Leicester City Council

WARDS AFFECTED: ALL WARDS (CORPORATE ISSUE)

EXECUTIVE BRIEFING **13 DECEMBER 2012**
OVERVIEW SELECT COMMITTEE **17 JANUARY 2013**
COUNCIL **24 JANUARY 2013**

TREASURY STRATEGY 2013/14 TO 2015/16

Report of the Acting Director of Finance

1. **Purpose of Report**

1.1 This report establishes the strategy for the Council's borrowing and investments during 2013/14.

2. **Summary**

2.1 Treasury management is the process that ensures that the Council always has enough cash to make the payments that are necessary for its operations, and this involves both borrowing and investment. The Council's borrowing totals some £250 million; and its investments vary from below £70 million to over £150 million depending on circumstances.

2.2 The strategy is broadly unchanged from the current treasury strategy for 2012/13. In particular it continues the current approach whereby investments will only be lent to highly credit worthy counterparties.

2.3 The strategy also envisages :-

a) a prolonged period of extremely low short term interest rates;
b) the use of our investment balances to avoid borrowing.

3. **Recommendations**

3.1 The Executive is recommended to approve this Treasury Strategy, and recommend it to the Council.

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

3.3 The Council is recommended to approve this Treasury Strategy.

4.0 **Treasury Strategy**

4.1 This document is the Treasury Strategy for 2013/14. At the beginning of each year the Council receives this report which identifies how it is proposed to borrow and invest in the light of capital spending requirements, interest rate forecasts and economic conditions.

4.2 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;

4.3 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.

5. **Current Portfolio Position**

5.1 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 £31M of debt managed by the County Council on behalf of the City Council and also excludes debt instruments by contractors for PFI schemes.

Treasury Position As At 23rd November 2012	Amount
Fixed Rate Funding	
Public Works Loan Board	£147m
Stock	£9m
Market Loans	£96m
Total Debt	£252m

Investments	£153m
Net Debt	£99M

6. **Treasury Limits For 2013/2014**

6.1 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 6.3 below) is a statutory limit under the Local Government Act 2003 which is set by the full Council as part of the budget. The other indicators are part of this treasury strategy.

6.2 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.

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

	2013/14 £m	2014/15 £m	2015/16 £m
Borrowing	295	295	295
Other forms of liability	130	130	130
Total	425	425	425

6.4 "Other forms of liability" relates to loan instruments in respect of PFI schemes and to pre-unitary status debt managed by the County Council (and charged to the Council). The remainder ,"borrowing", refers to conventional loans.

6.5 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:

2013/14 £400m
2014/15 £400m
2015/16 £400m

6.6 Recommended upper limits on fixed and variable rate debt exposures are shown in the table below. The figures shown are the principal sums outstanding of loans less investments. Variable rate loans include all loans where the lender has an option to vary the interest rate chargeable. Investments are treated as negative for this purpose. This table relates to “borrowing” rather than to “other form of liability” which are all substantially fixed rate.

	2013/14 £m	2014/15 £m	2015/16 £m
Fixed interest rate	270	270	270
Variable interest rate	60	60	60

6.7 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 loans. This table also excludes other forms of liability. Recommended limits are:

<u>Upper Limit</u>

	%
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

<u>Lower Limit</u>

	%
Less than 5 years	0
Over 5 years	60

6.8 The upper limit for principal sums invested for more than 364 days is £50m for 2013/14 and subsequent years. In the present investment climate, such investments would only be made in Government backed securities.

7. Prospects for Interest Rates

7.1 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, described below, and these underpin the strategy.

7.2 The poor outlook for growth in the UK is expected to result in official interest rates being maintained at low levels for a considerable period.

7.3 The forecast is that base interest rates (official interest rates paid by the Bank of England) will remain at 0.5% for the entire period covered by this strategy (to 2016). Market interest rates often differ from base interest rates.

7.4 In the money market 3 month interest rates are forecast to increase from about 0.55% to 0.75% over the duration of the strategy and 1 year rates are forecast to rise from 1.1% to 1.4%. We are likely to earn lower rates than this on our deposits because much of our money is lent to the government and to ultra-secure counterparties such as local authorities.

7.5 This difference between overnight rates and those paid for longer periods illustrates the opportunities and risks to be addressed in the investment strategy. The opportunity is that a higher interest rate on investments can be earned by investing for longer periods.

7.6 However this historically high interest rate differential reflects the market's perceptions of risk and echoes the reluctance of banks to expose themselves to the risk that they lend to other banks (and others) that are unable to repay loans.

7.7 The Council's strategy for borrowing is mainly determined by interest rates for periods longer than one year and these are expected to increase over the period covered by the strategy. For example, loans from the PWLB for 5 year rates are forecast to rise from 1.6% to 2.0% and for 50 year rates from 4.1% to 4.4%.

7.8 The perceived margin of error to these forecasts is that interest rates might be 0.5% higher or lower (although base interest rates are not expected to fall below the forecast level of 0.5%). However, given the current economic and political situation prevailing in the Eurozone the possibility exists of extreme events not foreseen within this estimate of the margin of error.

7.9 There is a lot of uncertainty and a number of scenarios are considered in section 12 of this report.

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

8.1 The Council's future need to borrow reflects the following factors:

i. New capital expenditure that is to be financed by borrowing;
ii. 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;
iii. Sums required to repay maturing loans.

8.2 Taking these factors together the Council does not have a borrowing requirement over the three year period 2013/14 to 2015/16. However, this forecast excludes additional borrowing on developments currently under consideration which may, or may not, involve an element of loan finance. The most significant of these possible schemes are the redevelopment of New Walk Centre and the next phase of the Building Schools for the Future Programme.

8.3 If these schemes do give rise to borrowing requirements then that borrowing requirement is unlikely to materialise in 2013/14 as cash balances can be used as a temporary alternative to borrowing.

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

9.1 Debt rescheduling is the premature repayment of loans with the repayment being financed by taking out new, cheaper, loans. Sometimes it is beneficial to to pay a penalty to repay a debt early if the interest rate on the new loan is sufficiently low. At other times it may be possible to repay a loan at a discount. It is proposed that debt rescheduling will be undertaken 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).

9.2 Such decisions will be guided by expectation of future movements in interest rates and 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 the taking of the replacement loan would be delayed until this happened. In the interim, temporary finance would be found by raising a temporary loan or by using cash balances.

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

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

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

9.6 Rescheduling decisions will also be influenced by the future borrowing requirements of the Council – given the unattractive terms offered on the premature repayment of debt it may be more economic to retain existing loans than to repay and then borrow new loans at a later date. However current long term projections indicate that in the absence of a stream of new debt funded capital schemes, the debt of the Council may soon peak. There are a number of uncertainties in this projection and the position will be kept under review.

9.7 At present it seems likely that any rescheduling in 2013/14 will be done as a risk reduction measure but, otherwise, favourable opportunities for cost reductions are unlikely to present in 2013/2014

10. **Investments**

10.1 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.

10.2 On 23rd November the Council had investments of £153M. 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. In addition the Council's investments tend to peak around mid-year (this reflects the timing of cashflows) and cash balances are expected to be substantially lower by the end of 2012/2013.

10.3 In 2012/13 our lending was confined to the UK Government's Debt Management Office, other local authorities and the large UK Banks.

10.4 Our current lending criteria specifies a minimum long-term credit rating of A-. The definition of an A credit rating is: *expectations of low credit risk. The capacity for payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings*.

10.5 Within this definition the main feature to note is ***more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings***. The "A" rating ranges from A+ to A- where the "+" indicates that the rating is at the higher end of the A credit rating definition and the "-" indicates that it is at the lower end. Investments with an "A+" rating will have a maximum maturity of 1 year, whereas those with an "A-" rating will have a maximum maturity of 1 month.

10.6 Investments would only be permitted where in the opinion of the Director of Finance there is a good prospect, should the bank run into problems, of support from a strong government or well resourced parent. In practice, this has limited us to major British banks in 2012/13.

10.7 Under the 2013/14 strategy the investments will always comply with these minimum credit ratings but other factors will be taken into account as contra-indicators and these will include 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.

10.8 These criteria permit investments in foreign banks but if such investments are made the Council will be even more cautious than when it invests in UK banks. The reason for this is that even with the benefit of the financial press, and other similar sources of information, it's easier to monitor to UK banks than it is to monitor the foreign banks.

10.9 We currently do not invest in money market funds, but in some circumstance these could be a useful investment tool. Any decision to make such investments would be made by the Director of Finance in consultation with the Exectutive.

10.10 Our minimum credit criteria exclude us from investing with smaller UK building societies because only a few of the larger building societies are credit rated, and the rest are not. It is understood that the reason that many smaller building societies do not have credit ratings is that they don't borrow enough money in the money markets to make a credit rating worthwhile (not that that are uncreditworthy). We will review the use of unrated building societies during the year and, if appropriate, submit a report to the Executive recommending lending limits for such investments.

10.11 The Council banks with the Co-operative Bank which has credit ratings lower than the banks with which it invests in the money markets. As part of its banking arrangements it makes use of a deposit account linked to its main bank accounts. Balances on that account do not generally exceed £2 million and the credit worthiness of the Co-operative Bank is monitored

10.12 The credit worthiness of investments will continue to be reported via six-monthly reports to the Overview Select Committee and monthly briefing reports to the City Mayor.

10.13 This investment strategy is based on the advice of Arlingclose, our Treasury Advisors and they have consistently taken a cautious approach (for example they advised against investing in Icelandic banks).

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

11.1 This strategy is based on the view that the economic outlook for 2013/2014 and later years carries a number of significant risks.

11.2 Short-term interest rates are expected to rise slowly over the medium term and the main risk is that they rise faster and/or sooner than expected. Any borrowing decision made during 2013/14 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. In practice, most of our portfolio is currently long-dated, and we may take the opportunity to borrow for a shorter term at lower rates.

11.3 There is uncertainty as to how fast the Council 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. If this expenditure could not be met from cash balances then a need to borrow would arise.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.

11.4 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 the current interest rate environment the financial risk is believed to be low - it's unlikely that lenders will exercise their option and if they did the cost of replacement loans could be kept low by borrowing short to medium term loans.

11.5 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 City Mayor and the Overview Select Committee.

11.6 The Council's lending criteria takes into account the likelihood that a bank that runs into trouble will receive Government support.

12. **Housing Revenue Account**

12.1 Since 1 April 2012 the Housing Revenue Account (HRA) has operated under a new self-financing regime. Under these arrangements it has earmarked debts separate from those of the General Fund.

12.2 Where appropriate, a separate loans strategy should be operated for each pool. However, the requirements of the HRA for 2013/14 are straightforward in that no new borrowing is required and the strategy described in this report is appropriate for the HRA.

13. **Treasury Management Advisors**

13.1 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. The existing contract expires in 2013 and will be retendered.

13.2 There have been many challenges in 2012/13 and Arlingclose's performance has been good.

14. **Leasing**

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

14.2 Before leasing is pursued consideration will be given to the options of finance leasing, operational leasing, and prudential borrowing. At present 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.

15. **Financial and Legal Implications**

15.1 The proposals are in accordance with the Council's statutory duties under Local Government Act 2003, Statutory Guidance and comply with the CIPFA Code of Practice on Treasury Management. In accordance with the Council's Constitution the strategy requires Full Council approval.

16. **Climate Change Implications**

16.1 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.

17. **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	

18. **Background Papers**

18.1 Background information is available on the files of the Acting Director of Finance.

19. **Consultation**

19.1 Arlingclose Ltd.

20. **Author**

20.1 The author of this report is David Janes of the Financial Services Division on extension 7490

Alison Greenhill
Director of Finance.

ANNUAL INVESTMENT STRATEGY 2013/2014

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. 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 (UK banks, overseas banks and building societies);
ii. Deposits for periods up to one year with other local authorities;
iii. Money Market Funds;
iv. Any deposit, bond, note, bill or other loan instrument with a residual maturity of up to one year which has the same economic characteristics as (i) or (ii).

Longer Term Investments

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

2.6 The Council will impose upper limits on the total amount of money to be invested according to the following criteria: -

i. Banks and building societies - £60 million;

ii. Money Market Funds - £50 million;
iii. Investments issued by or guaranteed by the UK Government or by a local authority – 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 (eg LIBOR), 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 Director of Finance 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 term deposits and callable deposits for periods of 3 months or less, a long-term rating of A, a short term rating of F1
iii. For term deposits and callable deposits for periods of 1 month or less, a long-term rating of A-, a short term rating of F1
iv. For money market funds, and other commercial secured deposit facilities, a rating for the fund of AAAmmf

For (i),(ii) and (iii) 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 or in other local authorities.

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 institutions;
ii. For investments with, or explicitly guaranteed by the UK Government – unlimited;
iii. For deposits with UK local authorities £20 million;
iv. For deposits in banks and other institutions not guaranteed by the UK Government - £6 million;
v. For deposits with the Co-op Bank "Public Sector Reserve" account £2.5 million although higher balances shall be permitted when practical reasons make this unavoidable (for example when unexpected income is received and it's not practical to invest it elsewhere).

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 good 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 deterioration 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 Director of Finance 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 - credit data is monitored at least once a month and this process take account of information in the financial press.

4. Investment balances / Liquidity of investments

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 No more than £50m will be held in longer term investments.

5. Investment Reports

5.1 Reports will be prepared twice yearly as part of the reports on treasury management activity, and a monthly note is prepared for the Director of Finance and the City Mayor.