LUTON BOROUGH COUNCIL	**For:** (x) Executive ☒ CLMT ☐ **Meeting Date:** 14th February 2011 **Report of:** Head of Corporate Finance **Report author:** Barry Crick	**Agenda Item Number:** 12

Subject: Treasury Management and Annual Investment Strategy 2011/12 (For Executive Only) **Lead Executive Member(s):** Councillor **Wards Affected:** None	Consultations: Councillors Scrutiny Stakeholders Others	(x) ☐ ☐ ☐ ☐

Recommendations

1. Executive is asked to recommend to Council that the Treasury Management Strategy Statement and the Annual Investment Strategy set out in this report be approved.

Background

2. This report is submitted in accordance with the Local Government Act 2003 and regulations laid down by the Chartered Institute of Public Finance & Accountancy (CIPFA) Prudential and Treasury Management Code of Practice.

The current position

3. The Local Government Act 2003 requires the Council to have regard to the CIPFA Prudential Code and the CIPFA treasury Management code of Practice to set Prudential and Treasury Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

4. The Act therefore requires the Council to set out it's treasury strategy for borrowing and to prepare an Annual Investment Strategy which will set out the Council's policies for managing its investments whilst ensuring security and liquidity of funds.

5. The Department of Communities and Local Government has issued revised investment guidance which came into effect from 1 April 2010. there were no major changes required over and above the changes already required by the revised CIPFA Treasury Management Code of Practice 2009.

6. The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management was updated in November 2009.

The primary requirements of the code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities
- Creation and maintenance of the Treasury Management Practices which set out the manner in which the Council seek to achieve those policies and objectives.
- Receipt by the full council of the Annual Treasury management Strategy Statement including the Annual Investment Strategy for the year ahead, Mid year Review Report and an Annual Report covering activities in the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For the Council this is the Financial Review Group

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7. The suggested strategy for 2011/12 in respect of the following aspects of the treasury function is based upon in-house views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisor.

The strategy covers:

- treasury limits in force which will limit the treasury risk and activities of the Council;
- Prudential and Treasury Indicators
- the current treasury portfolio position
- the borrowing requirement
- prospects for interest rates
- the borrowing strategy
- policy on borrowing in advance of need
- debt rescheduling
- the annual investment strategy
- policy on use of external service providers

8. It is a statutory requirement under section 33 of the Local Government Finance Act 1992, for the Council to produce a balanced budget. In particular section 32 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This, therefore, means that increases in capital expenditure must be limited to a level whereby increases in charges to revenue from:-

- increases in interest charges caused by increased borrowing to finance additional capital expenditure
- any increases in running costs from new capital projects are limited to a level which is affordable within the projected income of the Council for the foreseeable future.

Treasury limits for 2011/12 to 2013/14

9 It is a statutory requirement under section 3 of the Local Government Act 2003, and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is the 'Affordable Borrowing Limit'

10. The Council must have regard to the Prudential Code when setting the Affordable Borrowing Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax/rent levels is 'acceptable'.

11. Whilst termed an 'Affordable Borrowing Limit', the capital plans to be considered for inclusion incorporate those planned to be financed by both external borrowing and other forms of liability, such as credit arrangements. The affordable borrowing limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years

Prudential Indicators for 2011/12 – 2013/14

12 The following Prudential Indicators are relevant for the purposes of setting an integrated treasury management strategy :-

- Authorised limit for external debt
  - Borrowing
  - Other long term liabilities
- Operational Boundary
  - Borrowing
  - Other long term liabilities
- Upper limit for fixed interest exposure

- Upper limit for variable rate exposure (not used)
- Upper limit for variable rate exposure – Local prudential Limit
- Upper limit for total principle sums invested for over 364 days
- Maturity structure of fixed rate borrowing
  - Under 12 months
  - 12 months and within 24 months
  - 24 months and within 5 years
  - 5 years and within 10 years
  - 10 years and above

See appendix G of the Budget Report for the recommended level for each indicator.

Current Treasury Position

13. The Council's treasury portfolio at 24.01.11 comprised:

	£m	Principal £m
Borrowing		
Fixed		
Public Works Loan Board	143.16	
- Money Market	35.00	
Total Fixed		178.16
Variable – Money Market		35.60
Total Fixed & Variable		213.76
Credit Arrangements		0.95
Total		214.71
Luton Borough Council Investments		
Cash Flow Management		143.57
Other Investments		
Investments for Schools		12.03
Investments for London Luton Airport Limited		5.50

Borrowing Requirement

14. The borrowing requirement for the next 3 years is based on the Capital Financing Requirement, resulting from prudential borrowing, offset by provisions to repay debt. If it is opportune to borrow during the period, then it will be limited to the Capital Financing Requirement as reflected in the table below.

	2011/12	**2012/13**	**2013/14**
	£m	**£m**	**£m**
Potential new borrowing	8,920	14,689	3,152
Alternative Financing arrangements	0	0	0
Potential Replacement Borrowing	11,000	23,600	23,600
TOTAL	19,920	38,289	26,752

15. The Council currently has six LOBO (lenders option borrowers option) loans totalling £70.6m. These are loans where lender has the right to change the terms on an anniversary date and

the Council the right to refuse new terms and repay the loan. Loans totalling £23.6m could be called in during the period of 2012/13 - 2013/14 and should this happen then it is likely that replacement borrowing will need to be undertaken. The £11m in11/12 refers to a PWLB maturity in the year.

Prospects for interest rates

16. The Council retains Sector Treasury Services as treasury advisor to the Council and part of their service is to assist the Council to formulate a view on interest rates. The table below gives the Sector's central view on both short term (base rate):-

- 2010/11 - .50%
- 2011/12 - 1.00%
- 2012/13 - 2.25%
- 2013/14 – 3.25%

There is a downside risk to these forecasts if the recovery from recession proves to be weaker and slower than currently expected.

Borrowing Strategy

17. Borrowing rates

The Council retains Sector Treasury Services as treasury advisor to the Council and part of their service is to assist the Council to formulate a view on interest rates. The table below gives the Sector's central view on both short term (base rate) and longer term (PWLB) interest rates:-

	Mar 2011 %	**Jun 2011 %**	**Sep 2011 %**	**Dec 2011 %**	**Mar 2012 %**	**Mar 2013 %**	**Mar 2014 %**
Base Rate	0.50	0.50	0.50	0.75	1.00	2.25	3.25
5yr PWLB	3.30	3.30	3.40	3.50	3.60	4.30	5.00
10yr PWLB	4.40	4.40	4.40	4.50	4.70	5.10	5.40
25yr PWLB	5.20	5.20	5.20	5.30	5.30	5.50	5.70
50yr PWLB	5.20	5.20	5.20	5.30	5.30	5.50	5.70

As part of the Council's borrowing strategy the following points will be taken into consideration, when assessing new borrowing options:-

- Rates are expected to gradually increase during the year, across all periods, so it is likely that if new borrowing is taken it will be early in the new financial year. Consideration will be given to the period of borrowing as it is expected that shorter dated rates (5-10years) will be cheaper.
- PWLB variable rate borrowing is expected to be cheaper than long term borrowing throughout the year, though the uncertainty surrounding variable rate borrowing is a concern.
- Shorter dated borrowing from non PWLB sources.
- Temporary borrowing from the money market or other local authorities.
- Longer term fixed rate market loans at rates below PWLB whilst maintaining an appropriate balance between PWLB and market debt in the debt portfolio.

18. Against this background caution will be adopted with the 2011/12 treasury operations. The Head of Corporate Finance will monitor the interest rate market and adopt a pragmatic approach to any changing circumstances, reporting any decisions to the Executive as part of the regular Treasury Management reporting.

19. The main sensitivities of the forecast are likely to be the two scenarios below. The Council's officers, in conjunction with the treasury advisers, will continually monitor both the prevailing interest rates and the market forecasts, adopting the following responses to a change of sentiment:
    - If it were felt that there was a significant risk of a much sharper fall in long and short term rates, due to a marked increase of risk around relapse into recession or of risks of deflation, then long term borrowing would be postponed, and potential rescheduling from longer term fixed rate loans into short term loans will be considered
    - If it were felt there was a significant risk of a much sharper rise in long and short term rates perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks then it is likely that new fixed rate funding would be arranged whilst rates are still relatively cheap.

20. External v Internal borrowing

Comparison of gross and net debt positions at year end

	2009/10	**2010/11**	**2011/12**	**2012/13**	**2013/14**
	Actual	**Probable**	**Estimate**	**Estimate**	**Estimate**
	£'000	**£'000**	**£'000**	**£'000**	**£'000**
External debt (gross)	171,255	213,755	213,870	219,575	222,732
Cash Balances	71,180	78,089	27,078	3,291	4,578
Net Debt	100,075	135,666	186,792	216,284	218,154

This Council currently has a net debt position after deducting cash balances, of £70m

21. As will be seen from the above table, cash balances are expected to fall substantially in future years. This reflects the inherent strategy to utilise maturing investments and reduce as far as possible future borrowing, though regard will be had to the potential for incurring additional long term extra costs by delaying unavoidable new external borrowing until later years when PWLB long term rates are forecast to be significantly higher.

22. The scope to borrow has in fact been reigned in as a result of the discontinuance of supported borrowing by the Government and large reductions to the Council's capital programme.

23. One of the aims of the treasury management strategy is to reduce risk incurred by holding investments. The reduction in cash balances as mentioned above along with the creditworthiness policy detailed in paragraphs 32-36 addresses this aim.

24. The next financial year is expected to continue with historically abnormally low bank rates, supporting the strategy of reducing investment levels therefore external borrowing.

25. Over the next three years, investment rates are expected to remain below borrowing rates and so short-term value for money considerations would indicate that where possible new borrowing will be minimised and that maturing investments be used to finance capital expenditure and thus maximise short term savings.

Borrowing in advance of need

26. The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be considered carefully to ensure value for money can be demonstrated and that the Council can ensure the security of such funds.

In determining whether borrowing will be undertaken in advance of need the Council will :-

- ensure that there is a clear link between the capital programme and maturity profile of the existing debt portfolio which supports the need to take funding in advance of need
- ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered
- evaluate the economic and market factors that might influence the manner and timing of any decision to borrow
- consider the merits and demerits of alternative forms of funding
- consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use
- consider the impact of borrowing in advance on temporarily (until required) to finance capital expenditure) increasing investment cash balances and the consequent increase in exposure to counterparty risk, and other risks, and the level of such risks given the controls in place to minimise them

Debt Rescheduling

27. In 2007 the PWLB introduced a spread between rates applied to new borrowing and those applied to early repayment of debt. This was compounded on 20 October 2010 (the date of the Government's Spending Review announcement) by a considerable further widening of the difference between new borrowing and early repayment rates. The result is that debt restructuring is now much less attractive than it was before these events. Large premiums would be incurred and it is very unlikely that these could be justified on value for money grounds. It is possible that rescheduling money market loans (LOBO's) could create some savings though premiums will still be an issue.

The reasons for any restructuring to take place will include:

- the generation of cash savings;
- in order to enhance the balance of the long term portfolio (amend the maturity profile and/or the balance of volatility);
- in order to help fulfil the strategy outlined in paragraphs 18-20 above.

All rescheduling will be reported to the Executive as part of the standard Treasury Management Activity Report.

Annual Investment Strategy

Investment Policy

28. The council will have regard to the CLG's Guidance on Local Government Investments ("the Guidance) and the 2009 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's Investment priorities are:-

- the security of capital
- the liquidity of its investments.

29. The Council will aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of the Council is low in order to give priority to security of its investments.

30. The borrowing of monies purely to invest or on-lend and make a return is unlawful and the Council will not engage in such activity.

31. Investment instruments identified for legitimate use are shown at appendix A under Specified and Non Specified Investments. Counterparty limits are set as part of the Council's treasury Management Practices.

Creditworthiness Policy

32. The Council use the creditworthiness service provided by sector. The service has been enhanced over the last year and the model incorporates the ratings of all three agencies – Fitch, Moodys and Standard and Poors. The model does not rely solely on current ratings of counterparties but also provides the following data:-
   - credit watches and outlooks (banks can be placed on credit watch by an agency where there are initial concerns, many months prior to a formal change in a rating).
   - CDS spreads which can give early warning of concerns. (CDS stands for credit default swap. They provide an insurance against any institution's default. They are traded. The higher the CDS spread for a bank, the lower the confidence that the market appears to have in that bank.)
   - Sovereign ratings (that is, the credit ratings for each country) to select counterparties from only the most creditworthy countries who will be better able to support their banks if any get into difficulties.

33. The model combines credit ratings, credit watches and credit outlooks in a weighted scoring systems to which an adjustment is made for CDS spreads. The resultant score determines a series of colour code bands which indicate the creditworthiness of counterparties. The Council uses this colour coded system to determine both the cash exposure and duration of investments with counterparties.

34. The Council will not use the approach suggested by CIPFA of using the lowest rating from all three rating agencies to determine creditworthy counterparties as Moodys are much more aggressive in giving low ratings than the other two agencies. This approach would be virtually unworkable as very few institutions would feature on the Council's lending list.

35. All credit ratings are monitored on a weekly basis and Sector alert the Council to any changes by all three agencies as they happen.

   - if a downgrade results in the counterparty/country no longer meeting the Council's minimum criteria, further use as a new investment will be withdrawn immediately
   - if a counterparty/country is placed on negative rating watch and is currently near the floor of the minimum criteria then no further investments will be made with that counterparty or within that country
   - if a counterparty/ country is upgraded or then appropriate action will be taken to put them in the colour band applicable
   - in addition to the use of ratings sector will advise on credit default swaps which basically measure counterparty market performance on a weekly basis and highlight extreme market movements. This information could lead to the removal of a counterparty from the lending list.

36. Sole reliance will not be placed on the use of the Sector service, other market data and information from sources such as the Financial Times will be used.

Country Limits

37. The Council has determined that it will only use approved counterparties from countries with a minimum sovereign rating of AA+. A list of countries that qualify at the time of this report is shown at appendix C. This list will be added to or deducted from should ratings change.

Investment Strategy

38. The Council's investments are mainly cash flow derived with an element of core reserve balances that effectively make up the longer term non-specified investments (greater than I year).

39. The Council currently has non-specified investments totalling £22.5m, one being a £3m callable deposit (in the current and foreseeable interest climate, it is likely that the callable right will be exercised) and £19.5m repayable on the maturity dates**.**

Bank/Building Society	£m	Maturity Date	%	Terms	Next Call Date
HSBC	2.0	29.06.12	2.50	30 bp above 3month LIBOR Floor 2.50% Cap 4.50%	
Barclays	3.0	28.04.13	6.12	Non call 3yr / yearly	26.04.11
Nationwide	10.0	9.05.11	6.08	Maturity	
RBS	5.0	19.10.12	3.30	Maturity	
RBS	2.5	23.07.12	2.45	Maturity	

40. Base rate has remained unchanged since March 2009 but is expected to commence rising in the fourth quarter of 2011 and then to steadily rise from thereon. Forecasts for financial year ends (March) are as follows:-

- 2010/11 - .50%
- 2011/12 - 1.00%
- 2012/13 - 2.25%
- 2013/14 - 3.25%

There is a downside risk to the above forecasts if economic growth is weaker than expected , though there is also a risk that the MPC could raise the rate earlier in 2011 in order to contain inflation

41. As part of the Council's inherent strategy, to reduce the level of investments held by using maturing investments to balance cash flow, it is unlikely that long term investments (over one year) will be a prominent feature going forward. Investments will in the main be kept short to cover both daily and monthly shortfalls of cash and the current use of reserve accounts, deposit accounts and money market funds, for liquidity, will continue. It is envisaged that should the opportunity arise some investments, for periods up to one year, with highly rated counterparties (in some cases other Local Authorities) will be made to enhance return.

42. Estimated return on investments for the next five years are:-

- 2011/12 - 1.30%

- 2012/13 - 1.50%
- 2013/14 - 3.00%
- 2014/15 - 3.50%
- 2015/16 - 4.00%

43. It should be noted that whilst investment income rates are expected to rise, as shown above, income will not substantially rise as the cash available for investment will be reducing year on year.

44. The return for 11/12 (1.30%) is enhanced by, both, the projected return on existing long term investments and on investments made for up to one year in 10/11. Interest on new investments in 11/12 is expected to average out at .88%.

45. The maximum percentage of investments that the council will hold in long term investments (over one year) is 50%.

Investments defined as capital expenditure

46. The acquisition of share or loan capital in any corporate body is defined as capital expenditure under section 16(2) of the Local government Act 2003. Such investments will have to be funded from capital or revenue resources and be classified as non-specified investments.

47. Any loan or grant to another body for capital expenditure by that body will also be deemed, by regulation, to be capital expenditure by the council. It is therefore important for the Council to clearly identify if the loan or grant has been made for policy reasons or if it is an investment for treasury management purposes in which case it would be governed by the framework set for specified and non specified investments.

Provisions for Credit - related losses

48. If any of the Council's investments appeared at risk of loss to default (ie. a credit-related loss rather than a loss due to a fall in price or movement in interest rates) the Council will make revenue provision of an appropriate amount.

External Cash Fund Management

49. At present the Council does not employ the services of an external Fund Manager. This is kept under review and if the Council's treasury advisors consider that an external Fund Manager would be able to provide better value, net of fees, for a proportion of the Council's investments, then an external Fund Manager will be employed again.

Treasury Policy Statement

50. The Council's treasury Policy Statement is shown at appendix B

End of year Investment Report

51. At the end of the financial year the Council will prepare a report on the investment activity as part of the Annual Treasury Report.

Use of external service providers

52. The council uses Sector treasury Services as its external treasury management advisors.

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon external service providers.

It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources

Large Scale Voluntary Transfer (LSVT)

53. Any potential transfer will have treasury management implications and these would need to be considered by the Executive if the situation ever arises.

Other Issues

54. Specific consideration is given to funding PFI arrangements, as approved by the relevant Government department and H.M Treasury. The treasury management implications of PFI arrangements need to be fully considered by the Executive

Key Risks

Treasury Management is an area of significant risk. In relation to security and probity of investments all activity has been undertaken in accordance with the provisions of the Council's Treasury Management Practices (TMP's) which include a substantial section on risk, ion order to manage and minimise , so far as possible, the risks involved.

Appendices and additional background papers attached:

Appendices - A-C

IMPLICATIONS

		Clearance – agreed by:
Legal	There are no legal implications in respect of this report.	Brenda Vale
Finance	The financial implications are included in the body of the report'	Head of Corporate Finance
Equalities	The report has no direct or indirect equality, cohesion or inclusion implications except as far as it reports on investments and borrowings which may directly or indirectly have implications dependant upon how those investments are managed and how that borrowing is used	Head of Human resources
Environment	The report has no direct or indirect environmental implications except as far as it reports on investments and borrowings which may directly or indirectly have implications dependant upon how those investments are managed and how that borrowing is used	Climate Change officer

FOR EXECUTIVE ONLY - Options:

Executive can approve the strategy, amend the strategy, or ask for the strategy to be reformulated.