance has been issued by MHCLG and Cipfa with regards to "investments". The possibility of further guidance being issued remains. The main impact has been to extend existing guidance dealing with treasury investments (as described in this report) to also deal with other investments.

10.2 The background to this is the very large scale investments made by some local authorities and, in particular, large direct investments in properties (sometimes outside of the authority's own area) which have been made with borrowed money. Leicester City Council itself has not made direct investments in property solely to earn an income. Its approach is to invest in properties that support local economic development (and other service priorities) whilst still seeking a commercial return. Such investments do, however, fall within the new guidance. In essence the guidance seeks greater transparency around the non-treasury investments of authorities (which can be significant) and how the risks associated with these are managed.

10.3 We are working to prepare strategies and policies to be adopted in 2019/20 which focus on the matters of greatest significance for Leicester City Council

10.4 HM Treasury are concerned about authorities involved with very large scale investments. If it considers that the revised guidance is not applied in ways that meet its concerns, it is quite possible that more intrusive measures may be imposed.

11. Financial and Legal Implications

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

12. 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	

13. **Background Papers**

13.1 The Council's Treasury Management Strategy - "Treasury Strategy 2018/19" (Council 21st February 2018). The Council's Treasury Policy Document – "Framework for Treasury Decisions" – Council 29 March 2012.

14. **Consultation**

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

15. **Author**

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

Alison Greenhill
Director of Finance.