Meeting of the Council – 13th October, 2014

Report of the Audit and Standards Committee

Treasury Management

Purpose of Report

1. To outline treasury activity during the financial year 2013/14 and in the current financial year up to August.

Background

2. The Treasury Management strategy for 2014/15 has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011. The Code recommends that members are informed of Treasury Management activities at least twice a year. This report ensures that the Council is embracing best practice in accordance with CIPFA's recommendations.

3. Treasury Management entails the management of the Council's cash flows, its borrowings and investments, the management of the associated risks and the pursuit of the optimum performance or return consistent with those risks.

4. 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 £765m on our own account and another £172m 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 2013/14 on the Dudley fund

5. Our treasury activities were undertaken in the context of the Treasury Strategy Statement 2013/14 approved by Audit Committee and Full Council in February 2013. 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"

6. In 2013/14 our investments averaged around £36.4 million (with significant day to day variation as a result of cash flow). The average return on these investments was 0.51%. 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 2013/14. Our investment activity for 2013/14 is set out in more detail in Appendix 1.

7. The average value of long-term borrowings in 2013/14 was £540 million. The average rate of interest on these borrowings was 4.13%. The loans were due to mature on dates ranging from 2014 to 2061. The rate for a 50-year maturity loan from the Public Works Loan Board (PWLB) has fluctuated in 2013/14 between 4.04% and 4.71%. The Council qualifies for borrowing at the PWLB's "certainty rate" which is 0.2% below the standard rates. In addition the "Project Rate" which is set at 0.4% below standard rate, is available for approved single projects identified by Local Enterprise Partnerships (LEPs).

8. 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.

9. Due to cashflow requirements in the second half of 2013/14, it was necessary to undertake short term borrowing on 14 occasions at an average value of £2.8 miilion at 0.36% for an average duration of 9 days. Daily cashflow was managed by the use of call accounts.

<u>Treasury activity in 2013/14 on the WMDAF</u>

10. 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 2013/14. Having consulted with our treasury advisors at Arlingclose, we did not identify any opportunities to improve our position by restructuring of debt. It was necessary to undertake short term borrowing on 7 occasions at an average value of £3.4m million at 0.38% for an average duration of 56 days.

<u>Performance comparisons 2013/14</u>

11. We have compared our performance, both for Dudley and the WMDAF, with four of our neighbours in the West Midlands. Two of the neighbours did not send their performance data in time for this report. The results are summarised in the following table:

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[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.

West Midlands performance comparisons 2013/14

	Dudley	WMDAF	West Midlands average
Gross average borrowing rate (the cost of borrowing, ignoring the return on investments)	4.16%	6.36%	4.75%
Investment return rate (the return on investments, ignoring the cost of borrowing)	0.52%	0.37%	0.79%
Net average borrowing rate (a combination of the above, representing the cost of borrowing net of the return on investments)	4.42%	6.38%	6.05%
Lender's Option Borrower's Option (LOBO)[2] loans as a proportion of all borrowing	2%	5%	15%

12. Our cost of borrowing in 2013/14 was lower 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. The performance figures for the four other councils included in the performance comparisons are detailed individually in appendix 4 in an anonymised format.

13. 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.

14. 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.

<u>Prudential indicators 2013/14</u>

15. 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 indicators for 2013/14. In all cases, actual outturn was within the targets and limits set by the Council.

[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.

Treasury activity 2014/15 to August

16. Treasury activities in the current year have been undertaken in the context of the Treasury Strategy Statement 2014/15 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.

17. Our investments up to the end of August have averaged around £20.7 million (with significant day to day variation as a result of cash flow). The average return on these investments was 0.62%. All investments were placed with institutions that satisfied the criteria for credit-worthiness set out in the Treasury Strategy Statement 2014/15. Our investment activity for 2014/15 is set out in more detail in Appendix 3.

18. The medium term outlook for interest rates appears to suggest a possible gradual rise in the Bank of England's record low base rate of 0.50% commencing at the end of 2014. Despite recent growth in the UK economy and unemployment falling to 6.4%, the Monetary Policy Committee's general view is that the economy is still not performing at its full potential, whilst wage and price inflation remain low. Therefore, the base rate is likely to remain close to its historic low, and so there is little prospect of a substantial improvement in investment yields this financial year.

19. The average value of long-term borrowings up to the end of August has been £536.0 million. The average rate of interest on Dudley's loans is 4.10%. The maturity dates for the loans range from the current year to 2061. It has not as yet been necessary to undertake any new long-term borrowing in the current year, but we are monitoring interest rates and cash flow closely. We continue to anticipate that action may be required before the financial year end.

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

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

Review of investment strategy

22. The Council's investment strategy, which is set out in the Treasury Strategy Statement 2014/15 and is summarised in Appendix 5 to this report, has been largely unchanged for a number of years. Recent and ongoing legislative changes have prompted a review of this strategy.

23. The Council's existing strategy has been based on investing only in UK financial institutions with a very high credit rating and on the implicit assumption that the UK Government would support these institutions in the event of a major failure. As a result, investments have been concentrated in a very short list of very strongly supported financial institutions (currently five banks and building societies). The strategy has also allowed investments in UK local authorities and in the UK Government's Debt Management Office (DMO) whenever it has not been possible to invest in one of the named financial institutions. The DMO tends to give a lower return than banks, reflecting the lower risk.

24. In order to comply with recommendations from the Independent Commission on Banking and the European Union's Bank Recovery and Resolution Directive, the UK Government has legislated through the Financial Services (Banking Reform) Act 2013 to change the basis on which failing banks will be supported in the future. Secondary legislation, laying out the new arrangements in more detail, is due to be enacted shortly following a period of consultation earlier in the year.

25. The proposed new regulations are complex but in essence, if a bank gets into financial trouble in future, the level of financial assistance that the Government can provide will be severely limited. Losses will in the first instance fall on bank shareholders and bondholders. However, in more serious failures, an element of the losses could fall on institutional investors such as local authorities. In the worst case scenario a local authority could lose all of its investments with a failing institution (albeit this is very unlikely when dealing with a bank of very high credit quality).

26. In order to mitigate the slightly increased risk, we will continue with our existing policy of minimising the level of investments that we hold. This has been, and will continue to be, achieved in the main by delaying any decision to borrow until cash flow dictates and also by electing to pay employer's superannuation contributions in a single annual instalment in exchange for a reduction in those contributions. During the period from April to August of 2013, the average level of investments held by the Council was £62m. During the same period this year, the average level of investments has been £21m. Based on seasonal trends, the level of investments (and therefore the risk) is likely to be significantly lower for the rest of this financial year and into next year.

27. In light of the position set out above, Appendix 5 sets out a number of proposed amendments to the investment strategy. These amendments reflect a reduced level of reliance on government support and will ensure that exposure to a single financial institution has an absolute limit of £5 million at any one time. As there are only five banks and building societies who currently meet our investment criteria, any cash over £25 million will only be invested with other local authorities or the UK Government via the DMO. Given the cash flow position set out above, the actual level of investments will normally be below this level. However, there may be occasional "spikes" in the level of cash that we hold and the proposed changes are to protect us on those occasions. The strategy will be kept under review and, if necessary, any further proposed amendments will be brought back to this committee and Full Council for approval.

28. The investment strategy will continue to recognise that credit ratings are good but not perfect predictors of investment default. Full regard will therefore also be given to other information on the credit quality of the institutions in which the Council invests (e.g. credit default swap prices, financial statements, the financial press and advice from our treasury advisors Arlingclose). No investments will be made with an institution if there are substantive doubts about its credit quality even if it meets the credit rating criteria.

29. The Audit and Standards Committee at its meeting held on 18th September, 2014, considered this matter and agreed the recommendation set out in paragraph 33 below.

Finance

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

Law

31. 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

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

Recommendations

33. That the Council:

- notes the treasury activities outlined in this report;

- approves the amendments to the Council's investment strategy as detailed in Appendix 5.

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Chair of the Audit and Standards Committee

List of Background Papers

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

Appendix 1

Investment Activity 2013/14

Counterparty name	Number of investments	Average value £ million	Average rate %	Average duration (days)
Barclays Treasury Direct	22	6.22	0.36	23
Debt Management Office	42	5.59	0.25	12
Nationwide Building Society	14	6.53	0.38	31
Bank of Scotland Call Account	N/A	9.88	0.43	Call
Santander	N/A	1.08	0.40	Call
Nat West	N/A	0.01	0.51	Call
HSBC	N/A	6.59	0.32	Call
Salford MDC*	1	0.50	11.25	Matures in 2020

This is 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 2013/14

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	951
Operational boundary for external borrowing	819
Outturn - actual maximum external borrowing	736

CIPFA Code of Practice for Treasury Management in the Public Service

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%	98.2%
Upper limit for variable rate exposure	10%	1.8%
Upper limit of principal maturing in any one year for sums invested for over 364 days	£10m	nil
Maturity structure of fixed rate borrowing:-		
under 12 months	0-10%	1.3%
12 months and within 24 months	0-10%	1.7%
24 months and within 5 years	0-15%	6.4%
5 years and within 10 years	0-25%	16.1%
10 years and above	40-100%	74.5%

Appendix 3

Investment Activity 2014/15 to August

Counterparty name	Number of investments	Average value £ million	Average rate %	Average duration (days)
Barclays Treasury Direct	4	1.77	0.34	15
Debt Management Office	13	2.87	0.25	10
Nationwide Building Society	1	1.06	0.42	31
Barclays	1	0.814	0.28	22
Bank of Scotland Call Account	N/A	5.50	0.40	N/A
HSBC	N/A	3.05	0.32	N/A
Santander	N/A	5.12	0.40	N/A
Salford MDC*	1	0.50	11.25	Matures in 2020

*This is 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

West Midlands performance comparisons 2013/14

	Council					
	Dudley	**WMDAF**	**A**	**B**	**C**	**D**
Gross average borrowing rate (the cost of borrowing, ignoring the return on investments)	4.16%	6.36%	4.83%	4.27%	4.32%	4.54%
Investment return rate (the return on investments, ignoring the cost of borrowing)	0.52%	0.37%	1.66%	0.45%	0.46%	1.29%
Net average borrowing rate (a combination of the above, representing the cost of borrowing net of the return on investments)	4.42%	6.38%	4.95%	4.50%	5.53%	10.54%
Lender's Option Borrower's Option (LOBO) loans as a proportion of all borrowing	2%	5%	0%	18%	16%	53%

Appendix 5

Investment Strategy

	Current Strategy	Comments	Proposed Strategy
1	Investments are allowed for up to <u>1 month</u> in institutions with a minimum short term credit rating of F1 (Fitch), A1 (Standard and Poors), or P1 (Moody's) and a support rating of 1 from Fitch.	These are the second highest short term credit ratings for Fitch and Standard & Poor, and the highest for Moodys which does not have a P1+ rating. The support rating (Fitch) reflects the likelihood of government support and is no longer relevant under the Financial Services (Banking Reform) Act 2013 and proposed regulations.	Investments are allowed for up to <u>1 month</u> in institutions with a minimum short term credit rating of F1 (Fitch), A1 (Standard and Poors), or P1 (Moody's).
2	Investments are allowed for up to <u>3 months</u> in institutions with the highest short term credit ratings i.e. F1+ (Fitch), A1+ (Standard and Poors), P1 (Moody's), and a support rating of 1 from Fitch.	To only invest in the most credit-worthy banks for investments longer than a month. As above, the support rating is no longer relevant.	Investments are allowed for up to <u>3 months</u> in banks with the highest short term credit ratings i.e. F1+ (Fitch), A1+ (Standard and Poors), P1 (Moody's).
3	Investments with a single institution or group of banks should not exceed 20% of the total pool of investments or £5million (whichever is greater) at the time the investment is made.	This limits the Council's exposure to a bank default. An absolute limit for all institutions (other than the UK Government) limits the potential loss to £5m in case of a bank default. As there are currently five private sector counterparties who meet our criteria*, the maximum cash allowed to be invested in private sector institutions would be £25m. Cash flow forecasts indicate that investments will normally be below this level.	Investments with a single institution or group of banks should not exceed £5m at any time.
4	Element 3 of the strategy above applies to investments with other UK local authorities.	This limits the Council's exposure to a single local authority. Note that in the event of Scottish independence, local authorities in Scotland would become ineligible counterparties for investment under this criterion.	No change.

	Current Strategy	Comments	Proposed Strategy
5	No upper limit on the value of investments with the Debt Management Office (UK government)	All surplus cash which cannot be invested with private sector institutions or other local authorities would be deposited at the Debt Management Office. Investments with the UK Government are deemed to be the lowest level of risk.	No change.
6	Investments are not allowed in non-UK institutions	The existing strategy is based on the implicit assumption that the UK Government would support a failing UK bank. This factor is less relevant in light of the Financial Services (Banking Reform) Act 2013 and proposed regulations. That said, current cash flow predictions do not suggest that there is any compelling need to widen the investment strategy to non-UK institutions and so there is no proposal to change. The strategy will be kept under review in light of cash flow movements, changes in bank credit ratings and any impact in the event of Scottish independence.	No change.

*Current list of counterparties:
HSBC plc
Barclays
Nationwide
Bank of Scotland (Lloyds)
Santander