Manchester City Council
Report for Information

Report to: Audit Committee – 8 December 2011
Subject: Treasury Management Interim Report 2011-12
Report of: City Treasurer

Purpose

To report the Treasury Management activities of the Council during the first six months of 2011-12.

Recommendations

The Audit Committee is asked to note the contents of the report.

Wards Affected:

Not Applicable

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Background documents (available for public inspection):

Treasury Management Strategy Statement and Borrowing Limits and Annual Investment Strategy Report 2011-12 (Executive Committee 16 February 2011)
1 Introduction and Background

1.1 Treasury Management in Local Government is regulated by the CIPFA Code of Practice on Treasury Management in Local Authorities. The City Council has adopted the Code and complies with its requirements. A primary requirement of the Code is the formulation and agreement by full Council of a Treasury Policy Statement which sets out Council, Committee and Chief Financial Officer responsibilities, and delegation and reporting arrangements. This was approved by the Council on the 8th of October 2003, and updated and approved by the Executive on the 10th of February 2010.

1.2 CIPFA amended the CIPFA Treasury Management in the Public Services Code of Practice in late 2009, and the revised Code recommended that local authorities include, as part of their Treasury Management Strategy Statement, the requirement to report to members at least twice a year on the activities of the Treasury Management function. The recommendation was included within the Treasury Management Statement Strategy approved by the Executive on the 10th of February 2010, and by Council on the 3rd of March 2010. This report therefore ensures that the Council meets the requirements of the Strategy, and therefore the Code.

1.3 Treasury Management in this context is defined as:

“The management of the organisation’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”.

1.4 This interim report covers:

The Council’s portfolio position as at 30th Sept 2011
A review of economic conditions
External borrowing
Compliance with treasury limits and prudential Indicators
Temporary borrowing & investment outturn

2 Current Portfolio Position

2.1 The last year has seen an interest rate differential between the cost of long term debt (4% to 4.5%) and the return available from short term investments (under 1%) which led to the council following a strategy of borrowing internally (using cash backed reserves). As well as the cost of carry (paying out more interest on long term borrowing then can be earned from short term investing), there is also a difficulty in finding suitable organisations to lend surplus cash to as fewer of them meet our criteria since the banking crisis.

2.2 As outlined in the approved Treasury Management Strategy for 2011/12 there would normally be a need to undertake some permanent borrowing in 2011/12 to fund the capital programme and to replace some of the internal funds. Cash balances at the start of the year have been relatively high and, as it remains the
policy to keep cash low and minimise temporary investments, it has not been necessary to take any further borrowing at this stage.

2.3 The Council’s debt position at the beginning and middle of year was as follows:

<table>
<thead>
<tr>
<th>Loan Type</th>
<th>31 March 2011</th>
<th>30 Sept 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Principal £m</td>
<td>Average Rate %</td>
</tr>
<tr>
<td>PWLB</td>
<td>200.3</td>
<td>3.98</td>
</tr>
<tr>
<td>Temporary Borrowing</td>
<td>0.1</td>
<td>0.45</td>
</tr>
<tr>
<td>Market Loans</td>
<td>549.6</td>
<td>4.89</td>
</tr>
<tr>
<td>Stock</td>
<td>8.2</td>
<td>3.37</td>
</tr>
<tr>
<td><strong>Gross Total</strong></td>
<td><strong>758.2</strong></td>
<td><strong>4.63</strong></td>
</tr>
<tr>
<td>Temporary Deposits</td>
<td>(85.7)</td>
<td>0.57</td>
</tr>
<tr>
<td><strong>Net Total</strong></td>
<td><strong>672.6</strong></td>
<td><strong>5.15</strong></td>
</tr>
</tbody>
</table>

2.4 The temporary borrowing and deposit figures fluctuate daily to meet the daily cash flow requirements of the council. The temporary figures in the table above are therefore only a snapshot at a particular point in time.

2.5 No new borrowing has been taken this year. There remains an underlying need to borrow, and the latest forecast for the City Council is that it will need to borrow c. £40m by the end of the financial year. However, the consequences of HRA reform, due to take place on the 28th of March 2011, mean that there is little benefit from taking the required borrowing before this date.

2.6 Current estimates of the HRA reform settlement forecast a settlement for Manchester City Council of c. £255m. This will be reflected through Government paying off debt that the Council currently holds; in the first instance PWLB debt. As Manchester holds less PWLB debt than the estimated settlement, the issue has been raised with central Government regarding the possibility of redeeming market debt early, with Government bearing the costs of the associated premia.

2.7 Negotiations on this issue continue to take place between the Treasurer and Government. Ultimately, this means that it is inadvisable to take any PWLB debt until the settlement has taken place, as we would suffer a higher than necessary interest cost on debt that would then be cancelled by Government. There is the potential to take further market debt, but the instruments currently in the market are not attractive in terms of interest rate or period. It is likely that we will seek to borrow short term from either the money market or other local authorities until the settlement has been completed, and then look to replace the short term debt with longer term debt.

3 Review of Economic Conditions April to September 2011
3.1 In September the Bank of England left the key lending rate at a record low of 0.5\% for the 31st successive month. In October, there was an increase in the level of quantitative easing to £275bn, which was unanimously approved by the Monetary Policy Committee. The concerns expressed in our past reports about many banks being reluctant to lend, thereby limiting opportunities for the council to borrow from the market, continue to exist.

3.2 The new bank liquidity regime being pursued by the FSA may further impact the ability of the Council to achieve interest rates above the base rate on short term deposits. The Treasury Management function is actively researching alternative options which may protect the average rate achieved on deposits, should the regime be implemented as planned.

3.3 Appendix 1 provides a more detailed review of the recent economic situation.

4 **External Borrowing in the first half of 2011-12**

4.1 PWLB interest rates have fluctuated across the first 6 months of the year, gradually decreasing during the second quarter across all bands as illustrated in the table below and the graph at Appendix 2. This is mainly due to the concerns facing investors in the Euro zone, and the fact that the UK is being considered a safe haven for funds by many.

<table>
<thead>
<tr>
<th>PWLB Borrowing Rates 2011-12 for 1 to 50 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Year</td>
</tr>
<tr>
<td>--------</td>
</tr>
<tr>
<td>Low</td>
</tr>
<tr>
<td>High</td>
</tr>
<tr>
<td>Average</td>
</tr>
</tbody>
</table>

4.2 Whilst there remains an underlying need to borrow, the implications of the HRA reform settlement mean that it has been prudent to run down cash balances and refrain from fixing any longer term borrowing until after the settlement, as described in section 2.

5 **Compliance with Treasury Limits**

5.1 During the first half of the financial year, the Council operated within the treasury limits and Prudential Indicators set out in the Treasury Management Strategy Statement. Performance against these targets is shown in Appendix 3.

6 **Investment Strategy for 2011-12**

6.1 The Treasury Management Strategy Statement (TMSS) for 2011-12 was approved by Executive on 16th February 2011. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as (a) the security of capital and (b) liquidity of investments.
6.2 In order to achieve a higher level of security the City Treasurer introduced the following measures:

- Investments to be restricted to UK banks, building societies, local authorities and government institutions.
- Diversify the investment portfolio into more secure UK government and government backed institutions.
- Although the investment strategy allows investments up to 364 days, restrict deposits to as short a time period as feasible.

6.3 The City Council’s temporary cash balances are managed by the City Treasurer in-house and invested with those institutions listed in the City’s Approved Lending List. On one occasion during the first six months of 2011-12 these limits were breached. A large receipt was received too late for the Council to be able to arrange to invest it with any counterparty other than the Council’s banker. This lead to the Council’s balance overnight being above the limit set in the strategy by £400,000. This was rectified at the earliest possible opportunity on the next working day.

6.4 In early October two of the main ratings agencies, Moody’s and Fitch, lowered the credit rating of several British banks, including some of the counterparties used by the City Council. The downgrade was prompted by the ratings agencies deciding to reflect in their ratings the view that there is an increased political desire to reduce the implicit support for UK banks, and that without this support their current viability as banks is lowered.

6.5 Following the downgrades, the Treasury Management team have reduced their lending limits for the affected counterparties, as per the limits set out in the Annual Investment Strategy.

7 Temporary Borrowing and Investment Outturn for the first half of 2011-12

7.1 As illustrated in the economic background section (Appendix 1), investment rates available in the market continue to be at an historic low point. The average level of funds available for investment purposes in the first half of 2011-12 was just under £93m, mainly due to a significant number of grants being paid to the City Council at the start of the financial year. These funds were available on a temporary basis and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants, and progress on the capital.

7.2 Detailed below is the result of the temporary investment and borrowing undertaken by the Council. As illustrated, the authority outperformed the benchmark by 8 basis points on investments and 14 basis points on borrowing.
<table>
<thead>
<tr>
<th></th>
<th>Average temporary Investment /borrowing</th>
<th>Net Return/Cost</th>
<th>Benchmark Return / Cost *</th>
</tr>
</thead>
<tbody>
<tr>
<td>Temporary Investments</td>
<td>£92.98m</td>
<td>0.55%</td>
<td>0.47%</td>
</tr>
<tr>
<td>Temporary Borrowing</td>
<td>£0.13m</td>
<td>0.45%</td>
<td>0.59%</td>
</tr>
</tbody>
</table>

* Average 7-day LIBID / LIBOR rate sourced from Sector

7.3 None of the institutions in which investments were made show any difficulty in repaying investments and interest in full during the year. The list of institutions in which the Council invests is kept under continuous review. It remains the Council’s policy not to invest with institutions based outside the UK, including those in Ireland.

8 Conclusion

8.1 The current borrowing position reflects the strong balance sheet of the council. It enables net interest costs to be minimised and reduces credit risk by making temporary use of internal borrowing (reserves, provisions, positive cash flows etc). As cash balances have been relatively high, and it remains our policy to keep cash as low as possible and not to borrow in advance of need for capital purposes, no further borrowing has been taken this year.

8.2 Proactive treasury management during the first half of the year has enabled us to achieve an average net return on our investments of 0.55%, which is better than the Benchmark Average 7-day LIBID rate of 0.47% and an average net cost of temporary borrowing of 0.45% which is better then the benchmark of 0.59%.

8.3 There remains an underlying need to borrow, and it is estimated that the authority will need to borrow £70m by the end of the financial year. However, the issue of HRA reform and the implications of the proposed HRA settlement for the City Council have postponed any decision as to when to borrow this funding, and where to borrow it from. The Treasurer will continue to discuss with Government the best approach to the settlement for the City Council, and officers will continue to look for borrowing opportunities in the market. It is anticipated that any borrowing requirement will initially be funded short term, and that longer term solutions will be sought after the HRA settlement is completed by the end of March 2012.

8.4 Given the cash position of the council and the possible effects of the new bank liquidity regime, consideration will also be given to alternative forms of investment, such as treasury bills. However, these instruments will only be considered if they provide a level of security and liquidity that is acceptable to the authority, in line with the Treasury Management strategy.
Global economy

1.1 The Euro zone sovereign debt crisis continued with Spain, and particularly Italy, being the focus of renewed market concerns that they may soon join with Greece, Ireland and Portugal in needing assistance. This uncertainty and the lack of a co-ordinated or credible Euro zone response, left commentators concerned over the potential impact of sovereign default and resulting effects on the Euro zone banking sector. The approval by various countries of the €440bn bail out fund in September had brought temporary relief to financial markets but this does not provide a credible remedy to the scale of the Greek debt problem or the sheer magnitude of the potential needs of other countries for support.

1.2 This, coupled with political difficulties in the US over their plans to address the budget deficit, the size and control over the US sovereign debt, and the subsequent loss of the AAA credit rating from Standard & Poor’s, has led to a much more difficult and uncertain outlook for the world economy. Growth prospects in the US, UK and the euro zone have been lower than expected, with future prospects similarly cut. Whilst not a central view, concerns of a double dip recession in some Western countries have increased. World stock markets fell in the second quarter of 2011/12 as a consequence.

UK economy

2.1 Following zero growth in the final half of 2010/11 the UK economy grew by a weaker than expected 0.1% in the first quarter of 2011/12, providing a knock on effect to future growth prospects. Growth prospects will be governed by UK consumer sentiment, which is currently subdued due to falling disposable income. Higher VAT, overhanging debt, high inflation and concerns over employment are likely to weigh heavily on consumers into the future.

2.2 The announcement by the MPC on the 6th of October of a second round of quantitative easing of £75bn emphasised how seriously the MPC now views recession as being a much bigger concern than inflations. Although inflation remains stubbornly high, the MPC’s expectation of future falls resulting in an undershoot of its 2% target opened the way for this new round of QE.

2.3 International investors continue to view UK government gilts as being a safe haven from the EU sovereign debt crisis. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and sent PWLB borrowing rates to low levels.

Economic Forecast

3.1 The Council’s Treasury Advisers, Sector, have provided us with the following forecast:

3.2 Sector’s forecast on interest rates is below:
3.3 They stress that there remain huge uncertainties in economic forecast due to the following major difficulties:

- the increase in risk that the UK, US and EU could fall into recession;
- the likely political gridlock in the US preventing significant government fiscal action to boost growth ahead of the Presidential elections in November 2012;
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economies;
- the degree to which government austerity programmes will dampen economic growth;
- the potential for further quantitative easing, and the timing of this in both the UK and US; and
- the speed of recovery of banks’ profitability and balance sheet imbalances and the risk of substantial losses being incurred on EU sovereign debt.

3.4 The overall balance of risks is weighted to the downside and they expect low growth in the UK to continue, with a low Bank Rate to continue for at least 24 months, couples with a possible further extension of quantitative easing. This will keep investment returns depressed.

3.5 Sector believes that the expected longer run trend for PWLB borrowing rates is for them to rise, primarily due to the need for a high volume of gilt issuance in the UK, and the high volume of debt issuance on other major Western countries. However, they expect the current safe haven status of the UK may continue for some time, postponing any increases until 2012.
APPENDIX 3
TREASURY MANAGEMENT PRUDENTIAL INDICATORS: 2011-12
Performance to 30 September 2011

<table>
<thead>
<tr>
<th></th>
<th>Original £000</th>
<th>Minimum In Year to 30 Sept 2011 £000</th>
<th>Maximum In Year to 30 Sept 2011 £000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operational Boundary for External Debt - Borrowing</td>
<td>£1,218,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Long Term Liabilities</td>
<td>£0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Authorised Limit for External Debt - Borrowing</td>
<td>£1,307,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Long Term Liabilities</td>
<td>£0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Authority has adopted CIPFA’s Code of Practice for Treasury Management in the Public Services</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Upper Limit for Fixed Interest Rate Exposure</td>
<td>96%</td>
<td>78%</td>
<td></td>
</tr>
<tr>
<td>Net Borrowing at Fixed Rate as a percentage of Total Net Borrowing</td>
<td>96%</td>
<td>78%</td>
<td></td>
</tr>
<tr>
<td>Upper Limit for Variable Interest Rate exposure</td>
<td>48%</td>
<td>22%</td>
<td></td>
</tr>
<tr>
<td>Net Borrowing at Variable Rate as a percentage of Total Net Borrowing</td>
<td>48%</td>
<td>22%</td>
<td></td>
</tr>
<tr>
<td>Upper Limit for Principal Sums Invested for over 364 days</td>
<td>£0</td>
<td>£0</td>
<td></td>
</tr>
</tbody>
</table>

**Maturity structure of Fixed Rate Borrowing**

<table>
<thead>
<tr>
<th>Maturity structure of Fixed Rate Borrowing</th>
<th>Lower Limit 2011-12 Original</th>
<th>Upper Limit 2011-12 Original</th>
<th>Actual as at 30 Sept 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>under 12 months</td>
<td>0%</td>
<td>40%</td>
<td>0%</td>
</tr>
<tr>
<td>12 months and within 24 months</td>
<td>20%</td>
<td>70%</td>
<td>28%</td>
</tr>
<tr>
<td>24 months and within 5 years</td>
<td>0%</td>
<td>60%</td>
<td>32%</td>
</tr>
<tr>
<td>5 years and within 10 years</td>
<td>0%</td>
<td>50%</td>
<td>8%</td>
</tr>
<tr>
<td>10 years and above</td>
<td>30%</td>
<td>60%</td>
<td>32%</td>
</tr>
</tbody>
</table>
Glossary of Terms

**Authorised Limit** - This represents the limit beyond which borrowing is prohibited, and needs to be set and revised by the Council. 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** – the other party 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. This is calculated 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.

**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.

**LIBOR** – (London Interbank Offer Rate). The interest rate at which banks offer to take short-term borrowing from other banks in the London interbank market.

**LOBO** – Lender Option Borrower Option. Long-term borrowing deals structured in a such a way that a low rate of interest is usually offered for a short, initial period (anything from 1 year to 7 years), followed by a “step up” to a higher rate of interest (the “back end” interest rate), which is to be charged for the remainder of the loan period. The overall length of LOBOs is usually 50 or 60 years, but can be for shorter or longer periods. After the “step up” date, and at set intervals thereafter, the lender (the bank) has the option of increasing the “back end” interest rate. Whenever this option is exercised, if the proposed new interest rate is unacceptable, the borrower (the City Council) can redeem the loan without penalty. The City Treasurer has, more recently, looked at Vanilla LOBO loans, which have an interest rate which remains constant throughout the life of the loan, although still potentially subject to change at the lender’s option.
**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.

**Operational Boundary** – This 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 early warning 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. This is calculated 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. An institution managed by the Government to provide loans to public bodies at rates which reflect the rates at which the government is able to sell Gilts.

**Volatility** - The degree to which the debt portfolio is affected by current interest rate movements. The more debt that matures in the year and needs replacing, 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.