

## MANCHESTER CITY COUNCIL

**COMMITTEE:** RESOURCES AND GOVERNANCE  
OVERVIEW AND SCRUTINY COMMITTEE

**DATE:** 18 JUNE 2009

**SUBJECT:** TREASURY MANAGEMENT

**REPORT OF:** CITY TREASURER

### **PURPOSE OF REPORT:**

Following the well publicised problems of some local authorities with regard to the security of their short/medium term treasury investments, the Chair of the Committee requested a report on the City Council's Treasury Management activities.

### **RECOMMENDATION:**

That the Committee note the report and request the Audit Committee to give periodic consideration to the Council's Treasury activity with a view to ensuring prudent management of the Council's funds.

### **FINANCIAL CONSEQUENCES FOR THE REVENUE AND CAPITAL BUDGETS**

Management of the Council's short term Treasury activities and longer term borrowing strategy are an integral part of the Council's revenue and capital budgets. Interest earned or paid on lending/borrowing activities directly impact on the revenue budget. Any funds lost due to institutions who have been lent monies being unable to repay would be a direct call on the Council's revenue resources and lead to an unplanned reduction in General Reserves.

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### **BACKGROUND DOCUMENTS**

Treasury Management reports to Executive  
"Risk and Return" – Audit Commission report, March 2009

## 1. BACKGROUND

- 1.1 Following well publicised problems faced by some local authorities with regard to investments in Icelandic Banks, the Audit Commission published a 'cross-cutting' report during March which identified a number of issues which needed to be considered by Councils in order to ensure that their funds were prudently managed.
- 1.2 A key part of the Commission's conclusions was that Councils should ensure that their treasury management activities are properly resourced, managed and scrutinised. Whilst none of this will prevent commercial banks from collapsing in the future, the chances of local authorities suffering a loss will be reduced if proper arrangements are in place.
- 1.3 As already reported to the Audit Committee, the City Council had no exposure to Icelandic Banks, having identified some six months before their collapse that there were warnings of impending difficulties. At this time the City Treasurer decided it would be prudent to withdraw any investments from non-UK institutions.

## 2. INTRODUCTION

2.1 The key activities of the Treasury Management Function are to:

- Identify the Council's requirement to borrow money to meet its long term spending needs to support its capital programme
- To invest any surplus monies held (e.g. reserves)
- To identify the Council's day to day cash flow position and either borrow to meet any shortfall in cash or invest any daily balance of surplus cash held

2.2 When carrying out above functions, the service follows the recommendations contained in the CIPFA Code of Practice on Treasury Management, this is recognised as "...a code of practice made or approved by or under any enactment", and hence considered proper practice under the Local Government and Finance Act 1989. The guide defines Treasury Management Activities as:

*"The management of the organisation's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with these activities; and pursuit of optimum performance consistent with those risks."*

2.3 The key risks in Treasury Management are:

- Liquidity risk – does the Council have access to the cash it needs when it needs it
- Interest rate risk – has the Council protected itself as much as it can from sudden changes in interest rates
- Credit risk – the longer the time period that money is invested, the higher the risk that the money may not, for some reason be returned

- Counterparty risk – this is the risk that the organisation to which you lend the money (the counterparty) may hit difficulty and be unable to repay the deposit (e.g. the situation last year with the Icelandic Banks)
- 2.4 In reality, these risks often work against each other, for example money invested for a longer period will often attract a higher interest rate but the longer an investment is made the more chance there is that the chosen counterparty could hit financial problems and not be able to repay. Similarly often less financially secure counterparties will offer higher interest rates to attract investors than more stable counterparties. Generally speaking there is always a trade off between risk and return on investments and it is the role of the Treasury Management Function to balance all this risks to ensure that costs are minimised / income maximised without endangering the security of the council's money.
- 2.5 The Treasury Management function also has to have regard to the Local Government Act 2003 and supporting regulations which require the Council to 'have regard to' the Prudential Code for Capital Finance in Local Authorities and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.
- 2.6 The Act requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy which sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.
- 2.7 The proposed strategy for 2009/10 was reported to Executive on 11 February 2009 as part of the Budget report.
- 2.8 A glossary of common terminology used in the area of Treasury management is attached in Appendix C.

### **3. THE PRUDENTIAL CODE**

- 3.1 The Prudential Code is part of a new Prudential Borrowing Regime introduced in the Local Government Act 2003 and applied to Local Authorities from the financial year 2003/4. It sets out a framework for self-regulation of capital spending, in effect allowing councils to invest in capital projects without any limit, as long as they are "affordable, prudent and sustainable". Councils are allowed to determine the appropriate level of capital investment to properly deliver quality, public services, subject to affordability.
- 3.2 In order to ensure the level of borrowing proposed by a council was "affordable, prudent and sustainable" the new regime required authorities to produce a range of indicators (the Prudential Indicators). These are seen as facilitating the decision making process and supporting capital investment decisions, the Prudential Code requires the Council to agree and monitor a range of prudential indicators, some of which are separated for HRA and non-HRA capital investment. These indicators are mandatory and many cover

three years forward. The indicators cover affordability, prudence, capital expenditure and treasury management. These indicators also form the basis of in-year monitoring and reporting.

3.3 The Prudential Indicators covering the current year (2009/10) and the next two years where required, were agreed by Council as part of the Revenue and Capital budget setting process on 4 March, 2009 and are shown for information in Appendix A.

3.4 The PIs cover three main areas:

- Proposed overall capital programme and the borrowing requirement that flows from this - numbers 3 and 4 on Appendix A
- The affordability of proposed spend – numbers 1 and 2 on Appendix A
- Treasury Management Indicators – 5 to 12 on Appendix A

#### **Treasury Management PIs in more detail:**

3.5 The purpose of the Treasury Management PIs is to agree the overall parameters within which the activity of the treasury function can operate on a day to day basis. The limits are set to achieve the overall Treasury Management Strategy agreed by Council by identifying certain limits designed to manage the risks associated with the management of the council's cash as described in the introduction above in paragraph 2.3. These PIs are made up of:

3.6 **Operational Boundary and Authorised Limit** - The Authorised Limit is the absolute limit that the Council has agreed can be borrowed. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable. It is the expected maximum borrowing need, with some headroom for unexpected movements. Any early indications that we are about to breach the Authorised Limit should prompt a report to Executive. The Operational Boundary is based on the probable external debt during the course of the year; it is not a limit and actual borrowing could vary around this boundary for short times (temporary borrowing) during the year. It should act as an early warning indicator to ensure the Authorised Limit is not breached.

3.7 **Authority has adopted CIPFA's Code of Practice for Treasury Management in the Public Services** - This simply seeks assurance that the Council is working to the established code of practice.

3.8 **Upper Limits on Fixed and Variable Interest Rate Exposures** - These indicators have been set as upper limits to the Council's exposures to the effects of changes in interest rates. They provide a range within which the Council is able to manage its fixed and variable rate debt and investments. It is up to each authority to determine the limits it wants to set on different types of borrowing to reflect its own approach to managing its level of exposure to interest rate risks.

- 3.9 ***Upper and Lower Limits in respect of the Maturity Structure of Fixed Rate Borrowing*** - These indicators have been set to enable an authority to manage the volatility in its fixed rate debt portfolio, and avoid large concentrations of fixed rate debt maturing and having to be replaced at the same time. In accordance with best practice, to give more relevance and meaning to estimates and actuals, the maturity dates of Lender Option Borrower Option (LOBO) loans have been set as the next lender option call dates, rather than the actual maturity dates, which can be 40 to 70 years in the future. Upper and Lower Limits PIs in respect of the Maturity Structure of Fixed Rate Borrowing are only required for one year.
- 3.10 ***Upper Limits for Principal Sums Invested for over 364 days*** - The purpose of this PI is for a local authority to contain its exposure to the possibility of loss that might arise as a result of its having to seek early repayment or redemption of principal sums invested or its long term exposure to potential problems within the financial sector the risk of which increases the longer any money is invested (Credit Risk). The Council at present has no investments in excess of 364 days.

#### 4. **MANCHESTER'S APPROACH TO TREASURY MANAGEMENT**

- 4.1 The City Council has a dedicated Treasury Management Team which forms part of the Corporate Strategic Financial Planning team, developing and monitoring the Council's Medium Term Financial Strategy. It is physically located close to the City Treasurer and there is a regular dialogue between the Treasurer and Treasury staff. All major decisions with regard to long term borrowings are taken after consultation with the City Treasurer and having regard to the long term financial interest of the Council – rather than potentially being geared to achieving short term savings.
- 4.2 Day to day short term borrowing/investment decisions are taken by the Treasury Team within the parameters agreed within the Treasury Strategy and, with daily reports to the Treasurer on activity over the coming few days, allowing time for discussion as to the appropriateness, or not, of possible courses of action.
- 4.3 The Council's Treasury approach over the last few years has been designed to
- Achieve long/short term revenue savings
  - Reduce the amount of long term debt; either as a result of Housing Stock Transfers, or using surplus cash to repay long term debt.
  - Utilise surplus funds generated through normal activities to replace the need for longer-term external borrowings e.g. school balances, Council reserves.
  - Avoid over complicated financial products which, under certain external circumstances, might give rise to unintended financial consequences for the Council.

- 4.4 This approach has seen the Council's gross debt reduce from £1,019m at 31 March 1999 to just £588.6m as at 31 March 2009. Also over this period, the Council has moved away from borrowing just from the Public Works Loan Board (PWLB) to borrowing more in the open market (market loans as at 31/3/1999 were £268m). This has led to some significant savings in the cost of the Council's borrowing over the last few years which have been able to flow back into front line services.
- 4.5 The final Large Scale Voluntary transfers that took place in 2008/9 have seen debt reduce to its lowest level for many years, in particular debt with the PWLB, which at 31 March 2009 was just £6.2m. The changes in the Council's debt portfolio over the last twelve months is shown in the table below:

	31 March 2008		31 March 2009	
	Principal £m	Average Rate %	Principal £m	Average Rate %
Loan Type:				
PWLB	202.0	8.89	6.2	8.87
Temporary	15.5	5.48	1.7	0.43
Market Loans	559.6	4.85	549.6	4.89
Stock	8.3	3.36	8.2	3.36
Special (ITA)	0.4	5.13	22.9	0.50
<b>Gross Total</b>	<b>785.8</b>	<b>5.89</b>	<b>588.6</b>	<b>4.73</b>
Temporary Deposits	-25.1	5.67	-6.2	0.45
<b>Net Total</b>	<b>760.7</b>	<b>5.89</b>	<b>582.4</b>	<b>4.77</b>

- 4.6 Whilst the LSVTs have seen the council's debt reduce as the Government have cancelled PWLB loans associated with the stock transferred, the current policy of minimising borrowing by utilising cash available to fund spend has had an impact on the Council's cash position. Over the last twelve months, the average monthly surplus / deficit in the Council's cash flow has reduced from a high in May 2008 of over £60m surplus to a net deficit in March 2009 of around £15m (see chart attached as Appendix B). This points to the possible need in the near future to consider further borrowing to support the cost of the Capital Programme as the Council's other cash backed reserves have in effect been fully utilised to support spend. This has helped to minimise the level of cash that the Council has to invest in the open market thereby reducing the risk of loss that the Council may otherwise face. The trade off in this equation is that temporary borrowing can be achieved at a rate of circa 0.5% whilst long term borrowing would currently cost more than 4.5%. Any long term borrowing which led to cash being available to invest would potentially increase counter party risk and "cost" the council between 3% and 4% per year on the money invested.

4.7 Given this scenario it is unlikely that any large scale long term borrowing will be undertaken in the near future unless long term interest rates fall to levels that become attractive against historical norms.

## 5.0 **MONITORING OF TREASURY MANAGEMENT ACTIVITY**

5.1 Monitoring of Treasury Management Activity is carried out at a number of levels

- The reporting of daily information on activity to the Treasurer and Head of Financial Management
- The reporting of monthly performance information to the Head of Finance
- Monitoring information on TM Prudential Indicators to Executive bi-monthly as part of the global revenue monitoring report

5.2 The Treasurer is considering options for more formal monitoring of Treasury Management performance and activity to members. This would be in the form of a periodic report (perhaps quarterly) to the Audit Committee that would encompass all the current monitoring activity plus current information on the Council's debt portfolio and cash flow activity.

**APPENDIX A**

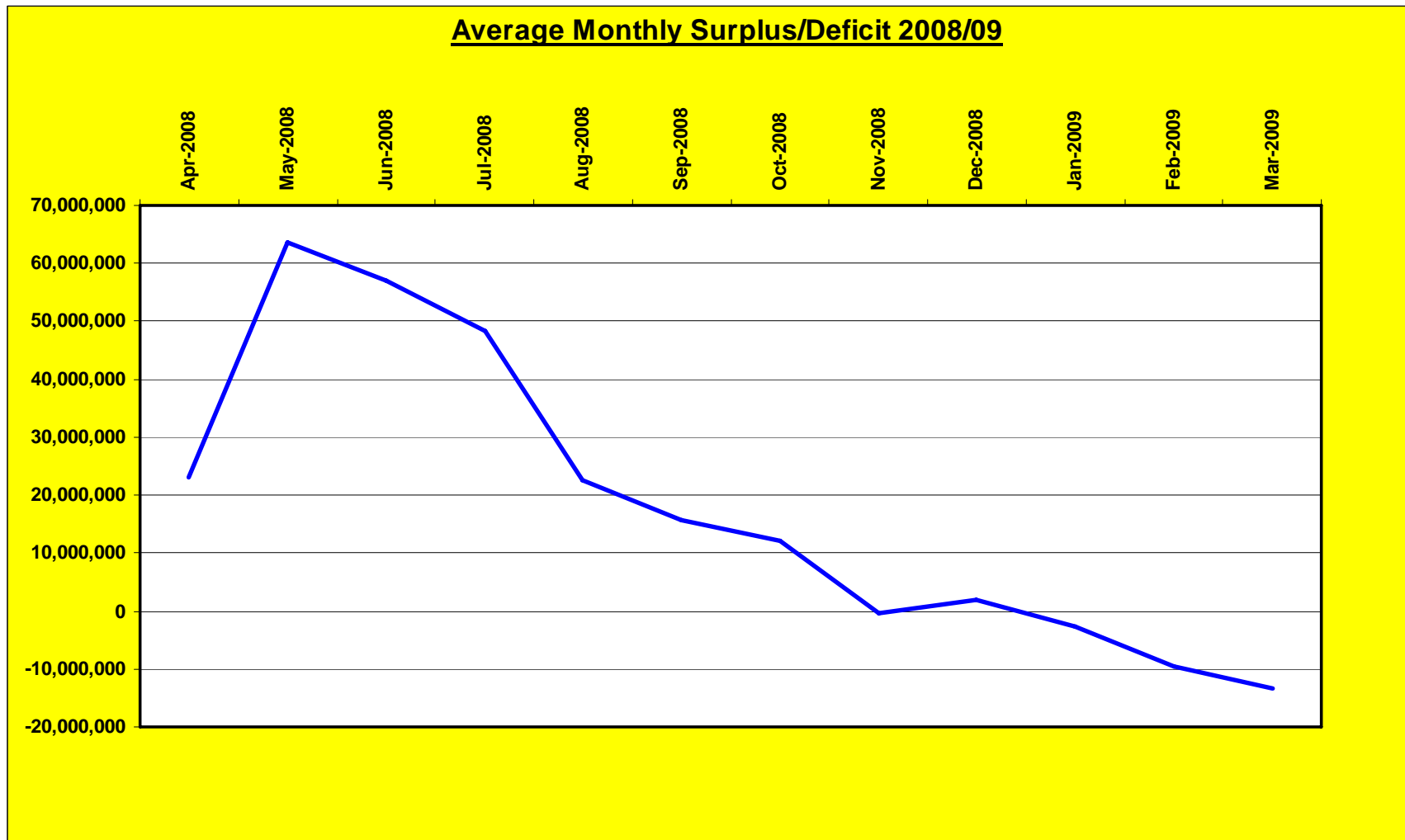
**PRUDENTIAL INDICATORS APPROVED BY COUNCIL ON 4 MARCH 2009**

**Note:** figures agreed last year shown in brackets

No.	PRUDENTIAL INDICATOR	2009/10	2010/11	2011/12
1	<b>Ratio of Financing Costs to Net Revenue Stream</b>			
	Non – HRA	9% (11%)	9% (11%)	9%
	HRA	21% (13%)	20% (12%)	21%
2	<b>Incremental impact of Capital Investments on :-</b>			
	Council Tax (Band D, per annum)	£6.00p	£28.51p	£64.34p
	Housing Rent per week (See note A below)	£0.00p	£0.00p	£0.39p
3	<b>Capital Expenditure</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
	Non - HRA	364 (301)	305 (274)	149
	HRA	37 (38)	28 (28)	15
	TOTAL (see note B below)	401 (339)	333 (302)	164
4	<b>Capital Financing Requirements (as at 31 March)</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
	Non - HRA	600 (600)	650 (650)	700
	HRA	400 (400)	450 (450)	450
	TOTAL	1,000 (1,000)	1,100 (1,100)	1,150
5	<b>Authorised Limits for External Debt -</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
	Borrowing	1,167 (1,304)	1,167 (1,304)	1,167
	Other Long Term Liabilities	0 0	0 0	0
	TOTAL (See note C below)	1,167 (1,304)	1,167 (1,304)	1,167
6	<b>Operational Boundaries for External Debt -</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
	Borrowing	1,028 (996)	1,060 (1,053)	1,108
	Other Long Term Liabilities	0 0	0 0	0
	TOTAL (see note C below)	1,028 (996)	1,060 (1,053)	1,108
7	<b>Authority has adopted CIPFA's Code of Practice for Treasury Management in the Public Services</b>		Yes (Yes)	
8	<b>Upper Limits on Fixed Interest Rate Exposures</b>			
	Net Borrowing at Fixed Rates as a percentage of Total Net Borrowing	73% (87%)	79% (93%)	80%
9	<b>Upper Limits on Variable Interest Rate Exposures</b>			
	Net Borrowing at Variable Rates as a percentage of Total Net Borrowing	71% (92%)	89% (94%)	93%

10	<b>Maturity Structure of borrowing (2009/10 only)</b>	Lower Limit	Upper Limit	
	under 12 months	0% (0%)	50% (50%)	
	12 months and within 24 months	0% (10%)	60% (60%)	
	24 months and within 5 years	20% (10%)	70% (60%)	
	5 years and within 10 years	0% (0%)	60% (60%)	
	10 years and above	10% (10%)	60% (60%)	
12	<b>Upper Limits for Principal Sums Invested for over 364 days</b>	£ 0 (0)	£ 0 (0)	£ 0

**APPENDIX B**



## APPENDIX C

### Glossary of Terms

**Authorised Limit** - This Prudential Indicator represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable. It is the expected maximum borrowing need, with some headroom for unexpected movements.

**Bank Rate** – the rate at which the Bank of England offers loans to the wholesale banks, thereby controlling general interest rates in the economy.

**Counterparty** – one of the opposing parties involved in a borrowing or investment transaction

**Credit Rating** – A qualified assessment and formal evaluation of an institution's (bank or building society) credit history and capability of repaying obligations. It measures the probability of the borrower defaulting on its financial obligations, and its ability to repay these fully and on time.

**Discount** – Where the prevailing interest rate is higher than the fixed rate of a long-term loan, which is being repaid early, the lender can refund the borrower a discount, the calculation being based on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender is able to offer the discount, as their investment will now earn more than when the original loan was taken out.

**Fixed Rate Funding** - A fixed rate of interest throughout the time of the loan. The rate is fixed at the start of the loan and therefore does not affect the volatility of the portfolio, until the debt matures and requires replacing at the interest rates relevant at that time.

**Gilts** - The loan instruments by which the Government borrows. Interest rates will reflect the level of demand shown by investors when the Government auctions Gilts.

**High/Low Coupon** – High/Low interest rate

**Liquidity** – The ability of an asset to be converted into cash quickly and without any price discount. The more liquid a business is, the better able it is to meet short-term financial obligations.

**Market** - The private sector institutions - Banks, Building Societies etc.

**Maturity Profile/Structure** - an illustration of when debts are due to mature, and either have to be renewed or money found to pay off the debt. A high concentration in one year will make the Council vulnerable to current interest rates in that year.

**Monetary Policy Committee** – the independent body that determines Bank Rate.

**Operational Boundary** – This Prudential Indicator is based on the probable external debt during the course of the year. It is not a limit and actual borrowing could vary around this boundary for short times during the year. It should act as an indicator to ensure the Authorised Limit is not breached.

**Premium** – Where the prevailing current interest rate is lower than the fixed rate of a long-term loan, which is being repaid early, the lender can charge the borrower a premium, the calculation being based on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender may charge the premium, as their investment will now earn less than when the original loan was taken out.

**Prudential Code** - The Local Government Act 2003 requires the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

**PWLB** - Public Works Loan Board. Part of the Government's Debt Management Office, which provides loans to public bodies at rates reflecting those at which the Government is able to sell Gilts.

**Specified Investments** - Sterling investments of not more than one-year maturity. These are considered low risk assets, where the possibility of loss of principal or investment income is very low.

**Non-specified investments** - Investments not in the above, specified category, e.g., foreign currency, exceeding one year or outside our minimum credit rating criteria.

**Variable Rate Funding** - The rate of interest either continually moves reflecting interest rates of the day, or can be tied to specific dates during the loan period. Rates may be updated on a monthly, quarterly or annual basis.

**Volatility** - The degree to which the debt portfolio is affected by current interest rate movements. The more debt maturing within the coming year and needing replacement, and the more debt subject to variable interest rates, the greater the volatility.

**Yield Curve** - A graph of the relationship of interest rates to the length of the loan. A normal yield curve will show interest rates relatively low for short-term loans compared to long-term loans. An inverted Yield Curve is the opposite of this.