
TREASURY STRATEGY 2014/15 TO 2016/17

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 2014/15.

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 £240 million; and its investments vary from below £110 million to over £230 million depending on circumstances.

2.2 The strategy continues the current approach whereby investments will only be lent to highly credit worthy counterparties. However, the financial climate (whilst still historically very difficult) appears more stable and has suffered less shocks in the past 12 months. We propose, therefore, to extend the maximum amount of money that we will lend to strong banks and to increase the maximum deposit period. We also propose to allow investments of modest sums in some building societies.

2.3 The strategy 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 The Council is recommended to approve this treasury strategy, and the authorised borrowing limit in paragraph 6.3.

4.0 **Treasury Strategy**

4.1 This document is the treasury strategy for 2014/15. 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 held by contractors for PFI schemes.

Treasury Position As At 19th November 2013	Amount
Fixed Rate Funding	
Public Works Loan Board	£134m
Stock	£9m
Market Loans	£96m

Total Debt	£239m
Investments	£188m
Net Debt	£51M

6. **Treasury Limits For 2014/2015**

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.

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 for 2014/15 are:

	£m
Borrowing	295
Other forms of liability	130
Total	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. The boundary recommended for 2014/15 and later years is £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 loans for this purpose. This table relates to "borrowing" rather than to "other form of liability" which are all substantially fixed rate.

	£m
--	----

Fixed interest rate	270
Variable interest rate	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:

Upper Limit

	%
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 over	100

We would not normally borrow for periods in excess of 50 years.

Lower Limit

	%
Less than 5 years	0
Over 5 years	60

- 6.8 The Council is required to set an upper limit for principal sums invested for more than 364 days. This limit can be over restrictive in that sometimes better rates are available if money is deposited for a few days more with no significant impact on credit risk. The overall limit recommended for 2014/15 and subsequent years is £100m and of this the amount permitted to be invested in excess of 366 days is £50m.

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 UK is now experiencing growth although it appears likely that official interest rates will be maintained at low levels for a considerable period of time in order to sustain this growth.
- 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 2017). 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 0.50% to 0.8% over the duration of the strategy and 1 year rates are forecast to rise from 0.9% 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 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 1.45% to 2.5% and for 50 year rates from 4.1% to 4.4%.
- 7.7 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%). Broadly speaking it is believed that there is more risk that interest rates will be higher than forecasts than they will be lower than forecast. Possible responses to this uncertainty and other risks and uncertainties are considered in section 11 of this report.

8. **Capital Borrowings and Borrowing Strategy**

- 8.1 The Council's future need to borrow reflects the following factors:
- i. New capital expenditure that is to be financed by borrowing. In practice, this is now low, as the Government supports capital schemes by means of cash grants.
 - 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 2014/15 to 2016/17 as cash balances can be used as an 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 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 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 has peaked. There are a number of uncertainties in this projection and the position will be kept under review.
- 9.4 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 2013/14
- 9.5 Whilst we may not reschedule debt the outright premature repayment of existing debt utilising cash investments is more likely. We may repay existing long term fixed rate loans from the PWLB using cash balances. Whilst the premia payable are high the interest savings are expected to be high also – this reflects the fact that the rate of interest earned on investments is significantly lower than the rate of interest paid on existing loans. Opportunities to do this will be actively sought, as it is the only infallible way of eliminating investment risk.

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 19th November the Council had investments of £188M. 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 lower by the end of 2013/14.
- 10.3 In 2013/14 our lending was confined to the UK Government’s Debt Management Office, other local authorities and the large UK Banks. In 2014/15 we may invest also in money market funds and with smaller unrated building societies and this is described further below.

- 10.4 The 2014/15 strategy proposes to increase the maximum amount of money that we will lend to credit rated banks and building societies from £6M to £10M and to increase the maximum deposit period from 1 year to 2 years. The maximum loan period is graduated according to the strength of the credit rating.
- 10.5 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 2013/14 and this will continue in 2014/15.
- 10.6 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.
- 10.7 We currently do not invest in money market funds, but believe that these would be a useful form of investment. A report will be prepared for the Executive in the new year. No money will be invested in money market funds until this is done.
- 10.8 Money market funds are a pool of investments shared by a large number of investors and managed by a fund manager. Investors invest or disinvest by buying or selling shares in the fund and the fund manager makes corresponding sales of the underlying investments.
- 10.9 In a money market fund investors pool their liquidity requirements (ie their need for cash on demand), as not all will need access to cash at the same time. This enables money market funds to invest for periods longer than overnight, typically 30 to 60 days, thereby earning a higher rate of interest than would be earned if the money was simply invested overnight. The funds are invested in a range of interest paying investments of high credit worthiness. A significant proportion of funds are held in investments which can be easily sold to give access to cash
- 10.10 We may also consider investing in funds with a similar structure, but which are not designed to give access to day to day liquidity. Such funds still contain a diversified pool of investments with a high credit rating. However (on average) the underlying investments are longer dated and the day to day value of these will fluctuate in line with market conditions (which will mainly reflect market interest rates). Such investments may be suitable for cash balances to be invested for a period measured in weeks or months (depending on the fund chosen) but not for cash for which immediate access is required.
- 10.11 Our current investment criteria excludes us from investing with unrated UK building societies and whilst a few of the larger building societies are credit rated, 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 they are uncreditworthy). Our treasury advisors have now carried out work on unrated building societies and recommend that some are suitable for investment. We therefore propose to use them, subject to routine provision of information on their finances via Arlingclose. The unrated building societies under consideration are: Furness, Leek United, Newbury, Hinckley & Rugby, Darlington, Market Harborough, Melton Mowbray, Tipton & Coseley, Scottish, Marsden, Loughborough, Mansfield, Vernon and Harpenden. The key issue regarding small societies is that updated financial information is produced less frequently than for banks, and we will avoid any societies whose financial strength could change significantly between reports. We also propose maximum investments in individual societies and the sector as a whole.

- 10.12 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. At the time of writing this report we have a restrictive approach to the use of this account and this reflects the pending refinancing of the Co-op Bank, but it is anticipated that this refinancing will have implemented by the time that this strategy comes into force.
- 10.13 The banking contract expires in 2015 and the Co-op Bank have told us that they will not retender for this work. When retendering for bank services credit ratings will be taken into account when deciding which bank to appoint.
- 10.14 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.
- 10.15 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. **Sensitivity of This Strategy**

- 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. Such changes will tend to impact most on investment decisions and on decisions to reschedule or repay existing long term loans.
- 11.3 No borrowing requirement is forecast in 2014/15 or later years and this is likely to change only if significant new debt funded capital schemes were approved by the Council or earmarked funds are spent faster than expected.
- 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 (which we would probably welcome) the cost of replacement loans (if needed) 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. The Government is progressively trying to reduce its exposure to the bailing out of banks that run into financial problems and, other things being equal, this increases the exposure of lenders to the bank. However, this a work in progress which will take a number of years to achieve, but it will be monitored. At the same time the Government is trying to reduce the risks of lending money to banks by such measures as requiring them to hold greater amounts of loss holding capital.

12. **Housing Revenue Account**

- 12.1 The Housing Revenue Account (HRA) operates under a self-financing regime in which it has earmarked debts separate from those of the General Fund. 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 2013/14 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 and statutory guidance, comply with the CIPFA Code of Practice on Treasury Management. In accordance with the Council's Constitution the strategy requires full Council approval.

17. **Other Issues**

OTHER IMPLICATIONS	YES/NO	Paragraph Within Supporting information	References
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 2014/2015

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 and building societies);
- ii. Deposits for periods up to one year with unrated building societies;
- iii. Deposits for periods up to one year with other local authorities;
- iv. Money Market Funds and similar pooled funds (subject to further approval of the Executive);
- v. 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), (ii) or (iii).

Longer Term Investments

- vi. Deposits for periods in excess of one year with UK local authorities or which are issued by or explicitly guaranteed by the UK Government;
- vii. Deposits with credit rated banks and building societies for periods up to two years.

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

- i. Banks and building societies - £80 million;
- ii. Within (i) a limit for unrated building societies - £10 million
- iii. Money Market Funds and other pooled funds – limit to be determined by the Executive;
- iv. 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 2 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 1 year or less, a long-term rating of A, a short term rating of F1
- iii. For term deposits and callable deposits for periods of 6 month or less, a long-term rating of A-, a short term rating of F2
- iv. For money market funds, and other commercial secured deposit facilities, a rating to be determined by the Executive

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 either being the UK government or else a 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 The credit worthiness of unrated building societies will be assessed by reference to the most recently published accounts and by reference to any other publically available market information. In particular regard shall be had to the capital held to absorb financial shocks, liquidity and profitability. Regard shall be had to advice from the Council's treasury advisors.
- 3.4 No credit rating is required for investments issued by or subject to an explicit guarantee from the UK government or in other local authorities.
- 3.5 The maximum sum to be deposited with individual counterparties, or in any one fund, shall be as shown below:
 - i. For money market funds and commercially secured deposit facilities – the limit to be determined by the Executive;
 - 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 credit rated banks and other credit rated institutions not guaranteed by the UK Government - £10 million;
 - v. For deposits in non credit rated building societies £1 million;
 - vi. 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).
- 3.6 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.
- 3.7 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.
- 3.8 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.

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 £100m will be held in investments in excess of 364 days of which no more than £50m will be invested in excess of 366 days.

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.