| REPORT TO | DATE OF MEETING |
|---|---|
| Governance Committee | 30 June 2009 |

| SUBJECT | PORTFOLIO | AUTHOR | ITEM |
|---|---|---|---|
| Treasury Management Strategy Update and Debt Repayment Proposals | Finance & Resources | J Blundell | 7b & c |

## SUMMARY AND LINK TO CORPORATE PRIORITIES

This report updates the Treasury Management Strategy and sets out proposals for the early repayment of Public Works Loan Board (PWLB) debt.

## RECOMMENDATIONS

That the Governance Committee:

1. note the contents of the report and appendices;

2. recommend for approval by Council the proposed amendments to the List of Financial Institutions and Investment Criteria in the Treasury Strategy, as shown in Appendix B;

3. note and comment as appropriate on the proposals for the early repayment of PWLB debt as detailed in Appendix C.

## DETAILS AND REASONING

**Background**

With support from its specialist appointed Treasury Management advisors, the Council annually reviews and agrees its Treasury Management Strategy in accordance with the CIPFA Code of Practice on Treasury Management. The Treasury Management Strategy for 2008/09, which incorporates the Council's investment policy, was approved by Council on 5th March 2008.

This Strategy was reviewed as a result of the unprecedented crisis in the financial markets during the year. The outcome of this was that an amended Treasury Management Strategy was approved on 5th November 2008 containing a revised, and considerably more restrictive approved list of Financial Institutions and Investment Criteria (see Appendix A).

In line with best practice, limits have been set on both the principal amounts invested and duration dependent on the financial standing of institutions and sector and country limits also applied.

This move to further enhance the security of investments, combined with a significant fall in interest rates during 2008/09 and in the current financial year has had a detrimental effect on interest earned by the Council. This is outlined within the Treasury Outturn report elsewhere on the agenda.

The Treasury Management Strategy was further reviewed and updated, prior to the start of the new financial year, at the Council meeting held on 4 March 2009.

## Current Investments

The table below sets out for information the cash deposits held by the Council as at 24 June 2009.

| Counterparty | Category (Appendix A) | Maturity | Interest Rate % | Principal £ |
|---|---|---|---|---|
| **Deposit /Call Accounts** | | | | |
| Bank of Scotland | Tier 4/6 | Call Account | 0.75 | 2,000,000 |
| Abbey | Tier 4/6 | Call Account | 0.60 | 2,000,000 |
| HSBC | Tier 4/6 | Deposit Account | 0.00 * | 332,884 |
| **Total** | | | | **4,332,884** |
| **Fixed Term Deposits : short-term** | | | | |
| DMADF | Tier 1 | 26 June 2009 | 0.30 | 2,500,000 ** |
| DMADF | Tier 1 | 6 July 2009 | 0.30 | 2,000,000 ** |
| Nationwide Building Society | Tier 4 | 29 June 2009 | 0.57 | 2,000,000 |
| The Royal Bank of Scotland | Tier 4 | 6 July 2009 | 0.46 | 1,000,000 |
| The Royal Bank of Scotland | Tier 4 | 8 July 2009 | 0.46 | 1,000,000 |
| Barclays | Tier 4 | 2 July 2009 | 0.45 | 1,000,000 |
| **Total** | | | | **9,500,000** |
| **Fixed Term Deposits : long-term** | | | | |
| Clydesdale Bank | See note *** | 28 June 2010 | 6.69 | 3,000,000 |
| **Total** | | | | **3,000,000** |
| **Fund Total (excluding Icelandics)** | | | | **16,832,884** |
| **Icelandic deposits**: | | | | |
| Heritable Bank | See note *** | 23 Oct 2008 | 5.85 | 1,000,000 |
| Heritable Bank | See note *** | 21 Nov 2008 | 6.00 | 1,000,000 |
| Landsbanki Islands | See note *** | 22 June 2009 | 6.65 | 3,000,000 |
| **Total** | | | | **5,000,000** |
| **Grand Total** | | | | **21,832,884** |

* *based on base rate less a tiered rate of interest*

** *the relatively high balance in DMADF is due to monies being held short-term both to fund precept payment in early July and, if approved, to be available to repay borrowing.*

* * * *counterparty removed from approved list for further investments*

## Revised Counterparty list / investment criteria

As reported to the previous Council in March 2009, the credit rating agency Standard & Poors (S&P) altered the “rating outlook” for Ireland’s sovereign rating from Stable to Negative back in January. Since then, the deposits held with Irish institutions at that time have matured and no further investments have been made. All Irish banks and building societies have been removed from the proposed List of Financial Institutions and Investment Criteria listed in Appendix B.

On 21 May 2009,Standard & Poor's credit rating agency announced that they had revised their outlook on the United Kingdom (U.K.) to negative from stable. At the same time, the 'AAA' long-term and 'A-1+' short-term sovereign credit ratings were affirmed. Although this change does not necessarily mean that the country rating will actually be downgraded from its current AAA status, there is a very strong chance that it will. In its press release, S&P stated that its decision on the UK sovereign rating depended critically upon the policies put in place post the next General Election with respect to tackling the burgeoning public sector debt burden. In view of this, no change is proposed in the investment criteria in relation to UK institutions at this stage. However, we will continue to invest with them within the approved criteria and report on any further changes to the sovereign rating should this occur.

Our current investment criteria allows a discretionary increase in the investment limit of £3 million per financial institution (subject to discussion with the Cabinet member for Finance and Resources). This discretion has not been exercised to date. However, it is becoming increasingly difficult to place surplus funds because of the reduced number of approved counterparties and also because the Council's cashflow position is forecast to substantially improve over the coming months as council tax income is collected in. Therefore this flexibility to increase the monetary limit on the Tier 4 counterparties only has been retained in the revised list in Appendix B.

The 2009/10 budget is based on an assumed return on short-term investments of 1.00%. This target is currently difficult to achieve, particularly when numbers of counterparties are restricted and the time limits for deposits are very short. This is illustrated in the list of current investments in the table above. The current time limit for placing deposits with Tier 4 counterparties (UK Banks highlighted in the Government Rescue Package) is up to 1 month. Current interest rates for these counterparties are as follows:

1 month 0.45% – 0.53%
2 months 0.75% – 0.90%
3 months 1.05% - 1.15%

Therefore the revised counterparty list includes a proposed change in the time limit for Tier 4 institutions from up to 1 month to up to a maximum of 3 months. As well as serving to secure better investment returns, this change will also enable officers to ensure that the timing of maturing investments is in line with the key payments made by the Council, such as precepts, which are paid out on pre-agreed dates throughout the year.

**Proposals to Repay Long-term Borrowing**

The Council currently has four outstanding loans totalling £3,308,000 from the Public Works Loans Board (PWLB) taken out to finance capital expenditure incurred in previous years:

| Date of Advance | Value £ | Interest Rate % | Repayment date |
|---|---|---|---|
| 29.01.04 | 1,200,000 | 4.80 | 29.01.30 |
| 07.07.05 | 472,000 | 4.25 | 29.01.11** |
| 23.01.06 | 436,000 | 3.70 | 29.07.46 |
| 08.03.07 | 1,200,000 | 4.25 | 29.07.52 |
| **TOTAL** | **3,308,000** | | |

The proposals set out in more detail in Appendix C. In essence, given investment balances are currently earning less than 1%, the proposal is to repay three of the above loans totalling £2,836,000 and attracting interest payable at an average interest rate of c4.4%. The remaining £472,000 of debt is relatively short term (maturing January 2011**) and it is proposed that this loan will be allowed to mature naturally as it is not considered financially advantageous to repay it early.

The current estimated net annual saving as a result of this exercise will be approximately £80 - 90,000. (based on investment rates remaining at 1%). However, the timing of any decision to repay borrowing would clearly also need to take into consideration the one-off premium or discount payable when redeeming the debt early. The latest information received suggests that the overall net premium would be c£28,000. However, any figures quoted can only be indicative, as rates change on a daily basis and small changes in rates make a big difference to the cost/savings forecasts.

The Treasury Management Strategy delegates decisions on borrowing (in terms of timing etc) to the Corporate Director (Resources). That said, the Committee's comments on this proposal would be welcomed and any final decision would only be taken following consultation with the Cabinet

Member for Finance & Resources. Interest rates will need to be monitored to ensure that the repayment is timed to maximise the overall annual general fund saving.

An added benefit from this proposal to repay debt is that counterparty risk would be much reduced. This is because, by having repaid the outstanding debt, we would in effect have £2.8m less cash to place with investment counterparties.

Going forward the situation would need to continue to be monitored to assess when it would be necessary to reinstate the borrowing. This decision would be guided by interest rate forecasts and the Council's cashflow.

## WIDER IMPLICATIONS

In the preparation of this report, consideration has been given to the impact of its proposals in all the areas shown below. The table shows the implications in respect of each of these.

| | |
|---|---|
| **FINANCIAL** | The indicative financial implications associated with the proposals to repay debt are set out in the body of this report.<br><br>Whilst continuing to assess counterparty risk, the proposed adjustment to the investment criteria should allow a marginally better return on cash deposits. |
| **LEGAL** | Compliance with the various regulations as covered by the adoption of the CIPFA Code of Practice for Treasury Management in Public Services. The Council's investment policy is governed by Government Guidance. |
| **RISK** | Risks are as identified within the report and the proposals for debt repayment and adjustments to the investment criteria are aimed at helping to manage counterparty risk given the current instability and uncertainty in financial markets. |
| **OTHER (see below)** | . |

| | | | |
|---|---|---|---|
| Asset Management | Corporate Plans and Policies | Crime and Disorder Act 1998 – Section 17 | Data Protection |
| Fair Access | Freedom of Information Act 2000 | Health and Safety | Human Rights Act 1998 |
| Implementing Electronic Government | Staffing | Sustainability | Training and Development |

## BACKGROUND DOCUMENTS

1. Treasury Management Strategy for 2008/09 – Cabinet 13th February 2008/Council 5th March 2008
2. Treasury Management Strategy – Council 5th November 2008
3. Treasury Management Strategy – Council 4th March 2009.

## APPENDICES

Appendix A Approved list of Counterparties
Appendix B Revised list of Counterparties
Appendix C Repayment of Debt Proposal

**GLOSSARY OF TERMS**

| | | |
|---|---|---|
| CIPFA | - | Chartered Institute of Public Finance and Accountancy. |
| Counterparties | - | Financial Institutions who the Council can place deposits with. |
| DMADF | - | Debt Management Deposit Account Facility. A Government body which accepts local authority deposits), |
| MMF | - | Money Market Funds. Guaranteed deposit facilities and strongly rated institutions offered support by the UK Government. |

## Appendix A

**Current Approved List of Financial Institutions and Investment Criteria**

| Invest-ment Group | Category | Institutions Included | Required Ratings | Sovereign Rating | Time Limit | Money Limit | Group Limit |
|---|---|---|---|---|---|---|---|
| Tier 1 | UK government or like investing | DMADF | Sovereign entity | n/a | 6 months (max available) | No limit (for emergency reasons) | |
| | | Local Authorities | Sovereign-type entity | n/a | 1yr | £3m | |
| | | UK Government Backed Money Market Funds | Highest MMF rating - AAA | n/a | n/a instant access rather than term deposit | £3m | |
| Tier 2 | UK Nationalised Institutions | Northern Rock | Government guarantee (although time limit) | n/a | 3 months (due to ability to withdraw guarantee) | £3m | Sum of individual limits |
| Tier 3 | Other government guaranteed institutions | Allied Irish Banks<br>Anglo Irish Banking Corporation<br>Bank of Ireland<br>Irish Permanent<br>EBS Building Society<br>Irish Nationwide Building Society | Government guarantee (although time limit) | AAA Stable from all 3 rating agencies | 3 months (even though guarantee extends to Sept 2010) | £1m * | Country cap of £3m |
| Tier 4 | UK Banks highlighted in Government Rescue Package | Abbey National<br>Bank of Scotland/Lloyds TSB<br>Barclays<br>HSBC<br>Nationwide Building Society<br>Royal Bank of Scotland | F1+ / P-1 / A-1+ (highest short term rating from all 3 agencies) | AAA Stable from all 3 rating agencies | 1 month | £2m ** | |
| Tier 5 | Money Market Funds | AAA rated MMFs | Highest MMF rating - AAA | n/a | n/a instant access rather than term deposit | £3m | |
| Tier 6 | Deposit/Call Accounts | HSBC | | n/a | Deposit Account | £3m | |
| | | Abbey National | | As tier 4 | Call Account | As above | |
| | | Bank of Scotland | | As tier 4 | Call Account | As above | |

* To allow some flexibility, in discussion with the Cabinet Member for Finance & Resources, in exceptional circumstances, this cash limit may be increased to £2 million for short term deposits.

** To allow some flexibility, in discussion with the Cabinet Member for Finance & Resources, in exceptional circumstances, this cash limit may be increased to £3 million for short term deposits provided that this is no more than 15% of total investments.

**Appendix B**

**Proposed List of Financial Institutions and Investment Criteria**

| Invest-ment Group | Category | Institutions Included | Required Ratings | Sovereign Rating | Time Limit | Money Limit | Group Limit |
|---|---|---|---|---|---|---|---|
| Tier 1 | UK government or like investing | DMADF | Sovereign entity | n/a | 6 months (max available) | No limit (for emergency reasons) | |
| | | Local Authorities | Sovereign-type entity | n/a | 1yr | £3m | |
| | | UK Government Backed Money Market Funds | Highest MMF rating - AAA | n/a | n/a instant access rather than term deposit | £3m | |
| Tier 2 | UK Nationalised Institutions | Northern Rock | Government guarantee (although time limit) | n/a | 3 months (due to ability to withdraw guarantee) | £3m | Sum of individual limits |
| Tier 3 | Other government guaranteed institutions | None (Irish institutions removed from list) | n/a | n/a | n/a | n/a | n/a |
| Tier 4 | UK Banks highlighted in Government Rescue Package | Abbey National<br>Bank of Scotland/Lloyds TSB<br>Barclays<br>HSBC<br><br>Nationwide Building Society<br><br>Royal Bank of Scotland | F1+ / P-1 / A-1+ (highest short term rating from all 3 agencies) | AAA Stable from all 3 rating agencies | 3 months | £2m ** | |
| Tier 5 | Money Market Funds | AAA rated MMFs | Highest MMF rating - AAA | n/a | n/a instant access rather than term deposit | £3m | |
| Tier 6 | Deposit/Call Accounts | HSBC | | n/a | Deposit Account | £3m | |
| | | Abbey National | | As tier 4 | Call Account | As above | |
| | | Bank of Scotland | | As tier 4 | Call Account | As above | |

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** To allow some flexibility, in discussion with the Cabinet Member for Finance & Resources, in exceptional circumstances, this cash limit may be increased to £3 million for short term deposits provided that this is no more than 15% of total investments.

**Appendix C**

# Repayment of Debt Proposal

## Background

### Current Treasury Position

The Council's current treasury position includes long term debt of £3.3m, coupled with significant investment balances (£15.8m at 31 March 2008 – although these have been reduced temporarily by the frozen Icelandic investments).

The Council's actual borrowing need, termed its Capital Financing Requirement (CFR), is expected to be £5.0m at 31 March 2009. This means the Council has taken a treasury management decision to only provide external funding of £3.3m against the borrowing need, utilising £1.7m of cash relating to cash flow and reserves to temporarily fund the Council's capital expenditure.

### Future Treasury Position

The key medium term change in the treasury position is the movement in the CFR, which is estimated to be £6.6m at 31 March 2010 and £7.2m at 31 March 2011. This represents an increase in borrowing need of £2.2m for which funding will be required, either through external borrowing or the use of cash flow monies.

### Restructuring of the Treasury Position

It is the Council's choice of how to fund its borrowing need – by either borrowing or utilising cash flow monies temporarily. Previously the Council has undertaken a low risk approach of part funding some of the borrowing need by long term borrowing, which has been available at relatively low cost (the average rate of debt is currently 4.38%).

The debt position has been regularly reviewed, but debt repayment has not previously been considered feasible for the following reasons:

the structure of interest rates has made this cost ineffective, since low coupon debt would be repaid with investments yielding relatively higher interest returns;

on 1 November 2007 the PWLB introduced lower repayment rates (providing higher premium costs);

### The Need For Review

The collapse of Lehman Bros and the near collapse of the banking system in autumn 2008 has seen this advantageous position reverse, with investments yielding very low returns (less than 1%), against higher debt costs and a background of very high counterparty risk. Many UK high street banks are now part owned by the UK Government. As a result of this banking crisis local authorities have been doubly caught by:

- A tightening of counterparty criteria; and
- A fall in credit criteria in relation to possible counterparties.

both of which have caused greater difficulty in the Council placing deposits with good quality counterparties as the pool of acceptable counterparties has reduced. This makes a consideration of debt repayment more pressing.

**Proposal**

The Council can repay £2.8m of debt at 4.4% with investment balances yielding less than 1% (the remaining £472,000 of debt is short term and it is not financially advantageous to repay). The result of this exercise will be two fold:

- There will be an annual saving of c £80 - 90,000 p.a. as long as investment rates remain at 1%; and
- Investment counterparty risk has been much reduced as £2.8m of debt will have been repaid with £2.8m of investment balances.

The current financial markets indicate that these loans could be repaid with minimal premiums, and potentially a discount.

**Risks to the Repayment**

The key risk to the exercise being undertaken is the possibility that the Council will need to replenish its borrowing in the near future. Current market expectations are that the sheer weight of UK Government Gilt (debt) issuance will see longer term fixed interest rates rise, and so the Council's risk is that it will need to borrow at higher rates for loans of a similar nature.

This risk will be mitigated by the following options/scenarios:

- The Council's cash flow forecasts suggest that the cash investment will be sufficient not to borrow over the next 3 year period (i.e. utilise cash flow monies to fund capital expenditure);
- The economy fails to recover quickly and growth and interest rates remain low – the Council will have no borrowing need and the under-borrowing will be maintained;
- Economic forecasts change more quickly than expected and the Council's cash flow resources are lower then expected – the Council borrows short/medium term debt (5 – 15 years) at rates below those applying to the repaid debt (4.4%).

**Timetable**

The exact repayment date will depend upon underlying movements in interest rates, but is expected to be in the next couple of months.

**Recommendation**

The Council has an opportunity to repay external debt at minimal cost both providing a lower counterparty risk and lower costs. Risk mitigation options have been considered in the event of an unexpected change in economic forecasts. It is recommended that the repayment of £2.8m of external debt should take place when the interest rate environment is advantageous.