

**Audit and Standards Committee – 20th September 2012**

**Report of the Treasurer**

**Treasury Management**

**Purpose of Report**

1. To outline treasury activity during the financial year 2011/12 and in the current financial year up to August.

**Background**

2. 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
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 £769m on our own account and another £182m 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 2011/12 on the Dudley fund**

4. Our treasury activities were undertaken in the context of the Treasury Strategy Statement 2011/12 approved by Audit Committee and Full Council in February 2011. 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 2011/12 our investments averaged around £42 million (with significant day to day variation as a result of cash flow). The average return on these investments was 0.85%. The majority of our investments were for less than one month or were in call accounts<sup>1</sup>. All investments were placed with institutions that satisfied the criteria for credit-worthiness set out in the Treasury Strategy

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<sup>1</sup> 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 The deposit can be "called" (withdrawn) at any time and deposits can also be made at any time.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.

Statement 2011/12. Our investment activity for 2011/12 is set out in more detail in Appendix 1.

6. The average value of long-term borrowings in 2011/12 was £213 million for Dudley's debt (excluding loans taken out in March for Housing Self Financing). The average rate of interest on these borrowings was 5.33% and they were due to mature on dates ranging from 2013 to 2058. The rate for a 50-year maturity loan from the Public Works Loan Board (PWLB) has fluctuated in 2011/12 between 3.98% and 5.35%. 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 other than for HRA Self Financing (see below)
7. Due to cashflow requirements, it was necessary to undertake one short-term borrowing at the year end. This loan was for £7m at 0.4% for a duration of only 3 days.

#### Treasury activity in 2011/12 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 2011/12. Having consulted with our treasury advisors at Arlingclose, we did not identify any opportunities to improve our position by restructuring of debt.

#### Performance comparisons 2011/12

9. 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:

## West Midlands performance comparisons 2011/12

	Dudley	WMDAF	West Midlands average
<b>Gross average borrowing rate</b> (the cost of borrowing, ignoring the return on investments)	5.51%	6.47%	5.10%
<b>Investment return rate</b> (the return on investments, ignoring the cost of borrowing)	0.85%	0.73%	0.82%
<b>Net average borrowing rate</b> (a combination of the above, representing the cost of borrowing net of the return on investments)	6.64%	6.48%	5.69%
<b>Lender's Option Borrower's Option (LOBO)<sup>2</sup> loans as a proportion of all borrowing</b>	2%	5%	9%

10. Our cost of borrowing in 2011/12 was higher than the average and the return on our investments was slightly higher 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.
11. 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.
12. 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 2011/12

13. 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 2011/12. In all cases, actual outturn was within the targets and limits set by the Council.

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<sup>2</sup> 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 2012/13 to August

14. Treasury activities in the current year have been undertaken in the context of the Treasury Strategy Statement 2012/13 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.
15. Our investments up to the end of August have averaged around £31 million (with significant day to day variation as a result of cash flow). The average return on these investments was 0.67%. All investments were placed with institutions that satisfied the criteria for credit-worthiness set out in the Treasury Strategy Statement 2012/13. Our investment activity for 2012/13 is set out in more detail in Appendix 3.
16. Consumer and business confidence levels are generally low and it is not easy to see potential for significant economic growth in the short term. As a result, there is unlikely to be a base rate increase in the short-term. Market sentiment towards the Eurozone has remained volatile as successive rescue packages have first raised, and then disappointed, expectations.
17. The past few months have seen Moody's downgrade a number of UK banks, namely Royal Bank of Scotland, Barclays, HSBC and Lloyds due to significant exposure to the volatility in the world's financial markets. The numerous credit rating downgrades have led to local authority lending lists being severely restricted. In order to mitigate this situation, officers are working to open up a Custodian account which will allow the Council to diversify its strategy by buying up Treasury Bills, Certificates of Deposits (CD's) and UK Government Gilts.
18. In the Chancellor's Budget on March 21, a reduction in the PWLB interest rate was announced. The reduction was to be applicable for those councils that provide 'improved information and transparency' on 'borrowing and associated capital spending plans'. The rate would then be reduced by 20 basis points from the current rate of 1% above central government's own borrowing to 0.8% above gilts from 2012/13. The government has also raised the prospect of those councils deemed to be the 'most efficient' being given access to even lower borrowing rates, however the details of these proposals are not yet known. There is no immediate effect on the Council from the above announcements. However, this will impact on future decisions that the Council may make to borrow from the PWLB
19. The average value of long-term borrowings up to the end of August has been £543.4 million of which £335.6 million relate to Housing Self Financing (see below). The average rate of interest on Dudley's loans is 4.11%. 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 cash flow has been managed through the use of call accounts.
21. There has been no change to the position on the WMDAF.

## Housing Self Financing

22. The council housing finance system was reformed in the Localism Bill which was passed in November 2011. Under these reforms, the Housing Revenue Account (HRA) subsidy (negative in Dudley's situation) was abolished and replaced with a one-off redistribution of debt amounting to £335.6m. Although releasing councils from the HRA Subsidy system and offering much greater freedom, these reforms have resulted in a significant transfer of risk.
23. The Treasury Management report to Audit Committee on 9th February 2012, set out the strategy for this borrowing as well as the framework for allocating debt financing costs between the HRA and General Fund. Actual borrowing was carried out on 26th March 2012, The Council borrowed £335.6 million broken down as follows :

Variable	£13m
Fixed 1-10 years	£0m
Fixed 10-19 years	£20.6m
Fixed 20-29 years	£61.0m
Fixed 30-39 years	£104.0m
Fixed 40-50 years	£137.0m

The average rate of pre-existing HRA debt is 5.33% whilst the average rate of interest on the new Self Financing debt is 3.36%. The combined rate for all HRA debt is 3.90%

## 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;
- refers all of the above for approval by full Council at its meeting on 8th October.



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## **List of Background Papers**

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

**Investment Activity 2011/12**

<b>Counterparty name</b>	<b>Number of investments</b>	<b>Average value £ million</b>	<b>Average rate %</b>	<b>Average duration (days)</b>
Barclays Treasury Direct	17	7.2	0.97	17
Debt Management Office	57	3.5	0.25	6
Nationwide Building Society	6	1.0	0.42	15
Bank of Scotland Call Account	N/A	5.7	0.75	Call
Yorkshire Bank	N/A	1.4	0.75	Call
Santander	N/A	10.0	0.8	Call
Nat West	N/A	7.4	0.8	Call
HSBC	N/A	2.9	0.32	Call
Yorkshire Bank	N/A	2.3	0.50	Call
Salford MDC	1	0.5	11.25	Matures in 2020

The table above includes investments that commenced during 2010/11 and matured in 2011/12. It also includes investments that commenced during 2011/12 and were due to mature in 2012/13.

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.

**Prudential indicators relating to treasury management 2011/12****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.

	<b>£m</b>
Authorised limit for external borrowing	955.9
Operational boundary for external borrowing	787.7
Outturn - actual maximum external borrowing	753.9

**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.

	<b>Indicator</b>	<b>Outturn</b>
Upper limit for fixed interest rate exposure	100%	97.6%
Upper limit for variable rate exposure	15%	2.4%
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%	2%
12 months and within 24 months	0-10%	2%
24 months and within 5 years	0-15%	5%
5 years and within 10 years	0-25%	13%
10 years and above	40-100%	78%

**Investment Activity 2012/13 to August**

<b>Counterparty name</b>	<b>Number of investments</b>	<b>Average value £ million</b>	<b>Average rate %</b>	<b>Average duration (days)</b>
Barclays Treasury Direct	9	4.2	0.51	14
Debt Management Office	31	7.5	0.25	9
Bank of Scotland Call Account	N/A	7.3	0.75	Call
HSBC	N/A	6.5	0.32	Call
Nat West	N/A	3.5	0.8	Call
Santander	N/A	1.4	0.8	Call
Yorkshire Bank	N/A	0.01	0.50	Call
Salford MDC	1	0.5	11.25	Matures in 2020

The table above includes investments that commenced during 2011/12 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.

## West Midlands performance comparisons 2011/12

	Council					
	Dudley	WMDAF	A	B	C	D
<b>Gross average borrowing rate</b> (the cost of borrowing, ignoring the return on investments)	5.51%	6.47%	4.56%	4.84%	5.01%	5.16%
<b>Investment return rate</b> (the return on investments, ignoring the cost of borrowing)	0.85%	0.73%	0.96%	0.64%	1.07%	0.63%
<b>Net average borrowing rate</b> (a combination of the above, representing the cost of borrowing net of the return on investments)	6.64%	6.48%	4.92%	6.62%	5.27%	6.40%
<b>Lender's Option Borrower's Option (LOBO) loans as a proportion of all borrowing</b>	2%	5%	22%	16%	5%	8%