SOUTH LANARKSHIRE COUNCIL

Report

Agenda Item

5

Report to:	**Finance and Information Technology Resources Committee (Special)**
Date of Meeting:	**11 February 2010**
Report by:	**Executive Director (Finance and Information Technology Resources)**

Subject:	**Treasury Management Strategy 2010/2011**

1. Purpose of Report

1.1. The purpose of the report is to:-

- provide the Treasury Management Strategy for 2010/2011.

2. Recommendation(s)

2.1. The Committee is asked to approve the following recommendation(s):-

(1) that the Treasury Management Strategy for 2010/2011 be endorsed.
(2) that the Treasury Management Strategy for 2010/2011 be referred to the Executive Committee for formal approval.

3. Background

3.1. The Council's treasury activities are regulated by statute, and a professional code of practice (the CIPFA Treasury Management in Public Services Code of Practice). It is a requirement of this Code, and the financial regulations of South Lanarkshire Council, that a Treasury Management Strategy is approved by Committee every year.

3.2. The level of borrowing required to fund the Council's Capital programme, together with the variable nature of interest rates, increases the risks associated with the Treasury Management function. As a result, the Council will take a cautious approach to its Treasury Strategy. The full Treasury Strategy for 2010/2011 is detailed at Appendix 1.

3.3. The Treasury Code requires this Committee to scrutinise and endorse the Strategy, and the report also requires to be referred to the Executive Committee for formal approval.

4. Strategy Highlights

4.1. The main areas covered by the Strategy are:

- debt and investment projections
- expected movement in interest rates
- borrowing and Investment strategies.

4.2. Total external debt is expected to reach £1,246.686m by the end of 2010/2011. Investments of £51.987m are expected.

4.3. External debt includes an estimate of £450m, being the liability that is to be included on the Council's balance sheet for the PPP schools and finance leases under International Financial Reporting Standards. It should be noted that, while these liabilities are to be classed as external debt, there is no requirement to borrow these amounts. There is no impact on borrowing costs and, therefore, no impact on revenue budgets.

4.4. The uncertainty over future interest rates increases the risks associated with treasury activity. As a result, the Council will take a cautious approach to its treasury strategy.

4.5. It is expected that borrowing rates will remain volatile while following an upward trend. It is also expected that short-term rates will remain lower than long-term rates. The Executive Director (Finance and IT Resources), under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time. This may also include repaying debt, borrowing in advance of need and rescheduling existing debt.

4.6. The main consideration when investing surplus funds will be the security of the transaction. The Council must also meet its liquidity requirement and only invest for the period of time that is prudent. Finally, and only after consideration of security and liquidity, the yield that will be gained from the investment will be considered. A Counterparty List will be maintained with each approved counterparty meeting an agreed criteria in terms of financial ratings and other security criteria. During this period of uncertainty in the banking sector, the Executive Director (Finance and IT Resources) will apply appropriate restrictions to the Counterparty List to ensure the security of deposits.

4.7. New investment regulations are expected from the Scottish Government over the coming months. An update to this strategy may be required after these regulations are introduced.

5. Employee Implications

5.1. None

6. Financial Implications

6.1. The financial impact from treasury activity and borrowing for capital expenditure has been built into the long-term revenue budget strategy.

7. Other Implications

7.1. None.

8. Equality Impact Assessment and Consultation Arrangements

8.1. An Equality Impact Assessment on the Treasury Management Strategy was carried out in November 2008.

8.2. The conclusion of the initial Equality Impact Assessment was that there were no adverse impacts on any part of the community covered by equalities legislation, or on community relations. This policy relates to the investment of funds and borrowing of the Council which is undertaken using professional guidance.

8.3. There is no requirement to carry out any consultation in terms of the content of this report.

Linda Hardie
Executive Director (Finance and Information Technology Resources)

4 February 2010

Link(s) to Council Values and Objectives
- Value: Accountable, effective and efficient

Previous References
- Finance and IT Resources Committee 14 February 2008

List of Background Papers
None

Contact for Further Information
If you would like to inspect the background papers or want further information, please contact:-
Jackie Taylor, Corporate Finance Manager
Ext: 5637 (Tel: 01698 455637)
E-mail: jackie.taylor@southlanarkshire.gov.uk

Appendix 1

Treasury Management Strategy 2010/11

1. Foreword

1.1. The treasury management function is an important part of the overall financial management of the Council's affairs. The treasury management function considers the effective funding of capital investment plans, and works toward ensuring that best practice is followed when making decision on managing council deposited funds.

The Council's treasury activities are regulated by the Local Government (Scotland) Acts 1975 and 2003, and a professional code of practice (the CIPFA Code of Practice on Treasury Management – revised November 2009). It is a requirement of this Code, and the financial regulations of South Lanarkshire Council, that a Treasury Management Strategy is approved by Committee every year.

A key requirement of this strategy is to explain both the risks and the management of these risks associated with the treasury function. A further report will be produced after the year end to report on actual activity during the year. It is a new requirement of the revision of the Code of Practice that a mid year monitoring report is produced. This will cover the period 1 April 2010 to 30 September 2010 and will be submitted to Committee after that date.

This strategy covers:

- The Council's debt and investment projections (Section 2);
- The Council's estimates and limits on future debt levels (Section 3)
- The expected movement in interest rates (Section 4);
- The Council's borrowing and investment strategies (Sections 5 and 6);
- Legal and Advisory costs (Section 7);
- Treasury Management Limits on Activity (Section 8)
- Treasury performance indicators (Section 9);
- Scottish Government Investment Regulations (Section 10)

2. Debt and Investment Projections 2010/11 – 2012/13

2.1 The expected levels of external borrowing and investment for 2010/11 to 2012/13 are shown in the table below. An updated position for 2009/10 is also shown.

£m	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
External Debt				
Borrowing	£620.270m	£796.686m	£890.593m	£980.256m
Other long term liabilities	£450.000m	£450.000m	£450.000m	£450.000m
Debt at 31 March	£1,070.270m	£1,246.686m	£1,340.593m	£1,430.256m
Investments				
Total Investments at 31 March	£20.000m	£51.987m	£51.987m	£51.987m

3. Estimates and Limits on Future Debt Levels

3.1 Within the prudential indicators there are a number of key indicators to ensure the Council operates its activities within well defined limits

3.2 For the first of these the Council needs to ensure that its total borrowing net of any investments, does not, except in the short term, exceed the total of the Capital Financing requirement (CFR) in the preceding year plus the estimates of any additional CFR for 2010/11 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

3.3 The projected Capital Financing Requirement and Net Debt is shown in the table below

	2009/10 Estimate £ m	2010/11 Estimate £ m	2011/12 Estimate £ m	2012/13 Estimate £ m
General Fund Capital Financing Requirement	990.532	1,082.146	1,155.389	1,220.719
HRA Capital Financing Requirement	151.281	175.069	195.733	220.066
Total Capital Financing Requirement	1,141.813	1,257.215	1,351.122	1,440.785
Net Debt	1,050.270	1,194.699	1,288.606	1,378.269

It can be seen that the estimated net debt levels for the period 2009/10 to 2012/13 are well within the forecasted CFR at the end of 2012/13, demonstrating that borrowing will only be undertaken for capital purposes.

3.4 Further limits are placed on gross debt levels through the Operational Boundary and Authorised Limit. The operational boundary is based on the expected maximum external debt that could be faced in the course of the year. It is set to accommodate the borrowing requirements as detailed at Indicator 1, and also includes sufficient scope to allow for changes to the capital programme throughout the year. This limit may be breached during the year, and this will be reported in the Prudential report presented to Committee after year end.

3.5 The Authorised Limit for External Debt represents a control on the overall level of borrowing. This represents a limit beyond which external debt is prohibited. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

3.6 The operational and authorised limits for the period 2009/10 to 2012/13 are shown in the table below:

	2009/10 Estimate £ m	2010/11 Estimate £ m	2011/12 Estimate £ m	2012/13 Estimate £ m
Operational Limit for external debt	1,100.000	1,270.000	1,370.000	1,460.000
Authorised Limit for external debt	1,120.000	1,290.000	1,390.000	1,480.000

4. Expected Movement in Interest Rates

4.1 The interest rate forecast provided by the Council's treasury advisor, Arlingclose Ltd is reproduced below: Financial markets remain reasonably volatile as the structural changes necessary within economies and the banking system evolve. This volatility produces opportunities for active treasury management. The Council will reappraise its strategy from time to time and if needs be, realign it with evolving market conditions and expectations for future interest rates.

Medium term Interest rates - Annual Averages

	Bank Rate %	5 year PWLB	20 year PWLB	50 year PWLB
2010/11	0.625	3.00	4.71	4.59
2011/12	2.25	3.78	5.15	4.90
2012/13	3	4.40	5.15	5.03

4.2 The Bank of England is expected to maintain the base rate at historically low levels to enable the economy to emerge from recession.

4.3 Gilt yields are expected to show volatility around a steadily increasing path. Gilt yields on shorter dated gilts are expected to remain lower than long dated gilts as they benefit more from the expectation of low interest rates in money markets.

4.4 PWLB variable rates have fallen below 1%. They are expected to remain low as the Bank Rate is maintained at historically low levels.

4.5 The differential between investment earnings and debt costs, despite long term borrowing rates being around historically low levels remains high and is expected to continue in 2010/11. This "cost of carrying" associated with long term borrowing compared to temporary investment returns means that any appetite for long term borrowing brings with it additional short term costs.

5. Borrowing Strategy

5.1 The Council's strategy is to maintain maximum control over its borrowing activities as well as flexibility on its loans portfolio. Capital expenditure levels, market conditions and interest rate levels will be monitored during the year in order to minimise borrowing costs over the medium to longer term. A prudent and pragmatic approach to borrowing will be maintained to minimise borrowing costs without compromising the longer-term stability of the portfolio, consistent with the Council's Prudential Indicators.

5.2 In conjunction with advice from its treasury advisor, Arlingclose Ltd, the Council will keep under review the options it has in borrowing from the PWLB, the market and other sources up to the available capacity within its CFR and Authorised Limit.

5.3 Taking account of the "cost of carrying" and to avoid high levels of investment the use of internal resources in lieu of borrowing has been a cost effective means of financing capital expenditure which the council has adopted, however there will come a point when internal resources will be exhausted and borrowing will be required.

5.4 Against a backdrop of interest rates remaining lower for longer and a continuation of the cost of carry backdrop, then a passive borrowing strategy i.e. borrow long term funds as they are required may remain appropriate. Equally, variable rate funds (that avoid the cost of carry) or EIP (equal instalments of principal) that mitigate the impact are both active considerations.

5.5 Any decision to borrow at low, variable rates of interest would only be taken after considering the absolute level of longer term interest rates and the extent of variable rate earnings on the Council's investment balances. When longer term rates move below the cost of variable rate borrowing any exposure to variable interest rates will be reviewed and, if appropriate, reduced.

5.6 The Council will continue to maintain a flexible policy for debt rescheduling. Market volatility may provide opportunities for rescheduling debt from time to time. The rationale for rescheduling would be one or more of the following:

- Savings in interest costs with minimal risk
- Balancing the volatility profile (i.e. the ratio of fixed to variable rate debt) of the debt portfolio
- Amending the profile of maturing debt to reduce any inherent refinancing risks.

5.7 In September 2009, the PWLB issued a Consultation document, entitled 'PWLB Fixed Rates', where the PWLB is reviewing the frequency of rate setting (currently daily) and could move to a live pricing basis. The deadline for the consultation period was 8 January 2010. The likely outcome of this is a reduction in the extent of the margins between premature repayment and new borrowing rates, particularly for longer maturities. This should make rescheduling opportunities less costly.

5.8 To manage potential rescheduling activity the Council's debt portfolio will be monitored against equivalent interest rates and available refinancing options on a regular basis. As opportunities arise, they will be identified by Arlingclose and discussed with the Council's officers.

5.9 All rescheduling will comply with the accounting requirements of the Local Authority SORP and Statutory requirements of the Scottish Government's Guidance on Local Authority Accounting Proper Accounting Practices dated 30 March 2007.

5.10 The overall strategy for borrowing will be to monitor interest rates, undertake planned borrowing at the best time, whilst investigating opportunities where possible to improve the management of our existing loan portfolio.

5.11 The expected borrowing requirement is shown below :-

	2009/10 Revised	**2010/11 Estimated**	**2011/12 Estimated**	**2012/13 Estimated**
Movement in CFR	£91.284m	£115.402m	£93.907m	£89.663m
Maturing Debt	£11.803m	£13.270m	£17.755m	£10.478m
Total borrowing need	£103.087m	£128.672m	£111.662m	£100.141m

6. Investment Strategy

6.1 The main consideration when investing surplus funds will be the security of the transaction. The Council must also meet its liquidity requirement and only invest for the period of time that is prudent. Finally, and only after consideration of security and liquidity, the yield that will be gained from the investment will be considered.

6.2 The Council's existing investment criteria was reported to Finance and IT Resources Committee on 3 May 2005 in the report entitled 'Criteria for Investment of Temporary Surplus Funds'.

6.3 In addition to the above report a supplementary report was approved which extended the Counterparty policy to include the Debt Management Office (DMO) Deposit facility provided by HM Treasury. This action was taken to ensure security for our surplus funds through a volatile period for banks.

6.4 The CIPFA Treasury Management Code of Practice adopted by the Council introduced a new section on Managing Treasury Management Risks, placing Credit and Counterparty risk at the forefront of treasury risks. The Code states:

Credit ratings should only be used as a starting point when considering credit risk. Organisations should make use of generally available market information, such as the quality financial press, market data, information on government /support for banks and the credit ratings of that government support.

6.5 In managing credit and counterparty risk the Council will be required to:

- Establish a sound diversification policy with high credit quality counterparties
- Set clear minimum credit limits for counterparties.
- Have regard to the credit ratings issued by all three rating agencies and make decisions based on the lowest rating
- Consider country, sector and group limits
- Regularly review credit ratings and act upon forward looking rating warnings

6.6 South Lanarkshire Council currently meet all the requirements detailed in 6.5 above, either formally through the counterparty policy approved by Finance and IT Resources Committee on 3 May 2005, or through restrictions to this policy introduced by the Executive Director, Finance and IT Resources during the exceptional market circumstances experienced recently.

6.7 The following minimum thresholds will be applied to term deposits of up to one year with banks and building societies in order to formally meet the new requirement to have regard to the credit ratings issued by all three rating agencies and make decisions based on the lowest rating.

Rating Agency	Long Term Rating	Short Term Rating	Maximum Deposit
Fitch	A+	F1	£10m
Moody's	A1	P-1	£10m
Standard and Poors	A+	A-1	£10m

6.8 In addition to the primary ratings detailed above, consideration will also be given to the secondary ratings provided by Fitch. As a minimum an organisation will require to have an individual rating of B or a support rating of 2.

6.9 The revised Code states that credit ratings should be used only as a starting point when considering credit risk. Prior to placing deposits with any bank or building society additional indicators of creditworthiness (such as credit default swaps, GDP; net debt as a percentage of GDP, potential sovereign and parental support, share price) will also be considered.

6.10 Banks on negative rating watch will be heavily scrutinised before any deposit is placed in that institution.

6.11 Currently, in response to the banking crisis, all our deposits are held in UK institutions. Foreign banks would only be considered if they meet our strict criteria, and are recommended by our Advisors. Any one foreign country would carry a limit of £10m deposits.

6.12 In the event that two or more organisations in the same group meet the criteria detailed in 6.7 then a group limit of £10m will be applied.

6.13 Deposits with UK local authorities, joint boards and passenger transport executives will also be permitted subject to a maximum period of 364 days and a maximum deposit size of £15m.

6.14 The use of the Debt Management Office (DMO) Deposit facility provided by HM Treasury will be continued. This facility offers the highest security for investments and deposits will be subject to a maximum period of 364 days and a maximum deposit size of £80m.

6.15 There is operational difficulty for managing investments during the current period of unrest in the banking sector. Ideally investments would be invested longer to secure better returns, however, uncertainty over counterparty creditworthiness suggests shorter dated investments would provide better security. The Executive Director, Finance and IT Resources will restrict the term of deposits as appropriate.

6.16 The existing Counterparty policy sets out a sound approach to investment in normal market circumstances. Whilst this policy still stands, under exceptional current market circumstances the Executive Director, Finance and IT Resources will temporarily restrict investment to those counterparties considered of higher credit quality than the minimum criteria set out in the policy. These restrictions will remain in place until the banking system returns to more normal conditions.

6.17 Examples of these restrictions would be greater use of strongly rated institutions offered support by the UK Government through the Credit Guarantee Scheme. The DMO account will also be used whenever appropriate.

7. Legal and Advisory Costs

7.1 We will continue all efforts to secure the return of funds currently invested in Icelandic banks and their subsidiaries. In pursuing this to our full ability certain financial advisory and legal costs may be incurred.

8. Treasury Management Limits on Activity

8.1 The revision to the Treasury Management Code has resulted in four prudential indicators now becoming treasury management indicators which are to be reported within the Treasury Strategy.

8.2 The purpose of these is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to reduce costs/improve performance. The indicators are detailed below

8.3 Setting an upper limit on fixed and variable rate exposure identifies a limit for exposure to fixed and variable rates of interest. The purpose of this indicator is to provide a measure of stability against the adverse effects of market fluctuations. The levels will allow us to undertake variable / fixed or EIP borrowing to take full advantage of current interest rates.

	2009/10 Estimate £ m	2010/11 Estimate £ m	2011/12 Estimate £ m	2012/13 Estimate £ m
Upper limit of fixed rate exposures	180%	180%	180%	180%
Upper limit of variable rate exposures	30%	30%	30%	30%

8.4 The actual fixed rate exposure will be assessed by comparing the amount of Net Debt (which is borrowing less investments) we hold at a fixed rate to the Total Net Debt (both fixed and variable) of the Council. The same will be calculated for variable rate exposure.

An illustration of this calculation is shown below :-

	£m		£m
Total Debt	535.3		
Total Investments	(103.7)		
Total Net Debt	**431.6**		
Fixed Net Debt		**Variable Net Debt**	
Fixed Debt	526.4	Variable Debt	8.9
Fixed Investments	(0)	Variable Investments	(103.7)
Fixed Net Debt	**526.4**	**Variable Net Debt**	**(94.8)**
Exposure	**122%**	**Exposure**	**(22%)**
(Fixed Net Debt / Total Net debt)		(Variable Net Debt / Total Net debt)	

8.5 By setting limits on the maturity structure of fixed rate borrowing the exposure to large concentrations of fixed rate debt needing to be replaced at the same time in the future at currently unknown rates can be limited. This effectively places a limit on exposure to longer term interest rate movement.

Maturity Structure of Fixed Rate Borrowings		
	Upper Limit	**Lower Limit**
Under 12 months	10%	0%
12 months and 24 months	20%	0%
24 months and 5 years	50%	0%
5 years and 10 years	50%	0%
10 years and 20 years	60%	0%
20 years and 30 years	70%	0%
30 years and 40 years	80%	0%

40 years and 50 years	90%	0%
50 years and above	90%	0%

8.6 Limits on the total principle sums invested for greater than 364 days protects against potential loss that we would suffer if we required to get our money back earlier than the full term of the investment. As we currently have no statutory powers to invest for periods longer than 364 days, this indicator shows a nil value.

9. Performance Indicators

9.1 The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. Examples of performance indicators often used for the treasury function are:

- Debt – Borrowing - Average rate of borrowing for the year compared to average available
- Investments – Internal returns above the 7 day LIBID rate

The results of these indicators will be reported in the Treasury Annual Report for 2009/10.

10. Scottish Government Investment Regulations

10.1 The Scottish Government is expected to issue Investment Regulations shortly.

10.2 The anticipated changes to the investment regime contained within the Regulations should provide greater autonomy for Councils in their investment activities. On issue of the Investment Regulations a revision to this strategy may be required. If required an updated strategy will be presented to committee for approval.