Agenda item: 10

Decision maker: Cabinet

Subject: Treasury Management Monitoring Report for the Third Quarter of 2011/12

Date of decision: 27 January 2012 (Governance and Audit Committee – for information)
6 February 2012 (Cabinet)

Report by: Head of Financial Services & Section 151 Officer

Wards affected: All

Key decision: No
Budget & policy framework decision: No

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1. Summary

The Chartered Institute of Public Finance and Accountancy (CIPFA) defines Treasury Management as "The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks". The risks associated with treasury management include credit risk, liquidity risk, interest rate risk and refinancing risk. The report contained in Appendix A reports on the City Council's treasury management position as at 31 December 2011.

2. Purpose of report

The purpose of the report in Appendix A is to inform members and the wider community of the Council's Treasury Management position at 31 December 2011 and of the risks attached to that position.

3. Background

In March 2009 the CIPFA Treasury Management Panel issued a bulletin on Treasury Management in Local Authorities. The bulletin states that "in order to enshrine best practice it is suggested that authorities report formally on Treasury Management activities at least twice yearly and preferably quarterly". The report in Appendix A covers the first nine months of 2011/12

4. Recommendations

That the following actual treasury management indicators for the third quarter of 2011/12 be noted:

(a) The Council's sums invested for periods longer than 364 days at 31 December 2012 were:

	Actual £m
Maturing after 31/3/2012	16
Maturing after 31/3/2013	0

(b) The Council's fixed interest rate exposure at 31 December 2011 was £258m, ie. the Council had net fixed interest rate borrowing of £258m

(c) The Council's variable interest rate exposure at 31 December 2012 was (£209m), ie. the Council had net variable interest rate investments of £209m

(d) The maturity structure of the Council's borrowing was

	Under 1 Year	**1 to 2 Years**	**3 to 5 Years**	**6 to 10 Years**	**10 to 20 Years**	**20 to 30 Years**	**30 to 40 Years**	**40 to 50 Years**
Actual	1%	5%	4%	6%	12%	12%	7%	53%

5. Implications

The net cost of Treasury Management activities and the risks associated with those activities have a significant effect on the City Council's overall finances. Effective Treasury Management provides support to the organisation in the achievement of its business and service objectives.

` **6. Corporate priorities**

This report and the activities it refers to contribute to the following Corporate Priority:

- Improve efficiency and encourage involvement

7. Equality impact assessment (EIA)

A preliminary equalities impact assessment (EIA) on Treasury Management Policy was carried out in March 2011. This concluded that a full EIA is not required.

8. Legal implications

The Section 151 Officer is required by the Local Government Act 1972 and by the Accounts and Audit Regulations 2011 to ensure that the Council's budgeting, financial management, and accounting practices meet the relevant statutory and professional requirements. Members must have regard to and be aware of the wider duties placed on the Council by various statutes governing the conduct of its financial affairs.

9. Head of Finance's comments

All financial considerations are contained within the body of the report and the attached appendices

…………………………………………………………………..
Signed by Head of Financial Services & Section 151 Officer

Appendices:

Appendix A: Treasury Management Monitoring Report

<u>Background list of documents: Section 100D of the Local Government Act 1972</u>

The following documents disclose facts or matters, which have been relied upon to a material extent by the author in preparing this report:

	<u>Title of document</u>	**Location**
1	Treasury Management Files	Financial Services
2		

The recommendation(s) set out above were approved/ approved as amended/ deferred/ rejected by the Cabinet on 6 February 2012.

…………………………………………….
Signed by: the Leader of the Council

APPENDIX A

TREASURY MANAGEMENT MONITORING REPORT FOR THE THIRD QUARTER OF 2011/12

1. GOVERNANCE

The Treasury Management Policy Statement, Annual Minimum Revenue Provision for Debt Repayment Statement and Annual Investment Strategy approved by the City Council on 7 March 2011 provide the framework within which treasury management activities are undertaken.

2. INTEREST RATE FORECASTS FOR THE THIRD QUARTER OF 2011/12

The City Council employs Sterling Consultancy Services to provide interest rate forecasts. When the policy statement was written in February 2011, it was anticipated that the bank base lending rate would rise to 1.0% by the end of 2011. The primary upside risk to base rate was the possible increase in inflation expectations stemming from the persistently above target Consumer Price Index. The increase in the VAT rate and rises in a number of commodity prices would have heightened the Bank of England's Monetary Policy Committee's (MPC) concern in this area. However the most persuasive factor for the majority of MPC members appeared to be the estimated margin of spare capacity. With fiscal tightening expected to depress demand, the likelihood of a material margin of spare capacity remaining throughout the next three years seemed quite high. The actual bank base lending rate however remained at 0.5% for the whole of the first three quarters of 2011/12 mainly due to the deteriorating external economic environment and soft domestic demand.

Investment Rates

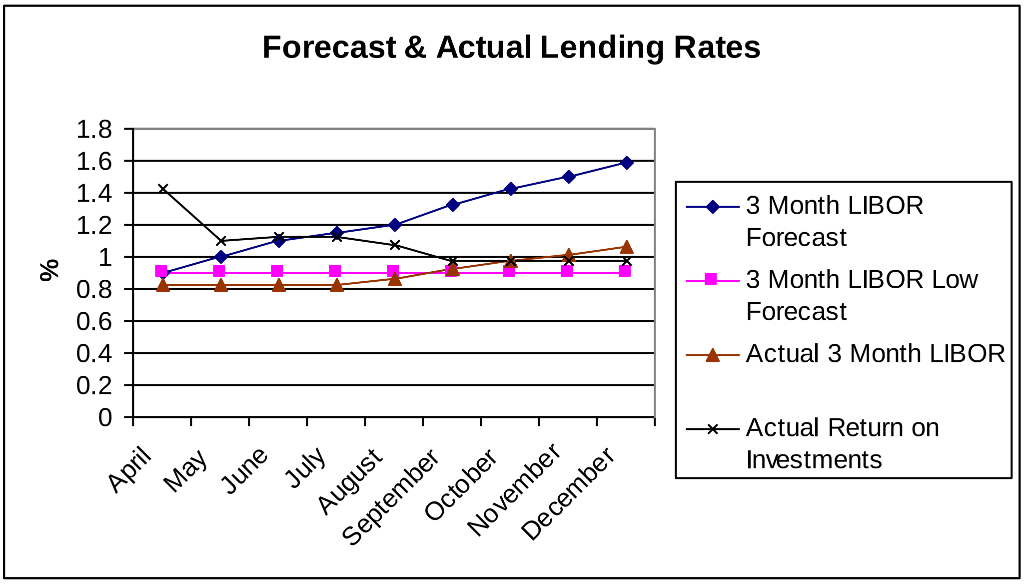
The estimated return on new investments was calculated using Sterling Consultancy Services low 3 month London Inter Bank Offer Rate (LIBOR) forecast of 0.90% for the first three quarters of 2011/12. The actual 3 month LIBOR rate averaged 0.90% for the first three quarters of 2011/12.

The table below shows a comparison of the interest rates used in calculating the City Council's annual estimates and the actual return on the Council's investments.

	Anticipated %	Actual %
Temporary Lending	0.90*	1.08

* Anticipated rate for new lending

The overall return on the City Council's investments is shown in the graph below:



The City Council's overall return on its investments was 1.44% at the start of the year, but fell to 0.98% by December as existing investments made in previous years matured and were replaced by new investments at the lower rates which were available at the time. The City Council's cash holdings increase in April as tax collection resumes, necessitating greater investment activity.

<u>Borrowing Rates</u>

The City Council uses Sterling Consultancy Services 25 year Public Works Loans Board (PWLB) high forecast to estimate the cost of new borrowing. The 25 year PWLB rate started the financial at 5.36%, below Sterling Consultancy Services probable forecast of 5.55%. It subsequently fell to 3.98% by December.

The table below shows a comparison of the interest rates used in calculating the City Council's annual estimates and the average interest rate on the Council's new borrowing in the first three quarters of 2011/12.

	Anticipated %	Actual %
Long Term Borrowing	5.70	4.51

3. SOURCES OF FINANCE

(a) Long Term Borrowing (more than 364 days)

Some of the rental income relating to council housing is currently paid to the Government in the form of negative HRA subsidy. The Localism Act includes measures to repeal the existing Housing Revenue Account (HRA) subsidy system and replace it with powers for the Secretary of State for Communities and Local Government to introduce self-financing. This will be achieved via a reallocation of housing debt on 1st April 2012, after which councils will retain all the rental income they collect. The Council will be required to pay the Government £90.4m on 28th March 2012.

No new borrowing is planned for 2011/12, apart from that necessary to fund the Housing Revenue Account Self Financing payment to the Government, although the Head of Financial Services and Section 151 Officer was given delegated powers to undertake new borrowing if expected interest rate movements make this an advantageous option.

Lower interest rate expectations and continuing concerns over the Euro zone sovereign debt caused a reduction in gilt yields and PWLB rates in April. With the expected direction of future gilt yields being upwards at that time, consideration was given to borrowing part of the Housing Revenue Account (HRA) Self Financing payment to the Government. With this in mind two loans were taken from the PWLB. The first loan was for £20m for 31 years at 5.01%. The second loan was for £14m for 20 years at 4.52%. Both loans are repayable through equal installments of principal.

Risk averse attitudes in the financial markets caused a further reduction in gilt yields and PWLB rates in August. With the expected direction of future gilt yields being upwards consideration was given to borrowing more of the Housing Revenue Account (HRA) Self Financing payment to the Government. With this in mind two further loans were taken from the PWLB. The first loan was taken on 16 August for £25m for 30 years at 4.44%. The second loan was taken on 23 August for £25m for 30 years at 4.19%. Both loans are repayable through equal installments of principal. All but £6.4m of the City Council’s HRA Self Financing payment is now fully funded.

On 29 September the Chief Secretary to the Treasury announced that local authorities would be allowed to borrow from the Public Works Loans Board (PWLB) at National Loans Fund (NLF) rates to fund the HRA Self Financing payment. NLF rates are typically 1.13% below the rates the PWLB normally offers to local authorities. The PWLB will make NLF rates available to local authorities on 26 March 2012 for the purposes of funding HRA Self Financing payments. Despite local authorities being given indicative HRA Self Financing payment figures before the start of this financial year, there was no indication that the PWLB would offer loans at NLF rates prior to 29 September.

The PWLB does not normally accept applications for the early redemption of loans that are less than one year old. Even if the PWLB was prepared to accept an application for the early redemption of the loans the City Council has taken to fund the HRA Self Financing payment the premium chargeable under the current regulations would be around £45m.

(b) Short Term Borrowing Requirements (less than 365 days)

The Head of Financial Services and Section 151 Officer has delegated powers to undertake long and short term borrowing within an approved limit set by the City Council. The authorised limit for borrowing in 2011/12 of £413m was approved by the City Council on 8 February 2011.

The City Council was in a lending position for the whole of the first three quarters of the financial year so this limit was not exceeded at any time and no temporary borrowing was outstanding at the quarter-end.

(c) Long Term Lending

Long term investments at 31 March 2012 are restricted to £129m which represents the Council's estimated core cash, ie. the amount of cash that will not be required to fund the Council's short term cash flows.

£2m was invested for 688 days at 1.45%. However, £12.5m of long term investments matured in the first three quarters of 2011/12. In addition a borrower exercised an option to repay £4m early. This brought the total long term investments to £16m at 31 December 2011. Long term investments now make up 7% of the City Council's investment portfolio. The average return on long term investments at 31 December was 1.24%. Interest rates on long term investments at 31 December 2011 ranged from 1.0% to 1.45%.

(d) Temporary Lending

Due to current market volatility and to reduce the Council's credit risk (ie. risk of default), coupled with the prospect of rising short term rates, the remaining surplus funds were invested in the short term, ie. for less than 365 days. The average return on short-term investments at 31 December was 0.96%. Interest rates on short-term investments at 31 December 2011 ranged from 0.45% to 2.10%.

4. NET DEBT

The Council's net borrowing position at 31 December 2011 was as follows:

	1 April 2011 £'000	31 Dec 2011 £'000
Borrowing	191,073	273,738
Finance Leases	5,608	5,608
Service Concession Arrangements (including PFIs)	88,055	88,055
Transferred debt administered by HCC	16,230	15,577
Gross Debt	**300,966**	**382,978**
Investments	(136,242)	(225,428)
Net Debt	**164,724**	**157,550**

The Council has a high level of investments relative to its gross debt due to a high level of reserves, partly built up to meet future commitments under the Private Finance Initiative schemes, HRA Self Financing and future capital expenditure.

The current high level of investments increases the Council's exposure to credit risk, ie. the risk that an approved borrower defaults on the Council's investment. In the interim period where investments are high because loans have been taken in advance of need, there is also a short term risk that the rates (and therefore the cost) at which money has been borrowed will be greater than the rates at which those loans can be invested. The level of investments will fall as capital expenditure is incurred and commitments under the Private Finance Initiative (PFI) schemes are met.

5. SECURITY OF INVESTMENTS

The risk of default has been managed through investing only in financial institutions that meet minimum credit ratings, limiting investments in any institution to £20m and spreading investments over countries and sectors. A limit of £40m is placed on investments in any single foreign country.

The 2011/12 Treasury Management Policy approved by the City Council on 7 March 2011 only permits deposits to be placed with the Council's subsidiaries, namely MMD (Shipping Services) Ltd, the United Kingdom Government, other local authorities and institutions that have the following credit ratings:

<u>Short Term Rating</u>

F1 (or equivalent) from Fitch, Moody's (P-1) or Standard and Poor (A-1)

<u>Long Term Rating</u>

A+ (single A category) or equivalent from Fitch, Moody's or Standard & Poor

<u>Financial Strength Rating</u>

C from Moody's (unless the institution is eligible for support under the UK Government's Credit Guarantee Scheme)

<u>Support Rating</u>

1 from Fitch

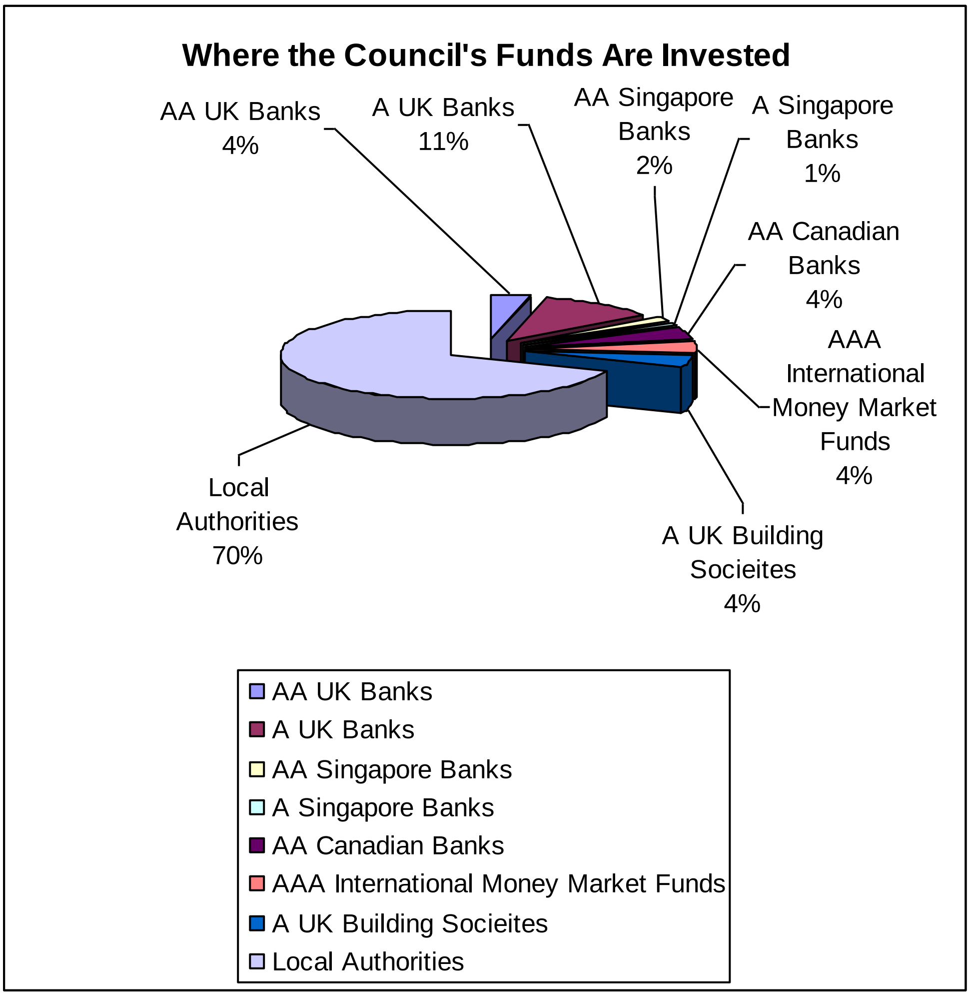
The credit rating agencies have down rated many financial institutions over the last quarter. The downgrades are the result of a reassessment of the level of government support that may be given to financial institutions. While they believe the government will continue to provide some level of support to systemically important financial institutions, it is now thought to be more likely that the government will allow smaller financial institutions, such as the Nationwide Building Society and Clydesdale Bank, to fail if they become financially troubled.

There is also a belief that global trading and universal banks, such as Barclays, are more vulnerable to market sentiment than more traditional banking models.

Consequently at 31 December 2011 the City Council had £33.3m invested with institutions that met the Council's criteria at the time the investment was made, but which no longer meet the Council's criteria. This accounts for 15% of the Council's investment portfolio. Once funds have been invested in a fixed term deposit, there is no provision in the contract for funds to be withdrawn prematurely.

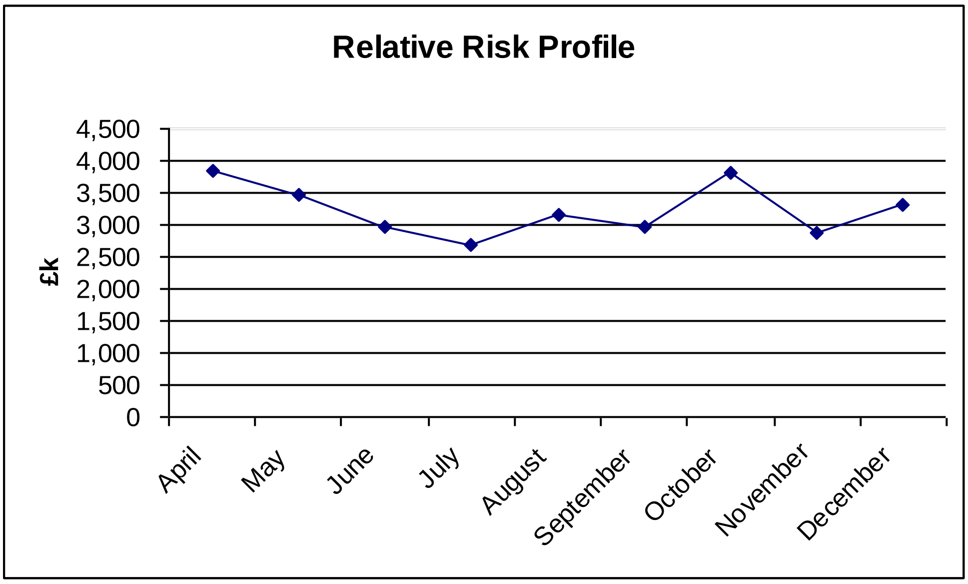
At 31 December 2011 the City Council had on average £7.5m invested with each institution.

The chart below shows how the Council's funds were invested at 31 December.



The Council has no direct investment exposure to the Euro zone. However, there is likely to be some indirect exposure to the Euro zone through the Council's investments in AAA rated international money market funds which currently make up 4% of the Council's investment portfolio.

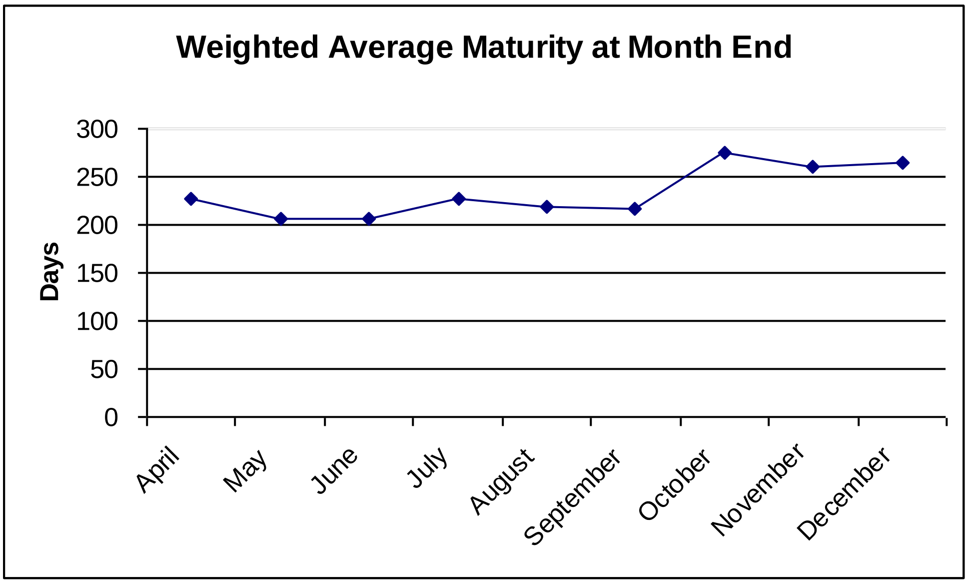
The credit rating agencies publish default rates for each rating category. Multiplying these default rates by the amount invested in each credit rating category provides a measure of risk that can be used as a benchmark to determine whether the City Council's investment portfolio is becoming more or less risky over time as shown in the graph below.



The City Council's investment portfolio became significantly less risky over the first four months of 2011/12 and then stayed level until October when the credit rating agencies down graded several financial institutions. The increase in the riskiness of the Council's investment portfolio in October reflects not so much a shift in the composition of the portfolio, but more a change in the perceived riskiness of the portfolio by the credit rating agencies. The riskiness of the portfolio reduced in November as investments in financial institutions that no longer met the Council's investment criteria were not replaced. The above graph should be read in relative terms. A default occurs when sums due are not paid on time. A default does not mean that the sum invested will be lost permanently.

6. LIQUIDITY OF INVESTMENTS

The weighted average maturity of the City Council's investment portfolio started at 227 days in April and increased to 265 days in December. This is shown in the graph below.



The 2011/12 Treasury Management Policy seeks to maintain the liquidity of the portfolio, ie. the ability to liquidate investments to meet the Council's cash requirements, through maintaining at least £10m in instant access accounts. At 31 December £9.8m was invested in instant access accounts. There was a slight short fall in instant access funds at 31 December due to actual net cash flows differing from the estimated net cash flows. Whilst short term investments provide liquidity and reduce the risk of default, they do also leave the Council exposed to falling interest rates.

Under CIPFA's Treasury Management Code it is necessary to specify limits on the amount of long term investments, ie. Investments exceeding 364 days that have maturities beyond year end in order to ensure that sufficient money can be called back to meet the Council's cash flow requirements. The Council's performance against the limits set by the City Council on 15 November 2011 is shown below.

Maturing after	**Limit** £m	**Actual** £m
31/3/2012	129	16
31/3/2013	115	0
31/3/2014	97	0

7. INTEREST RATE RISK

This is the risk that interest rates will move in a way that is adverse to the City Council's position.

The CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes require local authorities to set upper limits for fixed interest rate exposures. Fixed interest rate borrowing exposes the Council to the risk that interest rates could fall and the Council will pay more interest than it need have done. Long term fixed interest rate investments expose the Council to the risk that interest rates could rise and the Council will receive less income than it could have received. However fixed interest rate exposures do avoid the risk of budget variances caused by interest rate movements. The Council's performance against the limits set by the City Council on 7 March 2011 is shown below.

	Limit £m	Actual £m
Maximum Projected Gross Borrowing – Fixed Rate	280	274
Minimum Projected Gross Investments – Fixed Rate	(16)	(16)
Fixed Interest Rate Exposure	264	258

The CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes also require local authorities to set upper limits for variable interest rate exposures. Variable interest rate borrowing exposes the Council to the risk that interest rates could rise and the Council's interest payments will increase. Short term and variable interest rate investments expose the Council to the risk that interest rates could fall and the Council's investment income will fall. Variable interest rate exposures carry the risk of budget variances caused by interest rate movements. The Council's performance against the limits set by the City Council on 7 March 2011 is shown below.

	Limit £m	Actual £m
Minimum Projected Gross Borrowing – Variable Rate	-	-
Maximum Projected Gross Investments – Variable Rate	(264)	(209)
Variable Interest Rate Exposure	(264)	(209)

The City Council is particularly exposed to interest rate risk because all the City Council's debt is made up of fixed rate long term loans, but most of the City Council's investments are short term. Future movements in the Bank Base Rate tend to affect the return on the Council's investments, but leave fixed rate long term loan payments unchanged.

The risk of a 0.5% increase in interest rates to the Council is as follows:

Effect of +/- 0.5% Rate Change	**2011/12** **£**	**2012/13** **£**	**2013/14** **£**	**2014/15** **£**
Long Term Borrowing	325	41,158	94,500	94,500
Investment Interest	(102,229)	(494,603)	(584,117)	(509,630)
Net Effect of +/- 0.5% Rate Change	**(101,904)**	**(453,445)**	**(489,617)**	**(415,130)**

8. MATURITY STRUCTURE OF BORROWING

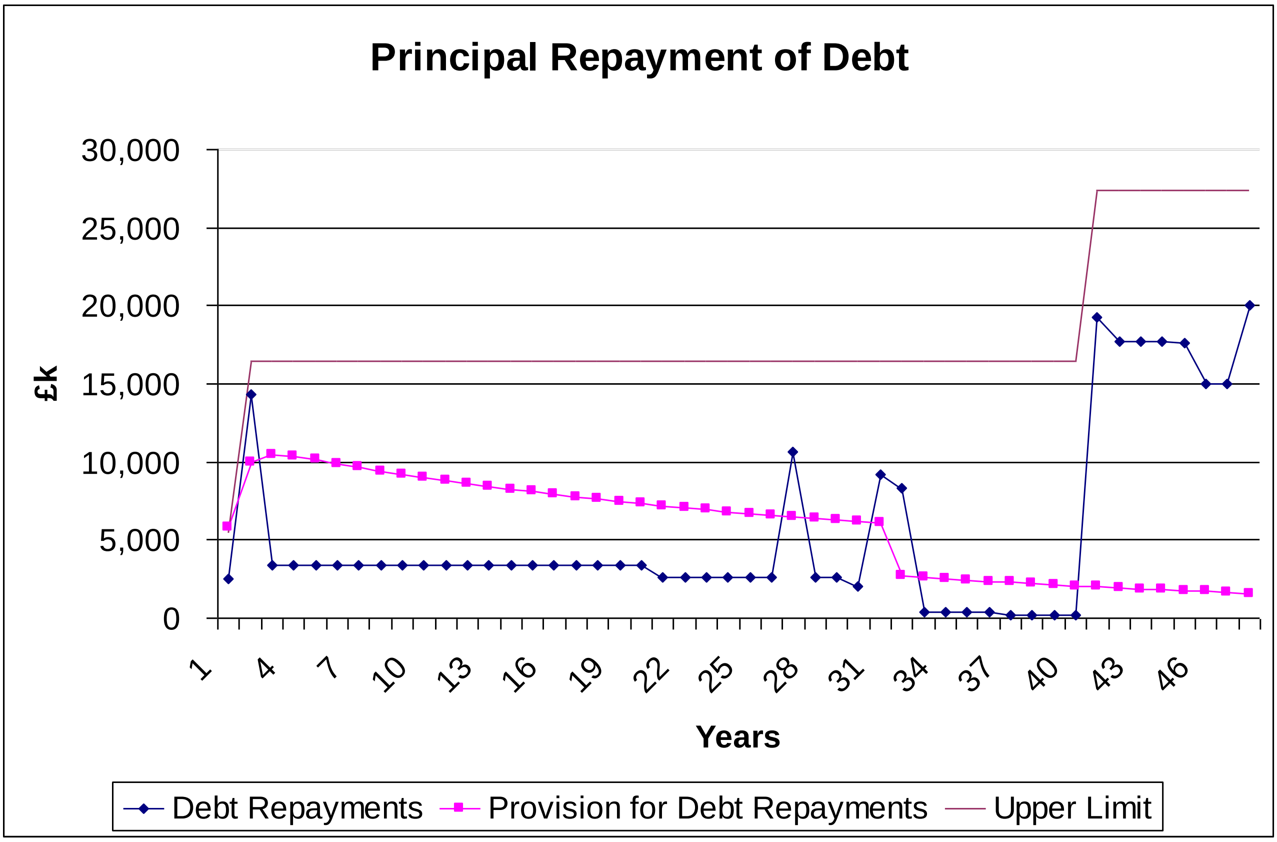
In recent years the cheapest loans have tended to be very long loans repayable at maturity.

During 2007/08 the Council rescheduled £70.8m of debt. This involved repaying loans from the Public Works Loans Board (PWLB) early and taking out new loans from the PWLB with longer maturities ranging from 45 to 49 years. The effect of the debt restructuring was to reduce the annual interest payable on the Council's debt and to lengthen the maturity profile of the Council's debt.

£50m of new borrowing was taken in 2008/09 to finance capital expenditure. Funds were borrowed from the PWLB at fixed rates of between 4.45% and 4.60% for between 43 and 50 years.

As a result of interest rates in 2007/08 when the City Council rescheduled much of its debt and interest rates in 2008/09 when the City Council undertook considerable new borrowing 53% of the City Council's debt matures in over 40 years time.

The Government has issued guidance on making provision for the repayment of debt which the Council is legally obliged to have regard to. The City Council is required to make greater provision for the repayment of debt in earlier years. Therefore the City Council is required to provide for the repayment of debt well in advance of it becoming due. This is illustrated in graph below.



This means that it is necessary to invest the funds set aside for the repayment of debt with its attendant credit and interest rate risks (see sections 5 and 7). The City Council could reschedule its debt, but unless certain market conditions exist at the time, premium payments have to be made to lenders.

CIPFA's Treasury Management in the Public Services Code of Practice which the City Council is legally obliged to have regard to requires local authorities to set upper and lower limits for the maturity structure of their borrowing. The limits set by the City Council on 7 March together with the City Councils actual debt maturity pattern are shown below.

	Under 1 Year	**1 to 2 Years**	**3 to 5 Years**	**6 to 10 Years**	**10 to 20 Years**	**20 to 30 Years**	**30 to 40 Years**	**40 to 50 Years**
Lower Limit	0%	0%	0%	0%	0%	0%	0%	0%
Upper Limit	2%	6%	18%	30%	60%	60%	60%	100%
Actual	1%	5%	4%	6%	12%	12%	7%	53%

9. REVENUE COSTS OF BORROWING 2011/12

The performance of the treasury management function against budget for the first nine months of 2011/12 is shown below:

	Budget for 2011/12	**Projected Expenditure for Year**	**Variance for Year**
	£'000s	£'000s	£'000s
Interest Payable & Similar Charges	20,327	21,424	1,097
Interest Receivable	(1,620)	(1,695)	(75)
Repayment of Principal	9,817	9,862	45
Total	**28,524**	**29,591**	**1,067**

The additional interest payable is due to borrowing to fund the HRA Self Financing payment earlier than anticipated. The majority of this additional cost is expected to fall on the HRA.

The Council also incurs costs in managing its cash flow, debt and investments. The Council's debt management expenses for the first three quarters of 2011/12 were as follows.

Debt Management Costs

	£
Other Expenses	36,853
Support Service Charges	60,000
	96,853