Derby City Council

AUDIT AND ACCOUNTS COMMITTEE
2 February 2012

ITEM 5

Report of the Strategic Director - Resources

Treasury Management – Progress Report 2011/12

SUMMARY

1.1 This report covers the Council's treasury management activity for the period to 30 September 2011.

1.2 Treasury management activity during the half-year has generated an average rate of return on investments of 0.88% to 30 September although our forecast outturn average rate for the year is 0.70%, with the average rate of interest being charged on our loans being 4.71%.

1.3 The very low rate of return on investments relative to the interest payable on loans continues, with consequent upward pressure on the Council's revenue costs.

1.4 The forecast outturn for the Treasury Management budget in 2011/12 is currently £17.1m, compared with an actual outturn of £14.2m in 2010/11. However, this will deliver an underspend currently estimated to be around £0.780m.

1.5 As highlighted in the previous Audit & Accounts Committee report on Treasury Management, the prudential indicator relating to the proportions of fixed and variable rate investments as at 31 March 2011 was breached. This indicator was reviewed and revised at Cabinet in November 2011, and the relevant issues are highlighted in this report.

1.6 Under a reformed Housing Revenue Account subsidy system the Council's HRA will from 1 April 2012 manage its own loans portfolio, which will mean it adopting a proportion of the Council's overall portfolio. This should not have a detrimental impact on the Council's General Fund.

RECOMMENDATIONS

2.1 To note the progress report on Treasury Management for the period to 30 September 2011.

2.2 To note the discontinuation of the year-end indicator relating to the proportions of fixed and variable rate investments.

2.3 To note the possible treasury management implications of the HRA reform.

REASONS FOR RECOMMENDATIONS

3.1 It is considered good Treasury Management practice for Audit & Accounts Committee members to monitor performance at least three times a year. This report covers treasury activity since the 2011/12 Strategy was approved at Cabinet in February 2011.

3.2 Continued use of the year-end indicator relating to the proportions of fixed and variable rate investments could lead to investment decisions detrimental to the Council's cashflow, creating liquidity problems. Other prudential indicators contained within the Strategy and reported to members adequately cover treasury management's three central concerns of security, liquidity and yield.

3.3 The arrangements underlying the HRA's management of its own debt portfolio have yet to be finalised. However, it is hoped that by retaining some of the Council's interest rate risk within the General Fund, and not passing this over to the HRA, the General Fund can make a short-term revenue saving.

SUPPORTING INFORMATION

4 Investments

4.1 The average size of the Council's investment portfolio for the first half of 2011/12 was £95.3m. This is 12% higher than the corresponding figure of £84.9m for 2010/11, despite the Council aiming to keep cash balances 'low' by permanently deferring £50m of borrowing, that is by aiming to be £50m 'under-borrowed' by the year end. This suggests that cash from other sources, such as capital grants, might have increased, or that the rate at which the Council spends the capital resources available to it has slowed down.

4.2 Interest rates on investments have also remained consistently low over the past two years, largely mirroring the Bank of England's base rate all-time low of 0.5%, which still shows no immediate sign of increasing. In its own investments the Council obtains around 0.6% when it places money in instant access Money Market Funds. Higher rates of around 1.5% can be obtained if longer-term investments are made, but the Council's Treasury Management Strategy now avoids such investments as not providing enough liquidity.

4.3 The average rate of interest on the Council's investments for the first half of 2011/12 is 0.88%. This figure is slightly higher than could have been obtained in the current market because it includes the tail-end of a 6.86%/£3m investment with Barclays Bank made in July 2008, maturing July 2011. This investment alone netted the Council £617,400 in interest earned over the period. The market no longer offers such high rates, and for liquidity reasons it is no longer advisable for the Council to tie its money up in fixed rate investments for so long. This means that, looking forward, the Council cannot expect to make more than around 0.6% for the second half of the year.

4.4 The low rate of return on new investments means that the forecast investment income for 2011/12 is approximately £600,000, compared with £851,000 in 2010/11.

5 Borrowing

5.1 The Council's capital financing requirement - CFR - for 2011/12 is currently estimated to be around £516m. In other words, by 31 March 2012 the Council will have borrowed £516m to finance its capital programme, planning to repay this over the next 40-50 years. The costs of the repayments (with interest) are built into the Council's treasury management budget.

5.2 As highlighted in paragraph 4.1 above, some £50m of this borrowing is expected to be deferred to 2012/13 by using other cash resources available to the Council (such as capital grants received early), and borrowing only when cashflow considerations dictate.

5.3 Taking account of the CFR and the planned under-borrowing, there is a need for the Council to borrow approximately £114m before the end of the financial year. None of this had been borrowed by the time of writing this report, and it may well be that the Council prudently uses its own cash balances to temporarily postpone even some of this until 2012/13. For information, it is assumed in the budget that any borrowing during 2011/12 will be taken from the Public Works Loan Board - PWLB - at an average interest rate of 5%.

5.4 The precise point of borrowing will be decided largely by cashflow considerations, and this depends on the expenditure profile of the Council's larger capital projects. This makes the point of borrowing difficult to forecast. It is generally assumed for budget purposes that required borrowing takes place at the midpoint of the year, but in practical terms it is more likely to be required nearer to the year end when cash balances are low.

5.5 Any postponement of borrowing from the midpoint of the year until later in the financial year represents a one-off saving to the Council, as interest charges are delayed. Monthly savings on interest charges to the General Fund from deferring borrowing £114m are approximately £0.237m. So the current forecast treasury management outturn under-spend of approximately £0.780m could become significantly higher if borrowing is postponed by several months.

5.6 For information, the Council's 2011/12 mid-year borrowing positions stands at £265.295m. Apart from £20m borrowed from Royal Bank of Scotland, all this borrowing has been taken from the PWLB. Its maturity profile and average weighted interest rates are shown in the table below:

Period remaining as at 30 September 2011	**%**	**£000**
Under 1 year	0.000	0
1 – 2 years	0.000	0
2 – 3 years	0.000	0
3 – 4 years	0.000	0
4 – 5 years	4.135	20,000
5 – 10 years	3.840	10,000
10 – 20 years	5.503	21,795
20 – 30 years	4.766	37,500
30 - 40 years	4.603	55,000
40 - 50 years	4.559	121,000
Total	**4.159**	**265,295**

5.7 The weighted average interest calculation above is only a snapshot of the Council's mid-year debt portfolio. Over the course of the year, taking into account the further planned borrowing of £114m, the forecast 'consolidated rate of interest' on the Council's debt portfolio for 2011/12 is projected to be 4.71%. This figure will be finalised at year-end.

6 Prudential Indicators

6.1 In the Treasury Management Annual Report 2010/11, taken to Cabinet in July, it was reported that the 70% upper limit for variable rate investments at year-end had been exceeded, the actual figure being 80.74%. In other words, some £7.250m of the Council's investments at that point were held in variable rate instant access accounts, instead of being invested, in accordance with the limit, in fixed-rate investments.

6.2 This limit was locally adopted and set by the Council when the Prudential Code governing local authority treasury management activity was first introduced, but it does not actually form part of the Code. The Council is therefore free to modify or even abandon this limit.

6.3 At Cabinet in November 2011 it was agreed that this limit should therefore be abandoned for the following reasons:

6.3.1 The Council no longer aims to maintain a substantial investments portfolio alongside a large debt portfolio. When the Prudential Code was first introduced interest rates were such that there was no ‘cost of carry’ relating to cash, and it was assumed that Councils would therefore have a relatively large investment portfolio built up from cash amounts borrowed prior to being spent as part of the capital programme. It made financial sense to invest a large part of this portfolio at the higher rates then offered by fixed-rate investments. The locally adopted limit ensured this (at least at year end). However, the current financial climate is such that the opposite is true: it now makes sense to delay borrowing for as long as possible and keep cash balances minimal. In such a climate, and especially at year end, it is prudent to keep as much cash as necessary in instant access accounts to cover possible cashflow shortfalls. These accounts are usually subject to variable interest rates.

6.3.2 The number of counterparties where the Council can place fixed rate investments has been greatly curtailed in recent months, because of various credit-rating downgrades by Fitch, Moody’s and Standard and Poor’s (the credit rating agencies). It is often the case that the only institution where the Council could place such a deal is the Bank of England Debt Management Office, which offers the lowest interest rate possible on investments – 0.25%. While the Council occasionally makes use of this facility, it would not be advisable to adopt a limit which forced its use when other counterparties on the Council’s approved list were available.

6.3.3 On a day-to-day basis the Council’s Treasury Management Strategy Report has specified a number of prudential indicators and other limits that should be used to ensure that the principles of security, liquidity and yield are adhered to throughout the year. These relate to the active management of the Council’s approved counterparty list, ensuring that investment limits with these counterparties are not exceeded, and ensuring that minimum liquidity thresholds are maintained. These indicators are checked daily by treasury management officers, and make redundant any additional indicators that might apply only to year-end.

6.4 It was therefore recommended to Cabinet that the indicator specifically measuring ‘the proportion of the Council’s investment portfolio held in variable rate investments as at 31 March’ be dropped.

7 HRA Reform

7.1 Under HRA Reform, which will allow the Housing Revenue Account to free itself from the subsidy system, Derby’s HRA will take on a portion of the Council’s overall debt portfolio as at 31 March 2012, and from that point on will have freedom to decide when and how much to borrow, independently of the General Fund.

7.2 At Derby this process will be managed by the HRA adopting a notional debt portfolio, derived from the Council’s overall portfolio, and then borrowing future amounts notionally from the General Fund at PWLB rates. This is convenient for the Council as a whole because it will allow the General Fund to manage the Council’s overall cash position while at the same time giving a greater degree of independence, certainty and control to the HRA.

7.3 The HRA's notional debt portfolio has been derived from the Council's overall portfolio by splitting all fixed term PWLB debt in proportion to the respective CFRs of the HRA and General Fund. This is considered the most equitable approach.

7.4 One exception to this relates to £20m of debt not taken from the PWLB. This is a Lender's Option Borrower's Option - LOBO - loan from the Royal Bank of Scotland (RBS). After an initial period of five years, RBS has the option to increase the interest rate on this loan, at which point the Council has the option to repay the loan in full. Officers are still considering how to split this loan between the General Fund and the HRA in such a way that the inherent risk (relating to prevailing interest rates after the initial loan period has ended) is distributed evenly between both sides.

7.5 The protocol for dealing with this and all other aspects of HRA debt is currently being drafted by treasury management and HRA officers, and the final version of the agreement will be subject to Council approval.

OTHER OPTIONS CONSIDERED

8.1 None.

This report has been approved by the following officers:

Legal officer	n/a
Financial officer	Roger Kershaw, Strategic Director – Resources
Human Resources officer	n/a
Service Director(s)	n/a
Other(s)	n/a

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Background papers:	• Council Cabinet report 23 November 2010 'Treasury Management Progress Report 2010/11' • Council Cabinet report 15 February 2011 'Treasury Management Strategy and Prudential Code Indicators 2011/12' • Council Cabinet report 19 July 2011 'Treasury Management – Annual Report 2010/11'
List of appendices:	Appendix 1 - Implications

IMPLICATIONS

Financial

1.1 As detailed in the report.

Legal

2.1 The Council is obliged to set and review prudential indicators in order to comply with the Local Government Act 2003. The Local Government Act 2003 states that the Council must adopt the Prudential Code, which, in turn, requires local authorities to adopt the CIPFA Treasury Management Code of Practice. Unless the government uses its powers under section 4 of that Act, the Council is free to set any reasonable indicators consistent with its other policies.

2.2 The Prudential Code states that the Prudential indicators for treasury management should be considered together with the local authority's treasury management strategy and the annual report on treasury management activities.

Personnel

3.1 None.

Equalities Impact

4.1 None.

Health and safety

5.1 None.

Carbon Commitment

6.1 None.

Value for Money

7.1 As outlined in the report

Corporate objectives and priorities for change

8.1 The priorities of the Council's Treasury Management Strategy contribute to minimising Council Tax and providing value for money.