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## **BOROUGH COUNCIL – 2 MARCH 2010**

### **Chapter 3: Treasury Management Strategy, Investment Strategy, Prudential Indicators and Minimum Revenue Provision Policy 2010/11**

**Report by: Director of Finance**

#### **Summary**

The Local Government Act 2003 and subsequent supporting regulations require the council to set out a suite of four reports covering its treasury management activities. This is a composite report and includes the:-

- Annual Treasury Management Strategy for borrowing
- Annual Investment Strategy for managing our investments and for giving priority to the security and liquidity of those investments
- Prudential and Treasury Indicators to ensure that the council's investment plans are affordable, prudent and sustainable
- Minimum Revenue Provision Statement setting out what provision is made in the General Fund for the repayment of debt and how this provision has been calculated.

#### **Recommendations**

1. Council is requested to adopt the
  - (i) Revised Treasury Management Policy Statement Section 2
  - (ii) Revised CIPFA Code of Practice and the four new clauses Section 3 and Appendix D
  - (iii) Treasury Management Annual Strategy Sections 4-19
  - (iv) Annual Investment Strategy Appendix E
  - (v) Prudential and Treasury Indicators Appendix F
  - (vi) Statement on Minimum Revenue Provision Appendix G
2. Council is requested to authorise the Director of Finance to
  - (i) Utilise short-term (temporary) borrowings
  - (ii) Use cash held in internal funds to offset the need to borrow externally.

- (iii) Subject to interest rates at the time of offer:
  - a. Take long-term loans, as required, from the Public Works Loan Board.
  - b. Take long term loans from the money market utilising any of the loan instruments available to the council as deemed most appropriate at the time of borrowing.
- (iv) Invest temporary surplus cash within constraints of normal cash flow considerations with approved counterparties.
- (v) Review and appoint external cash fund managers if appropriate when one-off lump sums are received subject to specific conditions for investment.
- (vi) Review and implement all prudent debt management functions which are required to produce advantages to the council's long term interest rate liabilities.
- (vii) Subject to available rental levels, to finance appropriate expenditure through leasing arrangements.
- (viii) Implement the Treasury Management Strategy in accordance with the Prudential Indicators.

## **1. Introduction**

1.1 The Local Government Act 2003 and subsequent supporting regulations require the council to set out a suite of four reports covering its treasury management activities. These are encapsulated within this report and cover the:-

- Annual Treasury Management Strategy for borrowing
- Annual Investment Strategy (as required by Investment Guidance issued subsequent to the 2003 Act); this sets out the council's policies for managing its investments and for giving priority to the security and liquidity of those investments
- Prudential and Treasury Indicators to ensure that the council's investment plans are affordable, prudent and sustainable
- Minimum Revenue Provision Statement setting out what provision is made in the General Fund for the repayment of debt and how this provision has been calculated.

1.2 In the light of the Icelandic banking crisis in 2008 the Chartered Institute of Public Finance and Accountancy (CIPFA) has amended its Treasury Management Code of Practice. Whilst this authority had no investments in Iceland it is still required to comply with all aspects of the CIPFA Code. The Code has been revised and Hounslow has revised its Treasury Management Policy Statement accordingly. The revised statement differs from the previous statement by separately identifying investment activities as part of the treasury

management function. Council is asked to adopt the revised Statement as set out in section 2.

## **2. Revised Treasury Management Policy Statement**

- 2.1 The council defines its treasury management activities as: “The management of the Authority’s investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks”.
- 2.2 The council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation.
- 2.3 The council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.

## **3. Adoption of Revised CIPFA Treasury Management Code of Practice 2009**

3.1 CIPFA has amended its Treasury Management Code of Practice. Besides amending our Treasury Management Policy Statement the new Code sets out various other requirements. The details of these are in Appendix D to this report. Council is asked to adopt the revised Code, Appendix D and the following four clauses:-

- i. The council will create and maintain, as the cornerstones for effective treasury management:
  - A treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities.
  - Suitable treasury management practices (TMPs), setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

The content of the policy statement and TMPs will follow the recommendations contained in the Code, subject only to amendment where necessary to reflect the particular circumstances of this organisation. Such amendments will not result in the organisation materially deviating from the Code’s key principles.

- ii. The council will receive reports on its treasury management policies, practices and activities, including, as a minimum, an annual strategy and

plan in advance of the year, a mid-year review and an annual report after its close, in the form prescribed in its TMPs.

- iii. The council delegates responsibility for the implementation and regular monitoring of its treasury management policies and practices to the Executive, and for the execution and administration of treasury management decisions to the Director of Finance, who will act in accordance with the organisation's policy statement and TMPs and, if he/she is a CIPFA member, CIPFA's Standard of Professional Practice on Treasury Management.
- iv. The council nominates the Audit Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

#### **4. Treasury Management Annual Strategy 2010/11**

4.1 The Strategy for 2010/11 is based upon the Director of Finance's views on interest rates, as informed by leading market forecasts provided by the council's external treasury advisor. The strategy covers:

- The current treasury position
- The borrowing requirement
- Prospects for interest rates
- The borrowing strategy
- Policy on borrowing in advance of need
- Debt rescheduling and repayment
- The investment strategy
- Treasury limits in force which will limit the treasury risk and activities of the council
- The Minimum Revenue Provision (MRP) strategy
- Money laundering
- Policy on use of external service providers
- Training
- Risk
- Financial implications.

4.2 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 a local authority must calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This means that any increases in capital expenditure must be limited to a level where increases in charges to revenue are kept to a level that is affordable within the projected income of the council for the foreseeable future. Such charges to revenue arise from increases in debt charges caused by increased borrowing to finance additional capital expenditure, and from any increases in running costs from new capital projects.

## 5. Base Portfolio Position

5.1 The council's treasury portfolio position at 31/03/09 was:

		Principal £m	£m	Average Rate %
Fixed rate funding	PWLB*	191.8		
	Market	47.3		
	<b>Total</b>		<b>239.1</b>	<b>5.96</b>
Variable rate funding	PWLB	-		
	Market	-	-	
	<b>Total</b>		-	-
<b>Total Debt</b>			<b>239.1</b>	<b>5.96</b>
<b>Total Temporary Investments</b>			<b>72.9</b>	<b>5.22</b>
<b>Net Debt</b>			<b>166.2</b>	

\*PWLB - Public Works Loan Board

## 6. Capital Financing Strategy

6.1 The current 'prudential' system of capital controls allows local authorities to determine their own levels of capital investment, as long as that level of investment is affordable, prudent and sustainable. The capital programme proposed in chapter 2, has been set at a level that can be financed within identified resources. The capital programme's main source of financing is capital grants, primarily from the Government. Capital receipts from the disposal of properties are also used. Other sources of finance are direct revenue financing and borrowing. The borrowing arrangements to finance the capital programme are the subject of this Treasury Management Strategy.

## 7. Borrowing Requirement

7.1 The council's borrowing requirement is as follows:-

	2009/10 £m	2010/11 £m	2011/12 £m	2012/13 £m
New supported borrowing	4.0	8.6	1.1	1.1
New prudential borrowing	17.0	8.1	2.0	2.0
Replacement borrowing	0.3	0.3	7.3	3.3
<b>Total borrowing requirement</b>	<b>21.3</b>	<b>17.0</b>	<b>10.4</b>	<b>6.4</b>

7.2 Supported borrowing relates to allocations by the Government where the financing costs are provided for within the formula grant system. However, as the council is at the floor for grant purposes it is a matter of contention that these borrowing approvals are not in fact fully supported by grant allocations. £8.6m of the supported borrowing allocation for 2010/11 relate to education schemes. The prudential borrowing refers to borrowing whose costs fall on the council's revenue budget and do not attract government support. For 2010/11

over £7.0m of this borrowing relates to approved borrowing for the leisure refurbishment programme. The remaining prudential borrowing is borrowing to replace capital receipts that were temporarily applied to repay debt in previous years, generating revenue savings for the Authority. The revenue implications of borrowing have been included in the council's revenue budget. Replacement borrowing relates to borrowing for maturing debt.

## 8. Prospects for Interest Rates

- 8.1 The council has appointed Sector Treasury Services as its treasury advisor. Part of their role is to assist the council formulate a view on interest rates.

### Economic background

- 8.2 Last year saw the longest and deepest recession since the 1950s. The Bank of England has left the bank rate unchanged at the historic low of 0.50% since March 2009, and have implemented a Quantitative Easing programme of £200 billion.

### Interest rate forecast

- 8.3 The following table gives the Sector view on interest rates: -

(%)	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Bank rate	0.50	0.50	0.75	1.00	1.50	2.25	2.75	3.25
5yr PWLB rate	3.05	3.20	3.30	3.40	3.60	3.85	4.15	4.55
50yr PWLB rate	4.60	4.70	4.75	4.90	5.00	5.10	5.15	5.20

### Bank rate

- 8.4 The bank rate has stayed at 0.50% since March 2009.
- 8.5 The bank rate is likely to be kept low until there is clear evidence that the economy is moving significantly out of recession. It is expected to rise gradually, with the first increase in mid to late 2010 and reaching 3.25% by the end of 2011.
- 8.6 There is a downside risk to this forecast if recovery from the recession proves to be weaker and slower than currently expected.

### Long term Public Works Loan Board (PWLB) rate

- 8.7 The 50-year PWLB rate is forecast to rise gradually from 4.60% to eventually reach 5.20% in 2011.
- 8.8 The 5-year PWLB rate is expected to rise from 3.05% to reach 4.55% in 2011.
- 8.9 From the above it can be seen that the yield curve is now positive, with longer-term rates being higher than short-term rates.

## **9. The Borrowing Strategy**

9.1 As detailed in paragraph 7.1 the borrowing requirement for 2010/11 is estimated to be £17.0m. The borrowing requirement takes account of the two main objectives of the Prudential Code, which are:

- a) that capital expenditure plans are affordable, and
- b) that all external borrowing and other long-term liabilities are within prudent and sustainable limits.

9.2 In view of the forecast for interest rates to increase, on the advice of our treasury management advisers, the council has entered into an agreement to borrow £25 million via the money market from February 2010. The loan is for 50 years with the interest rate at 3-month LIBOR (London Inter Bank Offered Rate) for the first two years (capped at 4.25%) and fixed thereafter at 4.17% with a LOBO (Lender's Option, Borrower's Option) at 4 years. At the four year anniversary the lender has the option to ask for repayment, or to change the interest rate. The borrower can decide whether to accept any new terms, or to repay the loan. The advantage of this arrangement is that the council is able to take advantage of low short-term rates at the front end of the loan but has locked in to a low fixed rate before interest rates rise.

## **10. Policy on Borrowing in Advance of Need**

10.1 The £25 million is more than the 2010/11 borrowing requirement but has been borrowed ahead of need to take advantage of current low fixed interest rates. Any surplus cash will be temporarily invested and interest earned should roughly match the 3-month LIBOR being paid at the front end of the loan. The borrowing has not been made in advance of need purely in order to profit from the investment of the extra sums borrowed, but has been made to secure long term value for money.

## **11. Debt Repayment and Rescheduling**

11.1 In November 2007 the PWLB introduced new rules governing the premature repayment of PWLB loans, which have had the result of making rescheduling more expensive, and hence not cost effective. The PWLB introduced different rates for new borrowing as opposed to those for the early repayment of debt. It has set of a spread between the two rates (of about 40 – 50 basis points for the longest period loans narrowing down to 25 – 30 basis points for the shortest loans), with the effect that PWLB to PWLB debt restructuring is now much less attractive. However, significant interest savings could still be achievable through using market LOBOs (Lenders Option Borrowers Option) loans and other market loans. The latter have not generally been available since autumn 2008 but if attractive rates do become available opportunities to save money by debt restructuring will be investigated.

11.2 Consideration will also be given to the potential for making savings by temporarily using investment balances for repaying debt prematurely, as short term rates on investments are likely to be lower than rates paid on currently

held debt. However, this will need careful consideration in the light of premiums that may be incurred by such a course of action. Other financial considerations relate to the fact that Hounslow's investments are all cash-flow derived. We do not have any longer term funds which can be segregated into externally managed portfolios and invested for more than a year.

## **12. Annual Investment Strategy**

12.1 Appendix E details the approach for identifying counterparties deemed sufficiently secure to place our investments. This area has become significantly more important since the Icelandic banking crisis, and the impact of the credit crunch on domestic banks. The monies the Authority has available for investing are primarily cash flow derived, and are only available temporarily pending expenditure. Hence they will usually only be invested up to a maximum period of 364 days. Hence our investment priorities are security and liquidity. This Authority did not have monies invested in Icelandic banks, and will only invest in institutions with the highest security. This policy is under constant review.

12.2 Funds will primarily be invested according to the Secretary of State's definition of specified investments, these being sterling deposits made for periods of less than one year, offering high security and high liquidity. Specified investments include deposits with the UK government, other local authorities, money market funds, and institutions with high credit ratings. A lending list is compiled to include counter parties satisfying the criteria set by the authority. The current lending list is in Appendix E.

## **13. Treasury Limits and Prudential Indicators**

13.1 It is a statutory duty under Section 3 of the Local Government Act 2003 for the council to 'determine and keep under review' how much it can afford to borrow. This is called the "Affordable Borrowing Limit" and is the authorised limit for external debt referred to in the Prudential Code. It is the maximum amount of loan debt that may be outstanding at any point in time, and includes both borrowing for capital purposes and an allowance for any temporary borrowing. The Prudential Code requires the council to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax and rent levels is 'acceptable'. All of the limits are contained in full in the section on the Prudential Code in Appendix F to this report.

## **14. The Minimum Revenue Provision (MRP) Strategy**

14.1 It is a statutory duty to set aside from revenue, for the General Fund only, a Minimum Revenue Provision (MRP) to repay debt. The council is required to approve a specific statement on this, which is Appendix G of this report. The purpose of the Statement is to ensure that provision is prudent, allowing debt to be repaid over a period commensurate with that over which the capital expenditure will provide benefits.

## 15. Money Laundering

- 15.1 The Money Laundering Regulations 2007 came into force in December 2007. The council will continue to monitor its activities to ensure compliance with the regulations.

## 16. Training

- 16.1 In line with best practice, the council operates a programme of treasury management training. There is a strong commitment that all staff dealing with treasury management receive comprehensive training on an ongoing basis. A training log is maintained.

## 17. Policy on the Use of External Service Providers.

- 17.1 The council uses Sector Treasury Services as its external treasury management advisers. The council recognise that responsibility for treasury management decisions remains with the Authority at all times and will ensure that undue reliance is not placed upon the external service providers.
- 17.2 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. A competitive tendering exercise was carried out last year, and as a result of that process Sector Treasury Services were reappointed for a period of three years from 1 July 2009 with the option to extend for a further year.

## 18. Risk

- 18.1 The key risks associated with treasury management issues are:-

**Interest rate risk:** the council's long term borrowing is currently all fixed rate debt and so will not be affected by increases in interest rates. We have forward financed £25m of borrowing as detailed in paragraph 10, and hence will have no additional long term borrowing requirements for 2010/11. The council will benefit from rises in interest rates during 2010/11 as its short-term investments are larger than its short term borrowing requirements;

**Counter party risks:** the Investment Strategy details how we identify counter-parties for investing with. We use only the highest credit rated institutions and set limits for exposure to each organisation;

**Liquidity risk:** this is the risk that cash will not be available when required. This is reduced by the preparation of cash forecasts, and investing bearing in mind future cash requirements. Our investments are all less than 364 days, and there is currently no reason to change this policy.

**Maturity risk:** our long term borrowing is phased over the next 60 years, so in any one year we will not be faced with a significant amount of debt needing to be refinanced.

18.2 Appendix F details the Prudential and Treasury Indicators. These are set at levels to limit risk and are monitored on either a daily, weekly, or monthly basis, as considered appropriate for each specific indicator.

## 19. Financial Implications

19.1 Estimated sums are as follows:-

### External loan debt

	<b>£000</b>
At 31 March 2009 (actual)	239,148
At 31 March 2010 (estimate)	263,480
At 31 March 2011 (estimate)	263,171

### Revenue estimates 2010/11

	<b>£000</b>
General Fund (GF)	
Minimum revenue provision – principal repayment	6,322
Interest for year (net)	4,065
Premium re debt rescheduling	111
Debt management expenses	42
<b>Total GF</b>	<b>10,540</b>
Housing Revenue Account (HRA)	
Interest for year (net)	10,036
Premium re debt rescheduling	451
Debt management expenses	115
<b>Total HRA</b>	<b>10,602</b>

19.2 Provision has been made within the appropriate budgets for these costs.