Leicester City Council

**WARDS AFFECTED:**
**ALL WARDS (CORPORATE ISSUE)**

**OVERVIEW SELECT COMMITTEE** **3rd December 2015**

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**REVIEW OF TREASURY MANAGEMENT ACTIVITIES 2015/16**

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**Report of the Director of Finance**

## 1. Purpose of Report

1.1 This report reviews how the Council conducted its borrowing and investments during the first six months of 2015/16.

1.2 2015/16 has seen continued economic growth in the UK and elsewhere. However, within the Eurozone, whilst economic and financial tensions have eased many underlying issues remain to be resolved.

1.3 A reduction in the rate of growth of the world economy has been a major contributor to the fall in the price of oil and other commodities and this has helped keep inflation rates low in the UK and push back the date at which commentators see UK interest rates rising. At the same time the US economy has shown robust growth which many commentators see as likely to lead to an increase in interest rates there, possibly as early as December. The impact of such an increase is difficult to predict, but there is a risk that there may be an adverse knock-on effect on emerging economies.

1.4 Overall the position presented is of one where major economies of the World are at, or near to turning points and where the exceptional measures (such as “quantitative easing”) put in place in response to the 2008 financial crisis and its aftermath may end, and may well be reversed, except perhaps in the Euro Zone. Such turning points can create turbulence in the financial markets as investors switch investments.

1.5 We continue to monitor the impact of the “bail in” requirements for major depositors 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 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 during 2015/16 to date its investments varied from below £189 million to over £240 million depending on circumstances.

2.2 The Council has a prudent approach to treasury management. It does not borrow more than it needs; generally preferring to use cash balances as an alternative to borrowing. In recent years we have not needed to borrow at all. It only lends to very strong banks and this discipline is enforced by maintaining a regularly updated list of who we will lend to. A particularly cautious approach has been adopted during the recent economic difficulties.

2.3 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 of local significance are financed by borrowing. 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 on the account to cover the payments made on the day but no more (cash held on the bank account earns neglible interest).

4.5 The Council has substantial investments but this is not "spare cash". Some comes from grants received in advance of expenditure and from reserves held for designated purposes. It also includes money set aside to repay debt but which has not been used to repay debt due to the punitive charges referred to above.

4.6 There is a provision for interest earned on investments in the Council's revenue budget.

### Treasury Management Policy and Monitoring

4.7 The activities to which this report relates were governed by the Treasury Strategy for 2015/16 which was approved by the Council on 22nd January 2015. 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.

4.8 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 2015/16

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) at 31/03/2015 and 19/11/2015. The rates shown are the averages paid and received up to 31/03/2015 and 19/11/2015.

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.

4.11 Investments have increased by £46m from £165m to £211m. This movement is broadly in line with expectations – cash balances at year-end are often low and subsequently increase in the new financial year.

**Table 1- Loans & Investments**

| | **Position at 31/03/2015 Principal £M** | **Average Rate** | **Position at 19/11/2015 Principal £M** | **Average Rate** |
|---|---|---|---|---|
| **Long Term Fixed Rate Loans** | | | | |
| Public Works Loan Board (PWLB) | 134 | 4.2% | 134 | 4.2% |
| Market & Stock | 9 | 7.0% | 9 | 7.0% |
| **Variable Rate Loans** | | | | |
| Bank Loans | 96 | 4.4% | 96 | 4.4% |
| **Gross Debt** | 239 | 4.4% | 239 | 4.4% |
| **Investments** | | | | |
| Banks and Build Soc | 60 | | 78 | |
| Other Local Authorities | 88 | | 108 | |
| Government Debt Management Office | 9 | | - | |
| Government Treasury Bills | 8 | | 5 | |
| Money Market Funds | - | | 20 | |
| **Total Investments** | 165 | 0.4% | 211 | 0.4% |
| **NET BORROWING** | **74** | | **28** | |

## 5. Credit Worthiness of Investments

5.1 2015/16 showed increasing signs of economic recovery within the UK economy and within the world economy. Within the euro zone the overall picture was one of economic recovery with the impact varying from country to country and with this recovery taking place against a background of continuing risks within the euro zone.

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 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 fail (or more likely 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 2015/16. 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 (either indirectly though the Debt Management Office or directly through the purchase of short-dated loans known as treasury bills).

5.4 The position remains under review. One factor is that other regulatory developments are continuing to require or push banks towards greater financial robustness in terms of their liquidity (their ability to sustain large outflows of cash) and capital strength (their ability to absorb losses). Another matter currently under review are the measures that will be put in place to require banks to "ring fence" bank deposits from other more risky activities. One consequence of this is that banks are reviewing the range of bank deposit products that they offer, and the interest paid. The Council, for its part, will review the impact of such changes on the security of its investments and receives advice on this matter from its treasury advisors.

5.5 The Council has an indirect exposure to non-UK banks through its investment in money market funds. At the time of preparing this report one fund is invested in, but we are looking to open a further 2-3 funds. Money market funds are like "unit trusts" but rather than investing in company shares these funds investment 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.

## 6. Implementation of Borrowing & Investment Strategy

6.1 The strategy approved by Council for 2015/16 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 in 2015/16 is too high for premature debt redemption to be viable.

## 7. Other Sources of Capital Finance

7.1 Major assets are funded primarily by grant or capital receipts. The acquisition of smaller assets such as vehicles and computer equipment can be financed by borrowing or leasing and a comparison is made in order to choose the option that is most cost effective. During the period under review, leasing has not been used, and assets have been bought outright.

## 8. Key Performance Measures

8.1 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. The second and the third of these do not apply because no new loans have been borrowed and no existing loans have been prematurely repaid.

8.2 The Council is a member of a benchmarking club: the latest data is for the second quarter of 2015/16. The average rate of interest on investments for members of that club is 0.82%. The Council's own rate is lower: 0.50%. This difference in performance can be attributed in part to the average authority investing for longer periods. As at 30th September 2015 the average maturity of our investments was 112 days whereas the group average was 177 days.

8.3 The implementation of our 2015/16 strategy has increased the average maturity of our investments. As at 30th September 2014 the average maturity of our investments was 81 days and the figure as at 30th September 2015 stood at 122 days, some 41 days higher. At the date of drafting this report the average maturity was 113 days.

8.4 The rate of interest on investments at the date of drafting this report is 0.6% which is 0.2% higher than the 0.4% rate on investments at 31st March 2015 and in the year to date. This increase is mainly due to the lengthening of maturity described above. We will continue to lengthen the maturity of our investments, subject to satisfactory investment opportunities being presented. Despite this it is likely that the next benchmarking results will show that the return on our investments is lower than that of the average authority with this difference being attributable to our cautious approach to credit risk. In particular a lot of our investments are, and will remain with, other local authorities.

8.5 There is a relationship between the credit rating of an investment and its return – generally the higher the credit rating the lower the return and visa-versa. As well as receiving information from the benchmarking club we also receive benchmarking data from our Treasury Advisors. We have reviewed this data and discussed it with our advisors who advise that we have struck an appropriate balance between risk and reward. They also support the approach of seeking higher returns by continuing to increase the average maturity of our investments.

8.6 The current low interest rate environment is forecast to continue for a number of years (although interest rates are expected to rise slowly) and this consideration will feed into the review as to whether cash balances should be used repay existing long-term, fixed rate, debts.

8.7 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 2015/16 and in the current economic climate continues to be a most important consideration. The "return of the principal" is considered more important than the "return on the principal", that is 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.

## 9. **Use of Treasury Advisors**

9.1 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.

## 10. **Compliance with the Council's Treasury Strategy**

10.1 As required by the statutory borrowing framework, the Council is required to set a number of prudential limits and indicators, and is encouraged to supplement these with local indicators when appropriate. These limits are set annually and can be found within the budget and Treasury Strategy.

10.2 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

10.3 These limits are monitored, and have been complied with.

## 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.

## 14. **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 | |

15. **Background Papers**

15.1 The Council's Treasury Management Strategy - "Treasury Strategy 2014/15" – Council 23rd January 2014. The Council's Treasury Policy Document – "Framework for Treasury Decisions" – Council 29 March 2012.

16. **Consultation**

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

17. **Author**

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

Alison Greenhill
Director of Finance.