Agenda Item

Report

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Report to:	**Finance and Information Technology Resources Committee (Special)**
Date of Meeting:	**10 February 2011**
Report by:	**Chief Executive**

Subject:	**Treasury Management Strategy 2011/2012**

1. Purpose of Report

1.1. The purpose of the report is to:-

- ♦ Provide members with a Treasury Management Strategy for 2011/12.

2. Recommendation(s)

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

(1) that the 2011/12 Treasury Management Strategy is endorsed
(2) that the report 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 2011/12 is detailed at Appendix 1

3.3. The Treasury Code requires this committee to scrutinise the treasury management strategy, and that it should 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 £1,066.992m by the end of 20010/11. Investments of £93.232m are expected.

4.3. External debt includes the liability of £269.640m that is 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 borrowing 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 expected that short term rates will remain lower than long term rates. The Chief Executive, 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.

4.7. A counterparty list will be maintained with each approved counterparty meeting an agreed criteria in terms of financial ratings and other security criteria. The Chief Executive will continue to apply appropriate restrictions to the counterparty list to ensure the security of our deposits.

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. South Lanarkshire Council recognises that any treasury management activity will carry an element of risk. It is important that risk is identified and controls put in place to limit those risks.

7.2. The preparation and approval of a Treasury Management Strategy sets a framework for treasury management activities and limits on debt and investments in order to mitigate risks.

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 is that there are 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

Archibald Strang
Chief Executive

4 February 2011

Link(s) to Council Values/Improvement Themes/Objectives
- Accountable, efficient and effective

Previous References
- Finance and IT Resources Committee 11 February 2010

List of Background Papers
None

Contact for Further Information
If you would like to inspect the background papers or want further information, please contact:-

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Treasury Management Strategy 2011/12

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 2011 to 30 September 2011 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);

2. Debt and Investment Projections 2011/12 – 2013/14

2.1 The expected levels of external borrowing and investment for 2011/12 to 2013/14 are shown in the table below. An updated position for 2010/11 is also shown.

£m	2010/11 Revised	2011/12 Estimated	2012/13 Estimated	2013/14 Estimated
External Debt				
Borrowing	£797.352m	£893.250m	£1,004.361m	£1,093.300m
Other long term liabilities	£269.640m	£269.640m	£269.640m	£269.640m
Debt at 31 March	£1,066.992m	£1,162.890m	£1,274.001m	£1,362.940m
Investments				
Total Investments at 31 March	£93.232m	£74.546m	£73.794m	£73.567m

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 The Council's Capital Financial Requirement (CFR) is the total outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying need to borrow for past and present capital expenditure.

3.3. 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 2011/12 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.

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

	2010/11 Estimate £ m	2011/12 Estimate £ m	2012/13 Estimate £ m	2013/14 Estimate £ m
General Fund Capital Financing Requirement	907.753	984.428	1,077.341	1,158.379
HRA Capital Financing Requirement	169.769	188.992	207.190	215.091
Total Capital Financing Requirement	1,077.552	1,173.420	1,284.531	1,373.470
Net Debt	973.760	1,088.344	1,200.207	1,289.373

It can be seen that the estimated net debt levels for the period 2010/11 to 2013/14 are well within the forecasted CFR at the end of 2013/14, 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 without consideration to revenue budgets.

3.6 The operational and authorised limits for the period 2010/11 to 2013/14 are shown in the table below:

	2010/11 Estimate £ m	2011/12 Estimate £ m	2012/13 Estimate £ m	2013/14 Estimate £ m
Operational Limit for external debt	1,090.000	1,190.000	1,300.000	1,390.000
Authorised Limit for external debt	1,110.000	1,210.000	1,320.000	1,410.000

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

	Base Interest Rate	5 year PWLB	20 year PWLB	50 year PWLB
2011/12	0.8750%	4.3750%	5.9375%	5.6875%
2012/13	2.1875%	5.0000%	6.0000%	5.5625%
2013/14	2.9375%	5.1250%	6.1250%	5.6250%

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 PWLB (Public Works Loans Board) fixed rates are influenced by the return, or yield, on UK Gilts. Shorter dated gilt yields are expected to remain lower than long dated gilt yields as they benefit more from the expectation in money markets of low interest rates. This means that borrowing for shorter periods will attract lower interest rates.

4.4 PWLB variable rates 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 remains high and is expected to continue in 2011/12. 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 Due to the high differential between investment earnings and debt costs that is expected to continue in 2011/12, it is expected that borrowing will only be taken as and when required. Equally, variable rate funds (that avoid the cost of carry) or EIP (equal instalments of principal) that mitigate the impact are both active considerations.

5.4 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.

5.5 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.

5.6 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.

5.7 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.

5.8 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.

5.9 The expected borrowing requirement is shown below :-

	2010/11 Revised	2011/12 Estimated	2012/13 Estimated	2013/14 Estimated
Movement in CFR	100.534	95.898	111.111	88.939
Maturing Debt	48.055	30.573	29.620	36.717
Total borrowing need	148.589	126.471	140.731	125.656

6. Investment Strategy

6.1. The Local Government Investments (Scotland) Regulations 2010 require that an Annual Investment Strategy is prepared prior to the start of the financial year.

6.2. A separate report on the Annual Investment Strategy 2011/12 is being made to this Committee.

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.

	2010/11 Estimate £ m	2011/12 Estimate £ m	2012/13 Estimate £ m	2013/14 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	797.3		
Total Investments	(93.2)		
Total Net Debt	**704.1**		
Fixed Net Debt		**Variable Net Debt**	
Fixed Debt	788.5	Variable Debt	8.9
Fixed Investments	(0)	Variable Investments	(93.2)
Fixed Net Debt	**788.5**	**Variable Net Debt**	**(84.3)**
Exposure	**112%**	**Exposure**	**(12%)**
(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 principal 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.

8.7. This Council will, at any one time, have no more than £10m invested for periods greater than 364 days, subject to a maximum period of 5 years.

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 2010/11.