Agenda item:

Decision maker:	Cabinet City Council
Subject:	Revision of Investment Strategy and Treasury Management Monitoring Report for the First Quarter of 2015/16
Date of decision:	24 September 2015 (Cabinet) 25 September 2015 (Governance and Audit and Standards Committee) 13 October 2015 (City Council)
Report by:	Chris Ward, Director of Finance & Information Services and Section 151 Officer
Wards affected:	All

Key decision: Yes
Budget & policy framework decision: Yes

1. Purpose of report

The purpose of the report is to amend the Investment Strategy to allow the Council to invest in 5 year equity trackers and to increase the geographical investment limits and the variable interest rate exposure limit. Appendix A contains the Treasury Management Monitoring Report which aims to inform members and the wider community of the Council's Treasury Management position at 30 June 2015 and of the risks attached to that position.

2. Recommendations

1) That the Investment Strategy be amended to permit unsecured investments with a duration in excess of 2 years to be placed with banks

2) That the Director of Finance and Information Services be given delegated authority to invest the Council's funds in equity trackers which follow the developed stock markets with a floor of 100% of the capital invested, ie. the Council's capital is guaranteed.

3) That an investment limit of £70m be applied to equity trackers

4) That the variable interest rate exposure limit be increased by (£70m) from (£278m) to (£348m), ie. that the limit for net variable interest rate investments be increased to £348m

5) That the investment limits applied to regions outside the United Kingdom be revised as follows:

Region	**Current Limit**	**Region**	**Revised Limit**
Asia & Australia	£40m	Asia & Australia	£60m
Americas	£40m	Americas	£60m
Continental Europe	£30m	Eurozone	£30m
		Continental Europe outside the Eurozone	£30m

6) That the following actual treasury management indicators for the first quarter of 2015/16 be noted:

(a) The Council's debt at 30 June:

Prudential Indicator	**Limit** £m	**Actual** £m
Authorised Limit	503	461
Operational Boundary	484	461

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

	Under 1 Year	**1 to 2 Years**	**3 to 5 Years**	**6 to 10 Years**	**11 to 20 Years**	**21 to 30 Years**	**31 to 40 Years**	**41 to 50 Years**
Lower Limit	0%	0%	0%	0%	0%	0%	0%	0%
Upper Limit	10%	10%	20%	20%	40%	40%	40%	50%
Actual	1%	4%	3%	4%	15%	11%	20%	42%

(c) The Council's sums invested for periods longer than 364 days at 30 June 2015 were:

	Prudential Limit £m	Quarter 3 Actual £m
Maturing after 31/3/2016	243	126
Maturing after 31/3/2017	231	45
Maturing after 31/3/2018	228	5

(d) The Council's fixed interest rate exposure at 30 June 2015 was £228m, ie. the Council had net fixed interest rate borrowing of £228m. This is within the Council's approved limit of £304m.

(e) The Council's variable interest rate exposure at 30 June 2015 was (£258m), ie. the Council had net variable interest rate investments of £258m. This is within the Council's approved limit of (£278m).

3. Background

The Council's investment portfolio has increased by £83.8m from £321.9m to £405.7m. This resulted in up to £85m being invested in AAA rated money market funds and 1 month UK Government Treasury Bills which paid interest of between 0.33% and 0.42% until it was possible to invest these funds for a longer term at higher interest rates. This also resulted in the Council being invested up to its limits in Australia and Asia, and continental Europe and being within £20m of its variable interest rate exposure limit, ie. its limit for net variable interest rate investments. Despite this the Council has been able to reduce its investments in other local authorities by £32.5m from £161.5m to £129m. Local authorities are currently typically offering 0.5% for a year or 0.9% for two years compared to 1.05% for a year or 1.30% for two years from other borrowers.

4. Reasons for Recommendations

Base rate remains at 0.5% and is likely to remain so until at least the first quarter of 2016. The Governor of the Bank of England, Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual. The Council's treasury management investment portfolio consists entirely of interest bearing deposits and tradable instruments, and generated an average return of 0.74% in 2013/14 and 0.76% in 2014/15.

There is potential to generate higher returns and to diversify the investment portfolio through the purchase commercial property either directly or through a commercial property fund. On 7 July the Council approved the creation of a £30m Property Investment Fund funded through the capital programme. It is therefore recommended that equity trackers be purchased to generate higher returns on the Council's Treasury Management investments and diversify the portfolio. This will prevent the Council becoming increasingly exposed to the commercial property market.

The Council would purchase equity trackers which follow the developed stock markets with a floor of 100% of the capital invested, ie. the Council's capital is guaranteed. In order to have the floor, these instruments would either have a cap, ie. maximum return, or a reduced participation rate, ie. the Council would only benefit from a proportion of stock market growth. It is envisaged that these investments would have a term of five years. Equity trackers have the potential to generate returns that are significantly greater than interest bearing investments, but do carry the risk of not generating a return if the value of equities does not increase and a greater credit risk due to the length of the investment which would be unsecured. It is therefore necessary to amend the investment strategy to permit investments in excess of 2 years that are unsecured. Equity trackers would be purchased from banks that meet the Council's investment criteria and the investment would count against the bank's investment limit. It is recommended that investments in equity trackers be limited to £70m to prevent the Council's exposure to the equity markets becoming excessive.

It is recommended that the variable interest rate exposure limit be increased by (£70m) from (£278m) to (£348m), ie. that the limit for net variable interest rate investments be increased to £348m. This is necessary to reflect the increased in the size of the Council's investment portfolio, and to allow equity trackers, which offer a variable return, and further floating rate notes to be purchased. Floating rate notes pay a margin over a published interest rate, often the 3 month London inter-bank offer rate (LIBOR), and allow the Council to gain exposure to any movements in interest rates. With interest rates being so low, 3 month LIBOR is currently 0.58%, there is more potential for interest rates to go up rather than down and there is only a very limited scope for interest rates to fall.

It is also proposed to increase the geographic limits in order to reflect the increasing size of the portfolio in the current and previous years.

` **5. Equality impact assessment (EIA)**

The contents of this report do not have any relevant equalities impact and therefore an equalities impact assessment is not required.

6. 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.

7. Finance comments

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

………………………………………………………………………………………..
Signed by Director of Finance & Information Services and Section 151 Officer

Appendices:

Appendix A: Treasury Management Monitoring Report

Background list of documents: Section 100D of the Local Government Act 1972

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

	Title of document	**Location**
1	Treasury Management Files	Financial Services
2		

The recommendation(s) set out above were approved/ approved as amended/ deferred/ rejected by the City Council on 13 October 2015.

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

APPENDIX A

TREASURY MANAGEMENT MONITORING REPORT FOR THE FIRST QUARTER OF 2015/16

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 17 March 2015 provide the framework within which treasury management activities are undertaken.

2. ECONOMIC BACKGROUND

After strong UK GDP growth in 2013 at an annual rate of 2.7% and 3.0% in 2014, quarter 1 of 2015 was disappointing at only 0.4%, though subsequent data indicates that this could well be revised up further down the line and also indicates a return to stronger growth in quarter 2. In its May quarterly Inflation Report, the Bank of England reduced its GDP forecast for 2015 from 2.9% to 2.5% and from 2.9% to 2.7% in 2016, while increasing its forecast for 2017 from 2.4% to 2.7%.

Uncertainty around the likely result of the UK general election in May has obviously now evaporated although this has been replaced by some uncertainty around the potential impact on the UK economy of the EU referendum promised by, or in, 2017. In addition, the firm commitment of the Government to eliminating the deficit within the term of this Parliament will have an impact on GDP growth rates. However, the Monetary Policy Committee (MPC) is fully alert to this and will take that into account, and also the potential spillover effects from the Greek crisis, in making its decisions on the timing of raising Bank Rate.

As for the American economy, confidence has improved markedly in this quarter that the US will start increasing the Fed funds rate by the end of 2015 due to a return to strong economic GDP growth after a disappointing start to the year in quarter 1, (a contraction of 0.2%), after achieving 2.4% growth in 2014.

In January 2015, the European Central Bank (ECB) started unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This already appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to a significant improvement in economic growth, though it remains to be seen whether this will have an enduring effect as strong as the recovery in the US and UK.

3. INTEREST RATE FORECAST

The Council's treasury advisor, Capita Asset Services, has provided the following forecast:

	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank rate	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%
5yr PWLB rate	2.30%	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%
10yr PWLB rate	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.70%	3.80%	3.90%	4.00%	4.10%
25yr PWLB rate	3.60%	3.70%	3.80%	4.00%	4.10%	4.20%	4.30%	4.40%	4.40%	4.50%	4.60%
50yr PWLB rate	3.60%	3.70%	3.80%	4.00%	4.10%	4.20%	4.30%	4.40%	4.40%	4.50%	4.60%

Capita Asset Services undertook a review of its interest rate forecasts after the May Bank of England Inflation Report. The ECB's quantitative easing programme to buy up EZ debt caused an initial widespread rise in bond prices and, correspondingly, a fall in bond yields to phenomenally low levels, including the debt of some European countries plunging into negative yields. Since then, fears about recession in the EZ, and around the risks of deflation, have abated and so there has been an unwinding of this initial phase with bond yields rising back to more normal, though still historically low yields.

The Governor of the Bank of England, Mark Carney, indicated that the first increase in Bank Rate is likely to be in quarter 1 of 2016 although he has repeatedly stated that increases in Bank Rate will be slow and gradual. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when average disposable income is only just starting a significant recovery as a result of recent increases in the rate of wage inflation, though some consumers will not have seen that benefit come through for them.

4. NET DEBT

The Council's net borrowing position excluding accrued interest at 30 June 2015 was as follows:

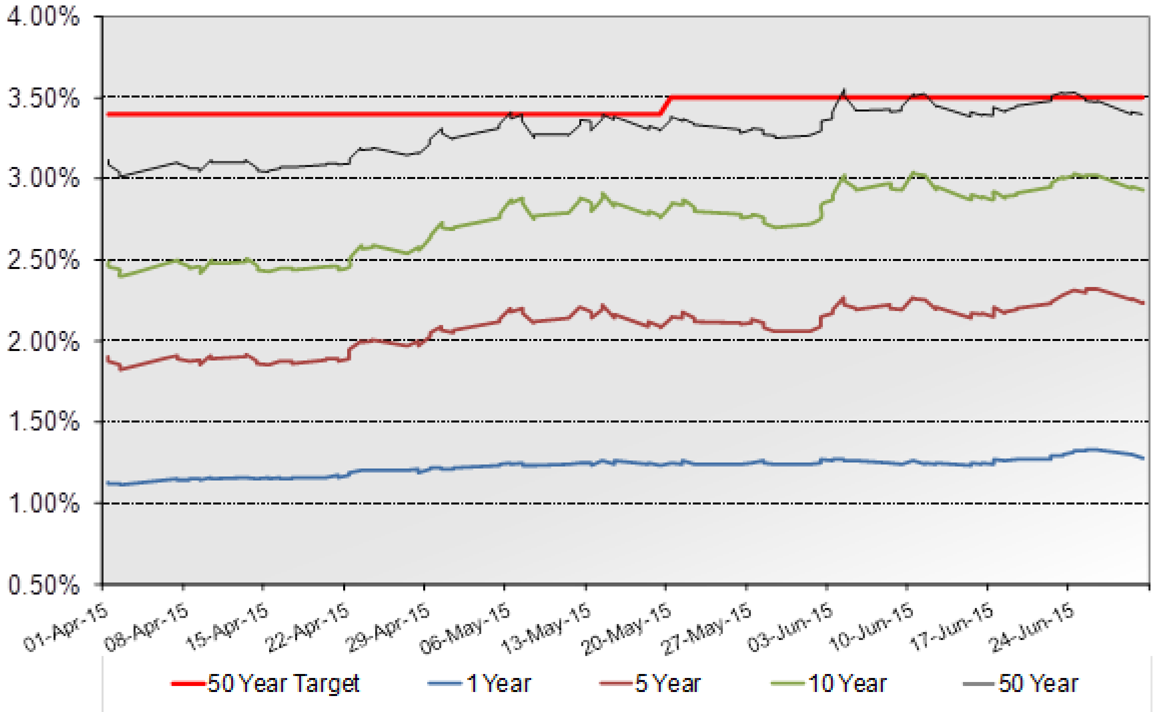
	1 April 2015	30 June 2015
	£'000	£'000
Borrowing	376,471	375,629
Finance Leases	3,027	2,862
Service Concession Arrangements (including PFIs)	83,068	82,828
Gross Debt	**462,566**	**461,319**
Investments	(321,917)	(405,708)
Net Debt	**140,649**	**55,611**

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 and future capital expenditure. However these reserves are fully committed and are not available to fund new expenditure. The £84m of borrowing taken in 2011/12 to take advantage of the very low PWLB rates and the receipt of £48.8m of City Deal Grant on 28 March 2014 together with £25m of new borrowing taken out in November have also temporarily increased the Council's cash balances.

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. BORROWING ACTIVITY

PWLB Certainty Rates for first quarter of 2015/16 are shown in then graph below:



PWLB rates have been on a generally rising trend.

No borrowing was undertaken in the first quarter of 2015/16.

The Council's debt at 30 June was as follows:

Prudential Indicator 2015/16	**Limit** £m	**Position at 30/6/15** £m
Authorised Limit	503	461
Operational Boundary	484	461

The operational boundary is intended to warn the Section 151 Officer and the Council if there is a possibility of the authorised limit being exceeded. The operational boundary differs from the authorised limit in that it is based on expectations of the maximum external debt of the authority according to probable, not simply possible, events and is consistent with the maximum level of external debt projected by the Council's estimates.

6. MATURITY STRUCTURE OF BORROWING

In recent years the cheapest loans have often been very long loans repayable at maturity.

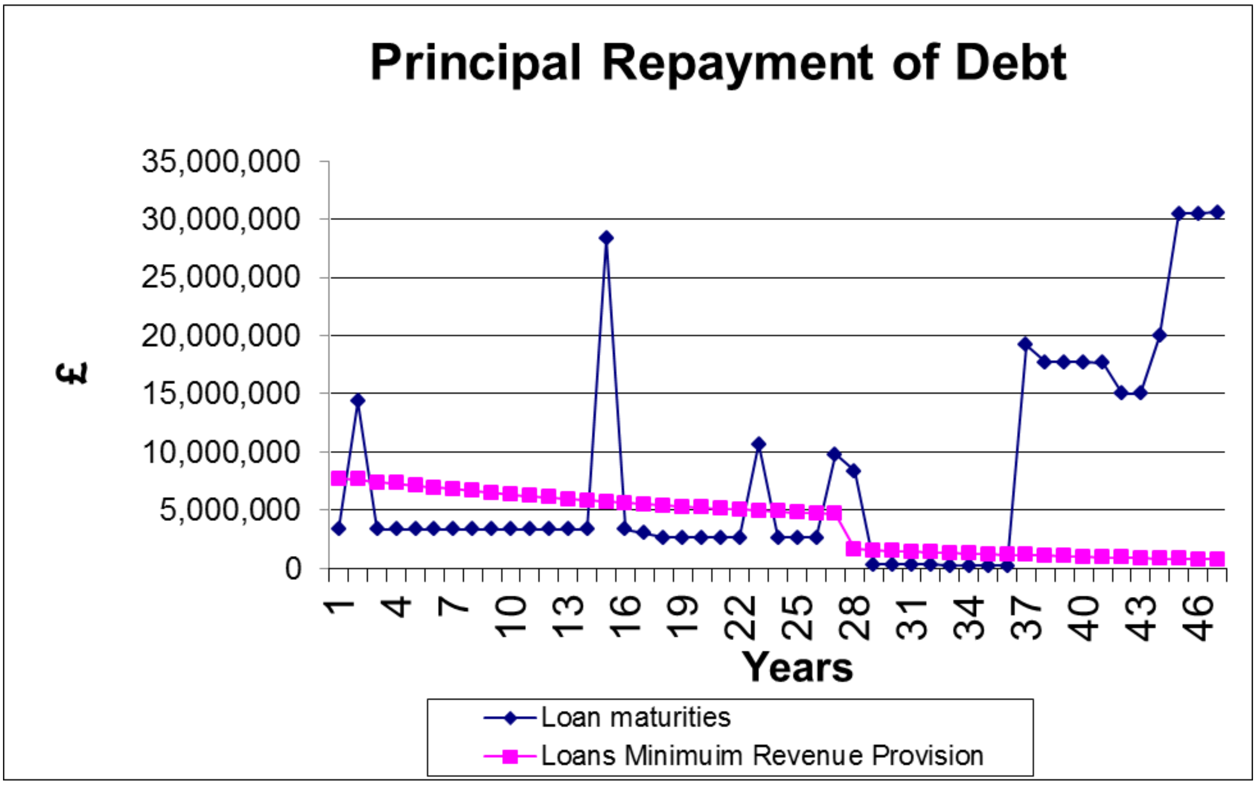
During 2007/08 the Council rescheduled £70.8m of debt. This involved repaying loans from the Public Works Loans Board (PWLB) early and taking out new loans from the PWLB with longer maturities ranging from 45 to 49 years. The effect of the debt restructuring was to reduce the annual interest payable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

A further £173m was borrowed in 2011/12 to finance capital expenditure and the HRA Self Financing payment to the Government. Funds were borrowed from the PWLB at rates of between 3.48% and 5.01%. £89m of this borrowing is repayable at maturity in excess of 44 years. The remaining £84m is repayable in equal instalments of principal over periods of between 16 and 26 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 and 2011/12 when the City Council undertook considerable new borrowing 62% of the City Council's debt matures in over 30 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 8 and 10). The City Council could reschedule its debt, but unless certain market conditions exist at the time, premium payments have to be made to lenders.

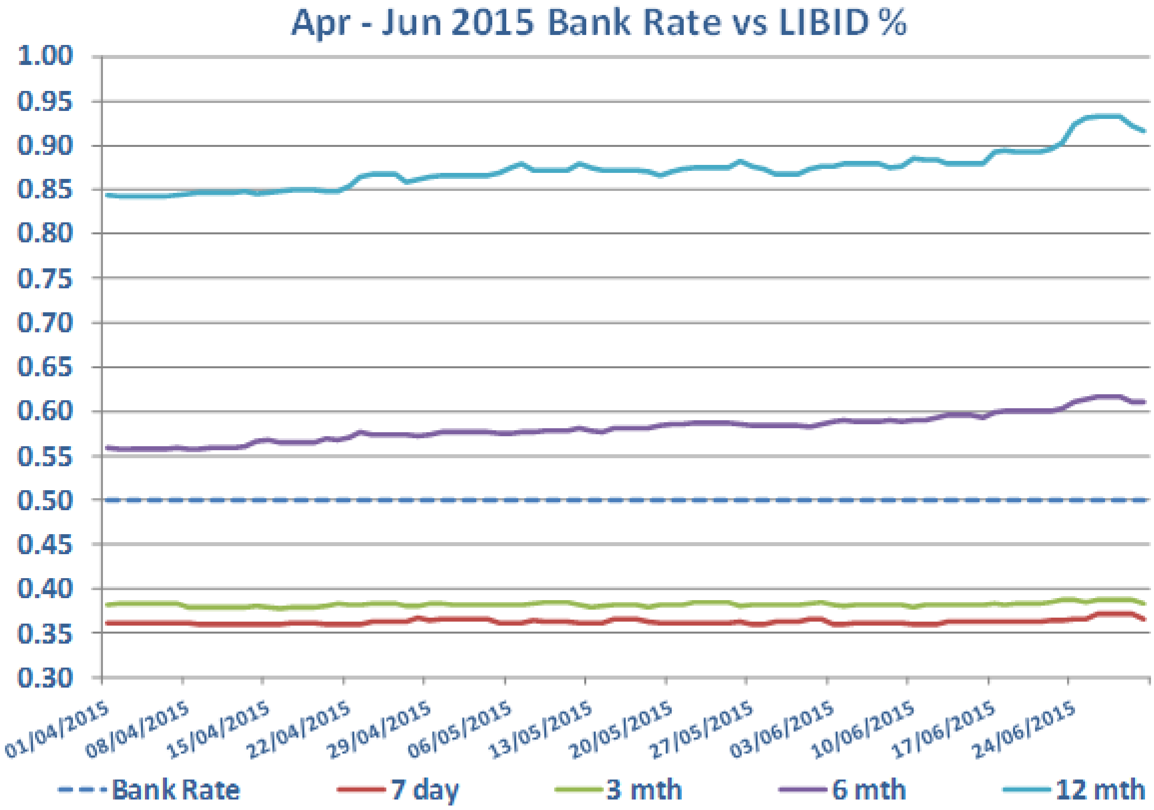
CIPFA's Treasury Management in the Public Services Code of Practice which the City Council is legally obliged to have regard to requires local authorities to set upper and lower limits for the maturity structure of their borrowing. The limits set by the City Council on 17 March 2015 together with the City Councils actual debt maturity pattern are shown below.

	Under 1 Year	**1 to 2 Years**	**3 to 5 Years**	**6 to 10 Years**	**11 to 20 Years**	**21 to 30 Years**	**31 to 40 Years**	**41 to 50 Years**
Lower Limit	0%	0%	0%	0%	0%	0%	0%	0%
Upper Limit	10%	10%	20%	20%	40%	40%	40%	50%
Actual	1%	4%	3%	4%	15%	11%	20%	42%

7. INVESTMENT ACTIVITY

In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite.

Short term market interest rates for the first quarter of 2015/16 are shown in the graph below:



There has been a slight increase in short term market interest rates in excess of 6 months in the first quarter of 2015/16.

The Council's investment portfolio has increased by £83.8m from £321.9m to £405.7m. This resulted in up to £85m being invested in AAA rated money market funds and 1 month UK Government Treasury Bills which paid interest of between 0.33 and 0.42% until it was possible to invest these funds for a longer term at higher interest rates. This caused the average return on the Council's investments to fall from 0.76% in 2014/15 to 0.68% in the first quarter of 2015/16. This also resulted in the Council being invested up to its limits in Australia and Asia, and continental Europe. Despite this the Council has been able to reduce its investments in other local authorities by £32.5m from £161.5m to £129m. Local authorities are currently typically offering 0.5% for a year or 0.9% for two years compared to 1.05% for a year or 1.30% for two years from other borrowers.

The Council’s budgeted investment return for 2015/16 is £2,297k, and performance for the year to date is in line with the budget.

8. 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 £26m and spreading investments over countries and sectors.

The 2015/16 Treasury Management Policy approved by the City Council on 17 March 2015 only permits deposits to be placed with the Council's subsidiaries, namely MMD (Shipping Services) Ltd, the United Kingdom Government, other local authorities, certain building societies, Hampshire Community Bank, and institutions that have the following credit ratings:

<u>Short Term Rating</u>

F2 (or equivalent) from Fitch, Moody's (P-3) or Standard and Poor (A-3)

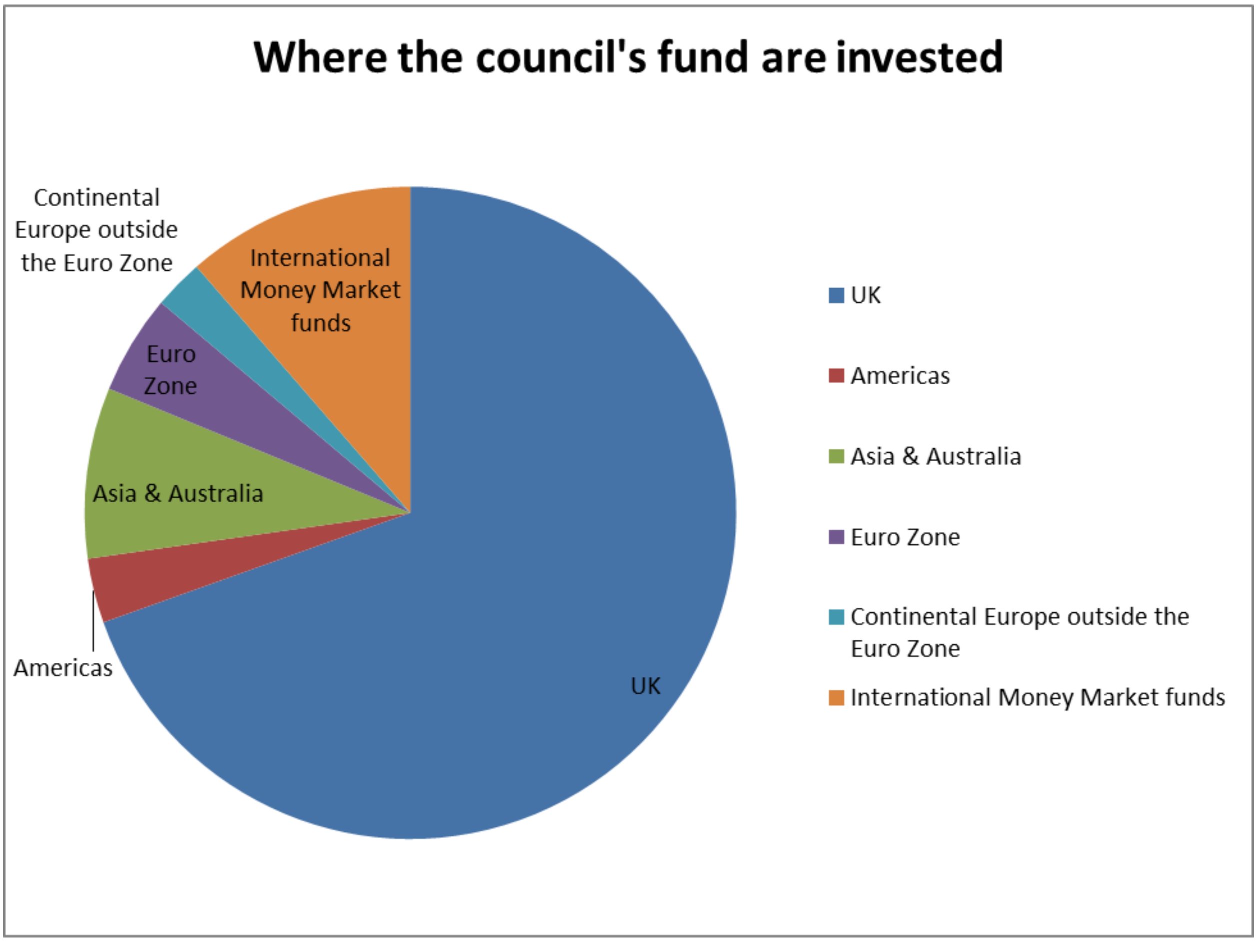
<u>Long Term Rating</u>

Triple B (triple BBB category) or equivalent from Fitch, Moody's or Standard & Poor

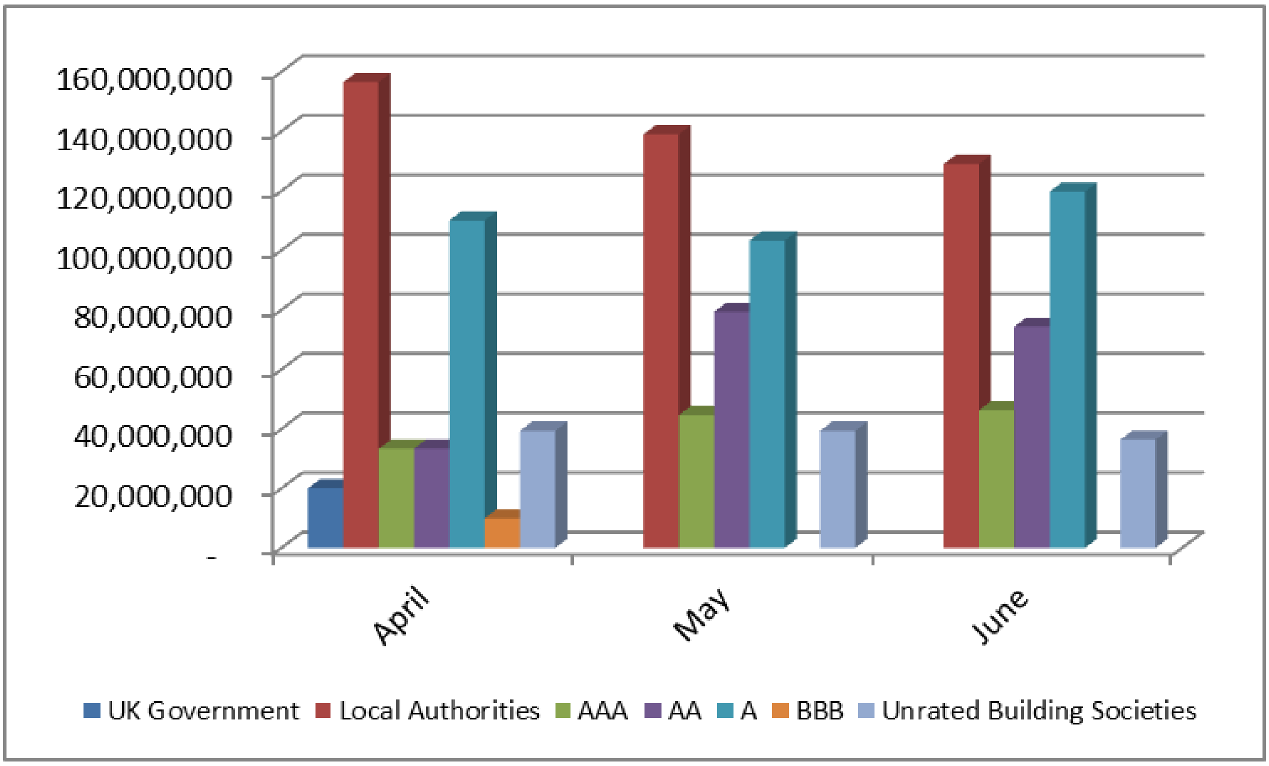
Under the Council's Annual Investment Strategy counter parties are categorised by their credit ratings for the purposes of assigning investment limits.

At 30 June 2015 the City Council had on average £6.2m invested with each institution.

The chart below summarises where the Council's funds were invested at 30 June.



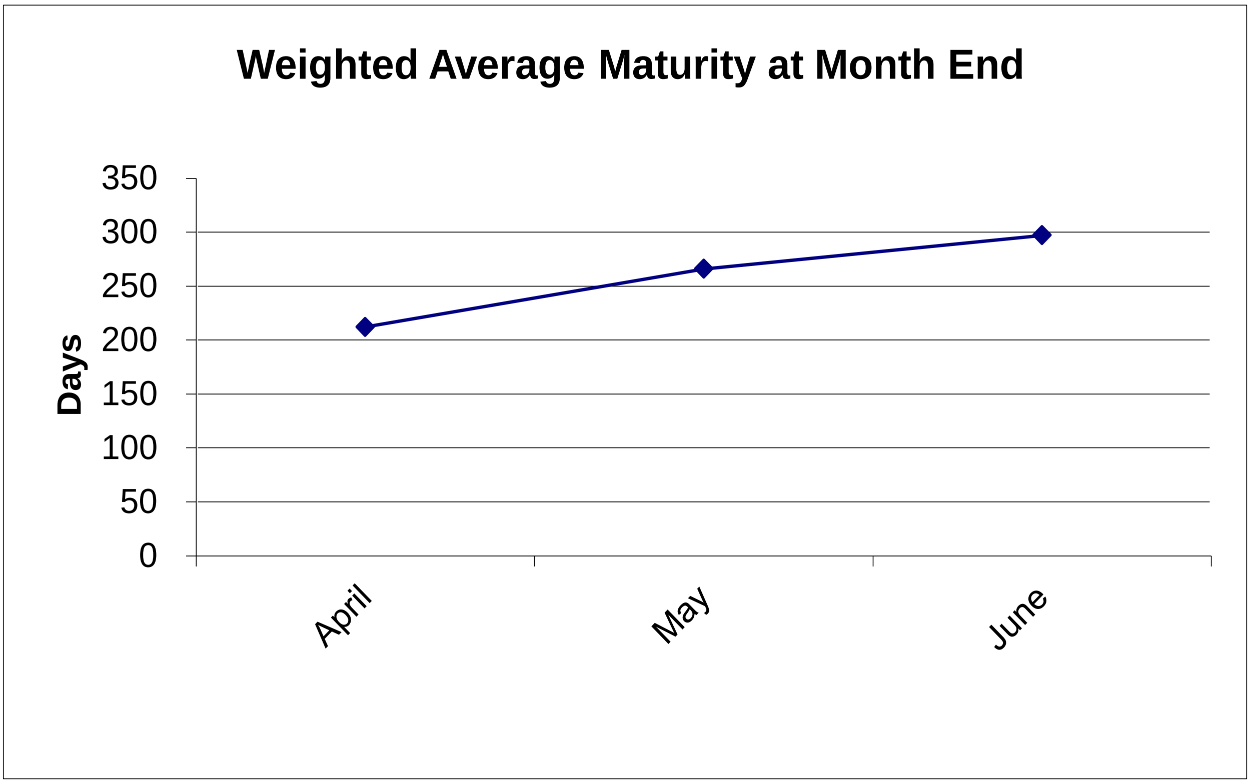
The chart below shows how the Council's investment portfolio has changed in terms of the credit ratings of investment counter parties over the first three months of 2015/16.



It can be seen from the graph above that investments in local authorities have declined over the first three months of 2015/16. These investments have largely been replaced by investments in A and AA rated counter parties which generally offer a better return than investments in local authorities.

9. LIQUIDITY OF INVESTMENTS

The weighted average maturity of the City Council's investment portfolio started at 212 days in April and increased to 297 days in June as suitable investments opportunities became available for the increased level of cash in the first quarter of the year. This is shown in the graph below.



The 2015/16 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 30 June £46.2m was invested in instant access accounts. 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 17 March 2015 is shown below.

Maturing after	**Limit** £m	**Actual** £m
31/3/2016	243	126
31/3/2017	231	45
31/3/2018	228	5

10. 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 17 March 2015 is shown below.

	Limit **£m**	**Actual** **£m**
Maximum Projected Gross Borrowing – Fixed Rate	395	376
Minimum Projected Gross Investments – Fixed Rate	(91)	(148)
Fixed Interest Rate Exposure	304	228

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 17 March 2015 is shown below.

	Current Limit £m	Revised Limit £m	Actual £m
Minimum Projected Gross Borrowing – Variable Rate	-	-	-
Maximum Projected Gross Investments – Variable Rate	(278)	(358)	(258)
Variable Interest Rate Exposure	(278)	(358)	(258)

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. However, this risk is limited by the very low market interest rates available for investments.

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

Effect of +/- 0.5% Rate Change	**2015/16** **£'000**	**2016/17** **£'000**	**2017/18** **£'000**
Long Term Borrowing	-	2	55
Investment Interest	(968)	(1,450)	(1,855)
Net Effect of +/- 0.5% Rate Change	**(968)**	**(1,448)**	**(1,800)**