Meeting of the Council – 13th October 2008

Report of the Audit Committee

Treasury Management

Purpose of Report

1. To outline treasury activity between April 2007 and August 2008.

2. To propose amendments to the Council's criteria for approved investments as set out in the Annual Investment Strategy.

Background

3. The Council undertakes treasury management activity on its own behalf and as administering authority for the West Midlands Debt Administration Fund *(WMDAF)*. We are responsible for administering capital funding of approximately £326m on our own account and another £220m on behalf of the WMDAF. The treasury function is governed by the Council's Treasury Policy Statement and Treasury Management Practices.

Treasury activity on the Dudley fund

4. During 2007/8 and in the current year to date, having considered cash flow forecasts and having consulted with our advisors at Sector Treasury Services Limited, we undertook the following additional long-term borrowing:

   - In December 2007 we borrowed £50 million from the Public Works Loan Board (PWLB) due to be repaid between 2053 and 2057 at rates ranging from 4.61% to 4.63%.

   - During August 2008 we borrowed £30 million from the PWLB due to be repaid between 2052 and 2057 at rates ranging from 4.43% to 4.45%.

5. The performance of our investments is largely dependent on movements in short-term *(up to one year)* rates. During 2007/8 our investments averaged around £37 million (with significant day to day variation as a result of cash flow). The average return on these investments was 5.89%, slightly below the average 3-month LIBID[1] in the same period of 5.93%. This in part reflects

[1] 3-month LIBID is a measure of the average return from a 3-month investment on the London money market.

our prudent stance particularly during the early stages of the sub-prime mortgage crisis, when we tended to invest for shorter periods than three months and, consequently, at slightly lower rates.

Treasury activity on the WMDAF

6. Our borrowing activities in 2005/6 placed us in a position where it was not necessary to undertake any new longer-term borrowing in 2006/7 or 2007/8. Having consulted with our advisors at Sector Treasury Services, we did not identify any opportunities to improve our position by restructuring of debt.

Prudential indicators

7. The 2003 Prudential Code for Capital Finance in Local Authorities sets out a framework for the consideration and approval of capital spending plans. In so doing, it requires the Council to set a number of prudential indicators, some of which concern matters of treasury management. Appendix 1 outlines those indicators for 2007/8. In all cases, actual outturn was within the targets and limits set by the Council.

Performance comparisons 2007/8

8. We have compared our performance, both for Dudley and the WMDAF, with our neighbours in the West Midlands. The results are summarised in the following table:

West Midlands performance comparisons 2007/8

	Dudley	**WMDAF**	**West Midlands average**
Gross average borrowing rate (the cost of borrowing, ignoring the return on investments)	5.72%	6.58%	6.17%
Investment return rate (the return on investments, ignoring the cost of borrowing)	5.89%	5.90%	5.78%
Net average borrowing rate (a combination of the above, representing the cost of borrowing net of the return on investments)	5.68%	6.58%	6.27%

9. The message from these comparisons is that, in respect of our own funds, we have been able to borrow more cheaply and invest at a better return than our neighbours. This has not been the case in respect of borrowing on the WMDAF where we are constrained by the statutory timetable for closure of the fund (March 2026) and have not been able to take advantage of very cheap long-term debt that has been available in recent years. Notwithstanding this restriction, we have managed WMDAF debt so that its

cost is falling year on year. It should be remembered that treasury performance measurement is not an exact science. These statistics represent the cumulative effect of decisions dating back over many years and the performance of our neighbours may have been achieved in circumstances different from our own.

Annual Investment Strategy

10. Councils' investment activities are regulated by government guidance issued under Section 15(1)(a) of the Local Government Act 2003. This guidance requires us to produce an Annual Investment Strategy. Our current Annual Investment Strategy was approved[2] by Audit Committee and full Council in February.

11. On the basis of guidance from our treasury advisers at Sector and Arlingclose and in the light of the ongoing situation in the financial markets following the sub-prime mortgage crisis, we are proposing two changes:

- Our current strategy allows us to invest with any UK building society with group assets of £1,000 million or more, regardless of its credit-rating. We are proposing that in future we should only invest with a UK building society where it meets the very high credit-rating criteria that we apply to UK banks (short-term rating of F1+ and support rating of 1 or 2 as supplied by Fitch IBCA).
- To compensate for the above change and to enable us to continue to manage our investments, we should increase the maximum proportion of our investments that can be placed with a single institution from 10% to 15%. On the basis of advice received, we assess this to be a lesser risk than continuing to invest with building societies that do not meet our credit-rating criteria.

A proposed revised Annual Investment Strategy, reflecting these changes, is attached as Appendix 2.

12. On consideration of the information contained in this report the Audit Committee, at its meeting held on 25th September, 2008, resolved to recommend to the Council as set out in paragraphs 16 and 17 below.

Finance

13. Forecasts of performance against budget for treasury management activities are highly sensitive to movements in cash flow and interest rates. At this stage in the year we are forecasting a surplus of £1m on our budget for 2008/9.

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[2] Presented as Section 5 of the Treasury Strategy Statement.

Law

14. These matters are governed by Part IV of the Local Government and Housing Act 1989 and Section 111 of the Local Government Act 1972, which empowers the Council to do anything which is calculated to facilitate or is conducive or incidental to the discharge of its various statutory functions.

Equality Impact

15. The treasury management activities considered in this report have no direct impact on issues of equality.

Recommendations

16. That the treasury management activity set out in this report be noted.

17. That the revised Annual Investment Strategy set out in Appendix 2 be approved.

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Chairman of the Audit Committee

Appendix 1

Prudential indicators relating to treasury management 2007/8

External debt

These indicators are intended to ensure that levels of external borrowing are affordable, prudent and sustainable. The authorised limit for external debt is a statutory limit (section 3 of the Local Government Act 2003) that should not be breached under any circumstances. The operational boundary is a lower threshold allowing for a prudent but not worst case scenario for cash flow.

	£m
Authorised limit for external borrowing	538
Operational boundary for external borrowing	473
Outturn - actual maximum external borrowing	445

CIPFA Code of Practice for Treasury Management in the Public Services

The Council adopted the CIPFA Code of Practice for Treasury Management in the Public Services in March 2002.

Interest rate exposures and maturity structure of borrowing and investments

These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates.

	Indicator	Outturn
Upper limit for fixed interest rate exposure	100%	100%
Upper limit for variable rate exposure	30%	0%
Upper limit of principal maturing in any one year for sums invested for over 364 days	£15m	nil
Maturity structure of fixed rate borrowing:-		
under 12 months	0-10%	3%
12 months and within 24 months	0-10%	1%
24 months and within 5 years	0-15%	6%
5 years and within 10 years	0-25%	14%
10 years and above	40-100%	76%

Appendix 2

<u>Proposed Revised Annual Investment Strategy (Section 5 of the Treasury Strategy Statement)</u>

5.0 ANNUAL INVESTMENT STRATEGY

5.1 Our investment activities are subject to government guidance issued under Section 15(1)(a) of the Local Government Act 2003. This section of the Treasury Strategy Statement constitutes an "Annual Investment Strategy" produced in accordance with the guidance.

5.2 In making investment decisions, our priorities will be security of council funds and liquidity. We will pursue the best possible return on our investments, but only to the extent that this is consistent with very low levels of risk in terms of security and liquidity.

5.3 *Strategy for "specified investments"*

5.3.1 The Council will make use of specified investments (as defined within the terms of the government guidance). These are investments that satisfy the following conditions:

a) The investment is denominated in sterling and any payments or repayments in respect of the investment are payable only in sterling.
b) The Council may require that the investment be repaid or redeemed within 12 months of the date on which the investment was made.
c) The making of the investment is not defined as capital expenditure by virtue of regulation 25(1)(d) of the Local Authorities (Capital Finance and Accounting)(England) Regulations 2003.
d) The investment satisfies *either* of the following conditions:
    I. The investment is made with the UK government, a local authority, a parish council or a community council.
    II. The investment is made with a body or in an investment scheme which has been awarded a "high credit rating" by a credit rating agency.

5.3.2 For the purposes of this strategy we define a "high credit rating" as follows (credit ratings taken from Fitch IBCA):

- UK banks and building societies – short-term rating F1+ and support rating of 1 or 2.
- Foreign banks – short-term rating F1+ and support rating of 1.

5.3.3 We will monitor credit ratings constantly through the receipt of credit rating bulletins from our treasury management consultants at Sector Treasury Services. Institutions that cease to meet the criteria above will immediately cease to be treated as specified investments.

5.4 *Strategy for “non-specified investments”*

5.4.1 Non-specified investments are those that do not meet the criteria in 5.3.1 above.

5.4.2 In determining which categories of non-specified investments may prudently be used, we will take account of:

- Advice from our treasury management consultants at Sector Treasury Services and Arlingclose.
- The views of experts at other councils.
- To the extent that investments are for a duration of 12 months or more, long-term credit ratings as determined by Fitch IBCA.

5.4.3 We have so far identified the following categories of investment as prudent for use. The table also shows a maximum proportion of our pool of investments that may be held in any one category:

Category of investment	**Maximum for this category of investments as a proportion of total investments (at the time of making a new investment)**
Sterling-denominated euro-sterling bonds issued by supra-national institutions with a long-term credit rating of AAA.	25%

5.5 *Liquidity of investments*

5.5.1 In determining the maximum period for which investments may be held, we will have regard to our most recent cash-flow forecast. We will not enter into an investment where our cash-flow forecast indicates that, as a result of that investment, we would be forced to borrow money in a future year that we would not otherwise have had to borrow.

5.5.2 We will ensure that, at the time of making a new investment, long-term investments (investments of one year’s duration or more) constitute no more than 50% of our total pool of investments.

5.6 Limit on investments with a single institution

5.6.1 Investments with a single institution or group of banks should not exceed 15% of our total pool of investments or £5million (whichever is greater).