Leicester
City Council

Council **Date: 22nd February 2017**

Treasury Strategy 2017/18

Report of the Director of Finance

1. **Purpose of Report**

1.1 This report proposes a strategy for managing the Council's borrowing and cash balances during 2017/18.

2. **Summary**

2.1 The Council has a substantial amount of debt, which has been borrowed to pay for past capital expenditure.

2.2 The Council also has high cash balances. The reasons for this are complex, and are explained in the report.

2.3 Treasury management is the process by which our borrowing is managed, and our cash balances are invested.

3. **Recommendations**

3.1 The Council is recommended to approve this treasury strategy, which includes the annual investment strategy at Appendix B.

4. **Borrowing**

4.1 As of 21st December 2016, the Council had a total debt of £239m.

4.2 In years prior to 2011, the Government supported our capital programme by means of "supported borrowing approvals." The Government allowed us to borrow money, and paid us to service the debt through our annual revenue support grant. This is similar to someone supporting a family member to buy a house, by paying the mortgage instalments.

4.3 The Government no longer does this, choosing instead to support our capital programme by means of capital grants (i.e. lump sums). Consequently, our debt levels are largely static, until individual loans are due for repayment. As most of our debt is long term, with repayments due 36 to 65 years from now, we expect to see little change in this level of debt.

4.4 We will not need to borrow any money in 2017/18, unless we use cash balances to repay existing debt. This is something we would like to do, but Government rules now make it prohibitively expensive in most cases.

4.5 Best practice requires the Council to set certain limits on borrowing, and these are provided at Appendix A. In reality, these will play no part in our management of borrowing unless we are, in fact, able to repay any debt. The overwhelming likelihood is that we will end 2017/18 with borrowing of £239m.

5. Investments

5.1 The effort involved in treasury management now revolves almost solely around management of our cash balances. These fluctuate during the course of a year, and range from £160m to £230m dependent on circumstances (e.g. closeness to employees' pay day).

5.2 These balances are high for three reasons:-

(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 do not actually 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.

5.3 The key to investment management is to ensure our money is safe, whilst securing the highest possible returns consistent with this.

5.4 In terms of **security**, the key issues are:-

(a) The credit worthiness of bodies we lend money to ("counterparties");

(b) The economic environment in which all financial institutions operate. The financial crash of 2008, for instance, destabilised a lot of banking institutions which appeared credit worthy prior to this;

(c) What would happen if a financial institution did, in fact, run into trouble?

5.5 The world economic situation has improved since 2008, but risks remain. There are financial and economic risks in the Euro Zone (some economies are in difficulty, and so are some countries' banks), and we do not yet know the impact of Brexit.

5.6 In 2008, many Governments bailed out banks regarded as "too big to fail". Since 2008, the world's largest economies have implemented measures to make banks stronger, but also to reduce the impact if they do fail (and the cost to taxpayers). These measures would see institutional investors who have lent money (such as the Council) taking significant losses before there is any taxpayer support. In practice, these measures are likely to be invoked when a bank starts to run into trouble, before it actually fails. This process is known as "bail in".

5.7 The upshot is that we cannot regard any financial institution as a safe haven over the medium term – we need to keep watch for any signs of trouble.

5.8 The key to our investment strategy is therefore to diversify our investments (so we don't "keep all our eggs in one basket"), invest with public sector bodies that <u>are</u> backed by the Government, or seek additional security for our money.

5.9 In respect of **<u>return</u>**, bank base rates are at record lows of 0.25%, and our advisors believe that they will remain extremely low for two years at least.

5.10 Greater returns can be achieved by lending for longer periods, but this starts to raise the risks described above.

5.11 The details of our investment strategy are described in Appendix B, but in summary:-

(a) We will lend on an unsecured basis to the largest UK banks for periods not exceeding one year. We will also lend to some smaller building societies for periods not exceeding six months. Bail-in rules mean lending for longer on an unsecured basis is too great a risk;

(b) We will lend for longer periods, and to smaller banks, if our money is secured (i.e. if we can take possession of the bank's assets in the event of failure to repay);

(c) Lending to other local authorities has long been a cornerstone of our investment strategy, and this will continue. We will lend to local authorities for up to two years, and may invest in bonds that they issue with a maturity of up to five years, enabling us to secure greater returns;

(d) We will place some money with pooled investments, such as money market funds. These are professionally managed funds, which place money in a range of financial assets, some based overseas. This helps achieve diversification. In cases where money is not secured, we will make sure funds can be returned very quickly;

(e) We will lend to the Government and other public sector bodies.

5.12 In addition to the above, we will place up to £15m in the CCLA "local authorities' property fund." This fund invests in commercial property, and is owned by its clients who are local authorities and charities. This is also a pooled investment, but in the case of this fund it would only be appropriate to invest if we expect to retain our holding for at least five years. The fund is expected to pay dividends at a rate of 4% to 4.5%, which exceeds current cash returns of around 0.5%. However, with such a fund there is always a risk that values will decrease.

5.13 The Treasury Strategy continues the policy of investing in projects which benefit the local economy, and permits the use of up to £20m for the Local Investment Fund.

5.14 Use of the CCLA, and local investment fund help us to reduce our reliance on cash investments as the sole means of achieving returns, but also introduce greater risk: such investments can lose value as well as make returns. The City Mayor may also, from time to time and in line with normal approvals, spend money on capital schemes which are expected to achieve returns greater than can be expected from investment of cash balances.

6. **Premature Repayment of Debt**

6.1 One tool of treasury management is the premature repayment of debt to achieve savings. This is something we used to do routinely, but (as discussed above) is now usually impossible. We will take such opportunities if they present themselves at a sensible cost.

6.2 The reasons why our debt has 36 to 65 years to run are historic, and reflect past circumstances and government policies at that time. In current circumstances, we would prefer a more even spread of repayment dates, and will use premature repayment to achieve this if possible.

7. **Treasury Management Advisors**

7.1 The Council employs Arlingclose as treasury advisors. Their performance has been good.

8. **Leasing**

8.1 We do not use leasing as a method of financing, preferring instead to use our cash balances.

9. **Financial and Legal Implications**

9.1 The proposals are in accordance with the Council's statutory duties under the Local Government Act 2003 and statutory guidance, and comply with the CIPFA Code of Practice on Treasury Management. In accordance with the Council's constitution (Article 4.03), the strategy requires full Council approval.

10. Background Papers

10.1 None.

11. Author

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Appendix A

Treasury Limits For 2017/2018

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 3 below), is a statutory limit under the Local Government Act 2003.

2. The first indicator is that over the medium-term net borrowing will only be for capital purposes – i.e. net borrowing should not, except in the short-term, exceed the underlying need to borrow for capital purposes (the "capital financing requirement").

3. The Council is required to set an "authorised limit" on borrowing which cannot be exceeded. The approved limits recommended for 2017/18 are:

	£m
Borrowing	280
Other forms of liability	145
Total	425

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.

5. The Council is also required to set an "operational boundary" on borrowing which requires a subsequent report to scrutiny committee if exceeded. The approved limits recommended for 2017/18 are:

	£m
Borrowing	270
Other forms of liability	145
Total	415

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 on "borrowing".

	£m
Fixed interest rate	240
Variable interest rate	60

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

8. The minimum percentage of its overall investments that the Council will hold in short-term investments is 40%. The Council will also maintain liquidity by holding maturing deposits and deposits on call to cover estimated payments less receipts over a rolling 30 day period (subject to the availability of funds to invest). 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.

9. The Council is required by statutory guidance to set a limit on those investments which are not "specified investments" and to specify what it means by this term. Specified investments have to be repaid within 12 months of the time they are agreed and must be invested with the UK government, a UK local authority or a body or pooled investment of high credit quality, which we define as having a credit rating of BBB+ or higher. In practice this means that no more than £120m will be held in investments in excess of 366 days, including investments which can be sold at shorter notice but where the intention is to hold the investment for a period in excess of 366 days.

Appendix B

Annual Investment Strategy 2017/18

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.

1.3 It does not cover the use of investments for local economic projects for which separate policies will be prepared. For example £20m may be invested in a Local Investment Fund. The City Mayor may also, from time to time and in line with normal approvals, spend money on capital schemes which are expected to achieve returns greater than can be expected from investment of cash balances.

2. **Investment Objectives & Authorised Investments**

2.1 All investments will be in sterling.

2.2 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 following part of this appendix specifies how the Council may invest, with whom and the credit worthiness requirements to be applied.

3. **Approved Investments**

3.1 UK Banking Sector: Credit Rated Institutions			
Type	**Description**	**Investment Period**	**Controls**
General	Covers the largest UK banks and building societies. Covers non-UK banks operating in the UK and regulated in the UK.		No more that £80M will be invested in total with these institutions. No more that £20M will be invested with any one institution. Of this £20M no more than £10M will be unsecured except when invested with Barclays (our bankers). £15M may be lent unsecured to Barclays of which no more than £10M may be lent longer than overnight. New bodies will not be added to the list without the written approval of the Director of Finance.
Unsecured deposits	UK banks only (not non-UK banks).	Maximum 366 days.	A list of approved counterparties will be maintained , based on credit ratings. Principally, we use Fitch. Minimum ratings as below. Other market intelligence will also be considered.
		Up to 366 days.	Long-term rating of A & short term rating of F1
		Up to 6 months.	Long-term rating of A- & short term rating of F2
		100 days or less.	Long-term rating of BBB+ & short term rating of F2

Covered Bonds	This is a deposit with a bank, which is secured on bank assets such as mortgages. These assets are not immediately saleable but the value of the assets exceeds loans secured upon them. If the deposit is not repaid the assets are sold and the proceeds used to repay the loan.	Maximum 5 years.	Bond is regulated under UK law and majority of assets given as security are UK based. Minimum long-term rating of AA .
Reverse REPOs	This is a deposit with a bank, which is secured on bonds and other readily saleable investments and which will be sold if the deposit it not repaid.	Maximum 1 year.	Judgement that the security is equivalent, or better than the credit worthiness of unsecured deposits. REPO/Reverse REPO is accepted as a form of collateralised lending and should be based on the GMRA 2000 (Global Master REPO Agreement). Should the counterparty not meet our senior unsecured rating then a 102% collateralisation would be required. The acceptable collateral is as follows:- • Index linked Gilts • Conventional Gilts • UK Treasury bills • DBV (Delivery By Value) • Corporate bonds

3.2 Unrated Building Societies			
Type	**Description**	**Investment Period**	**Controls**
General	Smaller building societies who do not have credit ratings. Many are mutually owned.	Up to 6 months.	No more than £10M will be invested in total with these institutions. No more than £1M will be invested with any one institution. A list of approved counterparties will be maintained. This will be based upon an analysis of the financial strength of the institution by our Treasury Advisers. New bodies will not be added to the list without the written approval of the Director of Finance.

3.3 UK Public Sector & Quasi Public Sector			
Type	**Description**	**Investment Period**	**Controls**
General	The UK Government and UK local authorities. It also includes bodies that are very closely linked to the UK Government or to local government such as Transport of London (TFL) or the Local Government Bond Agency.		No more than £130M to be lent to local authorities. No more than £20M to be lent to any one local authority. No more than £40M to be lent to bodies very closely linked to the UK Government and no more than £20M to be lent to any one body. No limit on amounts lent to the UK Government.
Deposits	Deposits with Local Authorities and the UK Government.	Up to 2 years.	Our judgement is that local authorities are of high credit worthiness and that the law provides a robust framework to ensure that all treasury loans are repaid. However, should the occasion arise, we would have regard to adverse news or other intelligence regarding the financial standing of a local authority.
Bonds – Local Authority	Bonds issued by local authorities.	Up to 5 years.	
Bonds – Municipal Bond Agency	Bonds issued by local authorities collectively through the Local Government Bond Agency.	Up to 5 years.	Minimum AA credit rating. The agency is new and until established the number of underlying borrowing local authorities will be low. When investing with the agency we will look at the underlying exposure to individual authorities when these are material and take into account existing exposures to those authorities.
Bonds – Bodies Closely Linked to UK Government		Up to 5 years.	Minimum AA credit rating. Approval by Director of Finance to the body being added to the lending list on the basis of a written case, including advice from the Council's treasury advisors.

3.4 International Development Banks			
Type	**Description**	**Investment Period**	**Controls**
Bonds	International Development Banks which are backed by the governments of the world's largest and strongest economies. The funding obligations are established by treaties or other binding legal agreements.	Up to 5 years.	No more than £40M to be lent in total and no more than £10M to be lent to any one bank. Approval by Director of Finance, in consultation with the City Mayor, to the body being added to the lending list on the basis of a written case, including advice from the Council's treasury advisors. A minimum credit rating of AA plus backing of one or more G7 country.

3.5. Pooled Investments – Shorter Dated Investments			
Type	**Description**	**Investment Period**	**Controls**
General	A structure where a wide base of investors share a common pool of investments. The most common legal form involves an intermediate company. The company has legal title to a pool of investments. The underlying investors own the company with a claim to their share of the assets proportional to their investment in the company.		We will only invest in funds where there is evidence of a high level of competence in the management of the investments, and which are regulated. Approval by Director of Finance to the body being added to the lending list on the basis of a written case, including advice from the Council's treasury advisors. The investment period will reflect advice from our Treasury Advisors on a fund by fund basis. We will be alert to "red flags" and especially investments that appear to promise excessive returns. We look for diversification away from the banks permitted elsewhere in this lending list (though some overlap is unavoidable). No more than £80M to be invested in all fund types listed in this table.
Money market funds	The underlying pool of investments consists of interest paying investments, for example deposits. The underlying borrowers include banks, other financial institutions and non-financial institutions of good credit worthiness. Banks may be UK or overseas.	Must have immediate access to funds.	Fitch rating of AAAmmf (or equivalent). No more than £20M in any one fund.

Short Dated Government Bond Funds	Similar to money market funds but mainly concentrated in highly credit rated government bonds.	Must have immediate access to funds.	Whilst these are very safe the interest returned is very low. We may use these in times of market turmoil. Fitch rating of AAAf (or equivalent). No more than £20M in any one fund.
Money market plus funds / cash plus funds / Short dated bond funds	Similar to money market funds but the underlying investments have a longer repayment maturity. We would use these to secure higher returns.	Must have access with one month's notice but normally would wish to hold for 12-18 months.	Fitch rating of AAf (or equivalent). No more than £20M in any one fund. We will "drip feed" money that we invest rather than investing it all at once.

3.6. Pooled Investments – Longer Dated Investments			
Type	**Description**	**Investment Period**	**Controls**
General	A structure where a wide base of investors share a common pool of investments. The most common legal form involves an intermediate company. The company has legal title to a pool of investments. The underlying investors own the company with a claim to their share of the assets proportional to their investment in the company. Longer dated investments expose us to the risk of a decline in value, but also provide an opportunity to achieve higher returns. Consequently, controls involve both the personal authorisation of the Director of Finance and consultation with the City Mayor.		We will only invest in funds where there is evidence of a high level of competence in the management of the investments, and which are regulated. The investment period will reflect advice from our Treasury Advisors on a fund by fund basis. We will be alert to “red flags” and especially investments that appear to promise excessive returns. We will “drip feed” money that we invest rather than investing it all at once. We look for diversification away from the banks permitted elsewhere in this lending list (though some overlap is unavoidable). No more than £40m to be invested in all fund types listed in this table.
Local Authority Property Fund	The underlying investments are mainly direct holdings in property. Whilst the fund normally has a small cash balance from which to fund redemptions the bulk of the fund is held in direct property investments. On occasions redemptions will not be possible until a property has been sold.	Generally have access with three months’ notice but normally would wish to hold for five years.	No more than £15M to be invested in this fund. Investment amounts and timing to be approved by the Director of Finance, in consultation with the City Mayor.

Longer-dated Bond Funds.	Similar to money market funds but the underlying investments are now mainly bonds with a maturity with an average maturity of up to 8 years.	Must have access with one month's notice but normally would wish to hold for two to three years.	Fitch rating of AAf (or equivalent). Approval by Director of Finance, in consultation with the City Mayor, to the body being added to the lending list on the basis of a written case, including advice from the Council's treasury advisors. No more than £10M to be invested in any one fund.
Asset Based Securities	The base investments are "securitised investments" which pool consumer debt (mortgages, car loans and credit cards) and loans to small businesses. The base investments are loans to borrowers of good credit worthiness. The investment we would make would be in a pooled investment containing a number of such securitised investments. They are normally issued by banks (UK or overseas).	Must have access with one month's notice but normally would wish to hold for two to three years.	Fitch rating of AAf (or equivalent). We look for particular strong evidence of expertise both from the organisations that issue the securitised investments and also from the managers of the pooled fund. We look for clear evidence of financial and operational independence between the fund managers and the banks that made the consumer loans in the first place. Approval by Director of Finance, in consultation with the City Mayor, to the body being added to the lending list on the basis of a written case, including advice from the Council's treasury advisors. No more than £10M to be invested in any one fund.