Agenda Item No. 8

Audit Committee – 22nd September 2011

Report of the Treasurer

Treasury Management

Purpose of Report

1. To outline treasury activity during the financial year 2010/11 and in the current financial year up to August.

2. To seek approval to amend the Treasury Strategy Statement 2011/12 in connection with proposed reforms to the Housing Revenue Account (HRA) under the Localism Bill.

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 £420m on our own account and another £188m on behalf of other West Midlands councils in respect of the WMDAF. The treasury function is governed by the Council's Treasury Policy Statement and Treasury Management Practices.

Treasury activity in 2010/11 on the Dudley fund

4. Our treasury activities were undertaken in the context of the Treasury Strategy Statement 2010/11 approved by Audit Committee and Full Council in February 2010. The Strategy Statement stated:

> "The primary factor in determining whether we undertake new long-term borrowing will be cash flow need. We may elect to borrow one or two years in advance of anticipated need if we judge that this is necessary in order to avoid being forced to borrow at higher rates at a later date."

5. During 2010/11 our investments averaged around £34 million (with significant day to day variation as a result of cash flow). The average return on these investments was 0.88%. The majority of our investments were for less than one month or were in call accounts[1]. All investments were placed with institutions that satisfied the criteria for credit-worthiness set out in the Treasury Strategy Statement 2010/11. Our investment activity for 2010/11 is set out in more detail in Appendix 1.

6. The average value of long-term borrowings in 2010/11 was £211 million for Dudley's debt. The average rate of interest on these borrowings was 5.55% and they were due to mature on dates ranging from 2011 to 2058. The rate for a 50-year loan from the Public Works Loan Board (PWLB) has fluctuated during 2010/11 from 4.65% in April 2010 to about 5.24% in March 2011.The increase was mainly due to the Comprehensive Spending Review in October which raised PWLB rates to one percent above UK government gilts. In the light of these rates, together with forecasts for future rates and the availability of investment balances to meet cash flow, we did not enter into any new long-term borrowing during the year.

7. It was not necessary to undertake any short-term borrowing in the year. Daily cash flow was managed through the use of call accounts.

Treasury activity in 2010/11 on the WMDAF

8. Our borrowing activities in 2005/6 placed us in a position where it was not necessary to undertake any new longer-term borrowing in the financial years from 2006/7 to 2010/11. Having consulted with our treasury advisors at Sector, we did not identify any opportunities to improve our position by restructuring of debt.

[1] A call account is a deposit account with a financial institution without a fixed maturity date. The deposit can be "called" (withdrawn) at any time and deposits can also be made at any time. Call accounts and the specific terms associated with them differ depending upon the bank offering the account.

Performance comparisons 2010/11

9. 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 2010/11

	Dudley	**WMDAF**	**West Midlands average**
Gross average borrowing rate (the cost of borrowing, ignoring the return on investments)	5.55%	6.52%	5.32%
Investment return rate (the return on investments, ignoring the cost of borrowing)	0.88%	0.97%	1.14%
Net average borrowing rate (a combination of the above, representing the cost of borrowing net of the return on investments)	6.43%	6.52%	5.85%
Lender's Option Borrower's Option (LOBO)[2] loans as a proportion of all borrowing	5%	5%	11%

10. Our cost of borrowing in 2010/11 was higher than the average and the return on our investments was lower than the average of our neighbours. We were less exposed than the average of our neighbours to the potential volatility of LOBO loans (see footnote). The cash flow position during the year constrained both our investment and borrowing activities and our policy on investments has been very cautious. In respect of the WMDAF we have been 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. 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.

Prudential indicators 2010/11

11. 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 2 outlines those

[2] The lender has the option (at regular intervals stipulated in the loan agreement) to vary the rate of interest. The borrower then has the option to either accept the new interest rate or repay the loan.

indicators for 2010/11. In all cases, actual outturn was within the targets and limits set by the Council.

Treasury activity 2011/12 to August

12. Treasury activities in the current year have been undertaken in the context of the Treasury Strategy Statement 2011/12 approved by Audit Committee and Full Council in February of this year. In that document we anticipated that long term borrowing would be required in the next 12 months due to cash flow need.

13. Our investments up to the end of August have averaged around £52.9 million (with significant day to day variation as a result of cash flow). The average return on these investments was 0.80%. All investments were placed with institutions that satisfied the criteria for credit-worthiness set out in the Treasury Strategy Statement 2011/12. Our investment activity for 2011/12 is set out in more detail in Appendix 3.

14. The average value of long-term borrowings up to the end of August has been £210 million. The average rate of interest on these borrowings was 5.53% and they were due to mature on dates ranging from the current year to 2058. It has not as yet been necessary to undertake any new long-term borrowing, but we are monitoring interest rates and cash flow closely. We continue to anticipate that action may be required before the financial year end.

15. It has not been necessary to undertake any short-term borrowing in the current year to date. Daily cash flow has been managed through the use of call accounts.

16. There has been no change to the position on the WMDAF.

Housing Revenue Account (HRA) reform

17. Government proposals to reform the council housing finance system are set out in the Localism Bill, currently progressing through Parliament. Under these reforms, the existing HRA Subsidy (negative in Dudley's situation) is to be abolished and replaced with a one-off redistribution of debt. Although releasing councils from the HRA Subsidy system and offering much greater freedom, these reforms will result in a significant transfer of risk.

18. Work is currently under way to develop a 30-year HRA Business Plan. The implications of this plan for the management, maintenance and improvement of the housing stock will be considered as part of a report to Cabinet later in the year. In the mean time it is necessary to start considering the very significant impact on the Council's treasury management activities.

19. Under current proposals, HRA reforms will require the Council to borrow to finance a payment to the Government of approximately £335 million on 28th March 2012. This will significantly alter the Council's level of indebtedness and the structure of its treasury portfolio. Further work is required to establish

a strategy for borrowing and accounting for new HRA debt. Such a strategy will need to take account of:

- the needs of the HRA Business Plan;
- the relative costs of alternative sources of borrowing;
- risks around interest rates and other economic factors;
- the flexibility of the debt portfolio (e.g. by having a mix of long-term, medium term and short-term loans);
- the impact on the General Fund, which should as far as possible be neutral.

20. Historically the cheapest source of borrowing for local authorities has been the Public Works Loan Board (PWLB). However, changes introduced in last year's Comprehensive Spending Review (see paragraph 6) have reduced the competitiveness of PWLB borrowing when compared to other market options. That said there is still good value in PWLB rates for loans for less than 10 years**.**

21. The increased divergence between PWLB and gilt rates coupled with inflexible market borrowing opportunities have created the conditions necessary to make the issue of local authority bonds, at a rate higher than the gilt rate but lower than the cost of PWLB borrowing, an attractive proposition (indicative savings of 0.2% to 0.25% as against PWLB rates may be achievable). The rate available will depend on a number of factors such as the type of borrowing facility, market rates on the day of borrowing and crucially, the credit worthiness of the Council. For a bond to be attractive to investors, the Council may need to obtain a credit rating. The indicative cost of obtaining and maintaining a credit rating is around £19,000 per year. The indicative costs of a ratings advisor are one-off fees of around £10,000 to £25,000. These costs need to be considered alongside the potential for significant savings in ongoing interest costs. However, this is an emerging market and there is potential for other options to be developed for which a credit rating is not required. It is proposed that the Treasurer, in consultation with the Cabinet Member for Finance, be authorised to obtain a credit rating for the Council if required.

22. Consideration may be given to the use of short-term "bridging loans" (from the PWLB) if it is found to be cost effective to wait until self-financing is embedded nationally before committing to any longer term borrowing. To help local authorities' treasury management, the Public Works Loan Board will, in the period leading up to the self-financing payment date, after Royal Assent is achieved for the Localism Bill, permit borrowers to take out a variable rate loan which may be repaid within the first twelve months of the date of advance.

23. It is proposed to add the text attached as Appendix 4 to the Treasury Strategy Statement 2011/12.

Finance

24. Forecasts of performance against budget for treasury management activities are highly sensitive to movements in cash flow and interest rates.

Law

25. 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

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

Recommendation

27. That the Committee:

- notes the treasury activities outlined in this report;
- approves the amendment to the Treasury Strategy Statement 2011/12 attached as Appendix 4;
- authorises the Treasurer, in consultation with the Cabinet Member for Finance, to obtain a credit rating for the Council if required;
- refers all of the above for approval by full Council at its meeting on 10th October.

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Treasurer

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List of Background Papers

- Treasury Policy Statement, Treasury Management Practices and Schedules to the Treasury Management Practices.

Appendix 1

Investment Activity 2010/11

Counterparty name	**Number of investments**	**Average value £ million**	**Average rate %**	**Average duration (days)**
Barclays Bank Plc	1	0.2	0.30	14
Barclays Treasury Direct	21	2.4	0.36	8
DMO Bank of England	7	0.1	0.25	3
Nationwide Building Society	10	1.4	0.34	18
Santander Call account	N/A	8.4	0.80	Call
Bank of Scotland Call account (1)	N/A	5.6	0.75	Call
Nat West	N/A	5.1	0.80	Call
Royal Bank of Scotland Call account	N/A	4.0	0.80	Call
Yorkshire Bank Call account	N/A	6.3	0.75	Call
Salford MDC	N/A	0.5	11.25	Matures in 2020

The table above includes investments that commenced during 2009/10 and matured in 2010/11. It also includes investments that commenced during 2010/11 and were due to mature in 2011/12.

There is also a fixed term deposit of £500,000.00 with Salford MDC at an interest rate of 11.25% that was made in 1985 and is due to mature in 2020.

Appendix 2

Prudential indicators relating to treasury management 2010/11

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	710
Operational boundary for external borrowing	520
Outturn - actual maximum external borrowing	473

CIPFA Code of Practice for Treasury Management in the Public Services

The Council adopted the Revised CIPFA Treasury Management in the Public Services Code of Practice in February 2010.

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	15%	nil
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%	2%
24 months and within 5 years	0-15%	8%
5 years and within 10 years	0-25%	19%
10 years and above	40-100%	68%

Appendix 3

Investment Activity 2011/12 to August

Counterparty name	Number of investments	Average value £ million	Average rate %	Average duration (days)
Barclays Bank Direct				
Barclays Treasury Direct	17	5.5	0.41	8
Debt Management Office	5	0.2	0.25	5
Nationwide Building Society	4	2.4	0.45	19
Bank of Scotland Call account	N/A	10.5	0.75	Call
Nat West	N/A	12.6	0.80	Call
Santander Call account	N/A	12.7	0.80	Call
Yorkshire Bank Call account	N/A	3.9	0.75	Call
Yorkshire Bank Instant Access account	N/A	4.6	0.50	
Salford MDC	N/A	0.5	11.25	Matures in 2020

The table above includes investments that commenced during 2010/11 and were due to mature in the current year. It also includes investments that commenced in the current year before August and were due to mature after August.

There is also a fixed term deposit of £500,000.00 with Salford MDC at an interest rate of 11.25% that was made in 1985 and is due to mature in 2020.

Appendix 4

Proposed amendment to the Treasury Strategy Statement 2011/12

6.5 Proposed reforms to the council housing finance system are set out in the Localism Bill, currently progressing through Parliament. Under current proposals, HRA reforms will require the Council to borrow to finance a payment to the Government of approximately £335 million on 28th March 2012.

Decisions about borrowing and accounting for new HRA debt will be made in consultation with our treasury management advisors at Arlingclose, taking account of:

- the needs of the HRA Business Plan;
- the relative costs of alternative sources of borrowing;
- risks around interest rates and other economic factors;
- the flexibility of the debt portfolio (e.g. by having a mix of long-term, medium term and short-term loans);
- the impact on the General Fund, which should as far as possible be neutral.

The Council may wish to borrow for all or part of this requirement from the PWLB. Loans are available for periods up to 50 years at both fixed and variable interest rates. On 20 October 2010, as a component of the Government's Comprehensive Spending Review, the Treasury instructed the Debt Management Office to raise all PWLB rates by increasing the margin over gilt yields for all maturity periods to 1%. Prior to this, the margin was about 0.15%. This has reduced the competitiveness of PWLB borrowing when compared to other market options. However, there is still good value in PWLB rates for loans under 10 years**.**

The increased divergence between PWLB and gilt rates coupled with inflexible market borrowing opportunities have created the conditions necessary to make the issue of local authority bonds, at a rate higher than the gilt rate but lower than the cost of PWLB borrowing, an attractive proposition (indicative savings of 0.2% to 0.25% as against PWLB rates may be achievable). For a bond to be attractive to investors, the Council may need to obtain a credit rating. However, this is an emerging market and there is potential for other options to be developed for which a credit rating is not required.

Temporary borrowing from the PWLB (up to 1 year) may be used as short-term finance in order to manage the immediate cash flow requirement pending a more advantageous time to borrow long term or greater clarity about the potential options available.