Housing, Finance and Corporate Services Policy and Scrutiny Committee

City of Westminster

Date:	12th September 2016
Classification:	General Release
Title:	Treasury Opportunities
Report of:	Steven Mair, City Treasurer
Cabinet Member Portfolio	Finance and Corporate Services
Wards Involved:	All
Policy Context:	Better City Better Lives Priority
Report Author and Contact Details:	George Bruce, Tri-Borough Director Treasury & Pensions x2258 gbruce@westminster.gov.uk

1. Executive Summary

Westminster holds short-term cash balances projected to average £728 million in 2016-17. In the prior year income of £4.8 million was earned at an average rate of 0.59%. This note details initiatives being considered with the potential to optimise the return earned on cash investments, including a number of projects being evaluated.

2. Key Matters for the Committee's Consideration

The Committee are invited to provide a view on:

- the risk appetite for the treasury portfolio,
- the appropriate process for approving special projects that are seen as non-standard treasury.

3. Background

3.1 Short term cash balances arise from a number of sources, principally,

- Reserve generation,
- Income collected in advance of expenditure

- Long term borrowing to fund the capital programme
- Provisions

3.2 The predictability of the timing of income and receipts is variable. Some elements are fairly certain e.g. council tax receipts and salaries, while others are unpredictable both in scale and timing e.g. the capital programme. Cash forecasting is important both to time borrowing decisions and to facilitate the investment of cash balances. A certain amount of cash is held for liquidity purposes e.g. to pay the bills, but in general holding large amounts of cash is not a policy and balances represent anticipated future expenditure or debt repayments.

3.3 Since 2008, the income generated from cash balances has plummeted as returns are closely related to Bank of England base rates. Thus when the BoE base rate dropped from 5.5% at the start of 2008 to 0.5% in March 2009, the revenue expectation from cash was reduced by 90%. The recent base rate cut to 0.25% and the projections that rates will continue to stay around current levels for 2-3 years has further challenged income potential.

3.4 This report details current initiatives to increase revenue generation through making greater use of existing opportunities, widening the scope of permitted investments and special projects currently being evaluated. Work is continuing on this and will continue to develop over the coming months before being refined for the budget and then developed continuously throughout the MTP period. Clearly the earnings that can be realised are heavily dependent on the cash balances and the interest rates prevalent during the period and thus may vary significantly

4. **Treasury Guidelines**

4.1 There are no legislative restrictions on the selection of treasury investments. Rather, regulations require a reporting cycle to ensure that treasury activity is scrutinised by Members. Investment of cash balances is controlled by the annual treasury management strategy statement (TMSS) that includes the annual investment strategy. Within this are set out eligible counterparties, maximum duration and various limits on individual and classes of investments, all designed to ensure that the cash balance is invested with high quality counterparties and highly diversified. The TMSS is prepared by the City Treasurer, being approved by EMT, Cabinet, this Committee and finally by Full Council. Mid-year and annual reports on activity enable Members to ensure that the agreed strategy is being followed, in particular that priority is given to security, liquidity and then income.

5. Future Income Opportunities

5.1 This note considers future income opportunities at four levels:

- Yields based on treasury advisor guidance
- Utilising the current TMSS to its full potential
- Modestly widening the scope of the TMSS

- Special projects

6. Yields Based on Treasury Advisor Guidance

6.1 Westminster treasury advisor, Capita, provide a ‘prudent’ average yield for treasury budgeting purposes. This rate has been reduced following the recent cut in base rates and an expectation of another cut to follow. Using Capita’s budgeting rate and assuming cash balances remain largely unchanged in the MTP period then this provides a base income of circa £1.8m in 2016/17, reducing to £700k in 2017/18 and increasing back to £1.8m in 2018/19

7 Working within the existing TMSS

7.1 Westminster treasury is able to add value above the Capita suggested budgeting yield through selective use of longer maturity deposits, both directly and in-directly through managed fund investments. These longer term investments have protected Westminster’s income projections in 2016-17 and will enable higher yields on new investments. With most investments still relatively short term, there are further opportunities to gradually extend duration. Working within the current TMSS, income projections for future years increase by £2.9m in 2016/17 and 2017/18 and £1.5m in 2018/19

8 Modest Widening the Opportunity Set within the TMSS

8.1 There are a various areas that the TMSS can be widened to increase the opportunities available while still investing in traditional financial instruments and retaining the emphasis on security and liquidity. These include:

- Building societies
- Challenger banks
- Wider range of non UK banks
- Corporate bonds
- Short-dated bond funds

8.2 These are all traditional opportunities for treasury portfolios. For example building societies were one of the main classes of counterparty pre 2008, but their use fell away with increased emphasis on credit ratings as many are unrated. Credit quality of building societies and smaller banks can be assessment using financial ratios that will support modest deposits.

8.3 Westminster has made limited use of non-UK banks. Following the problems encountered by local authorities investing in Iceland, caution in assessing the robustness of overseas financial markets is justified. However, there are banks and jurisdictions that offer greater security than UK banks and can be justified for inclusion in the TMSS.

8.4 Most treasury investments are with banks and other financial entities. Non-financial corporates also borrow short-term and offer a diversification benefits and yield enhancement.

8.5 Short-dated bond funds invest in the types of counterparties described above but for longer durations than Westminster would directly consider. However, these funds are highly diversified and offer short term (weekly) liquidity, together with a significant yield pick up over short-term deposits.

8.6 Combining all these opportunities, indicated potential additional income of 0.25% p.a. (equivalent to £1/4 million for every £100 million of investments). In monetary terms this is £1.8m in 2017/18 and 2018/19

8.7 Amending the TMSS to include these opportunities will not take full effect until 2017-18.

8.8 There is evidence that other local authorities treasury teams have tapped into these opportunities. Capita, Westminster's treasury advisor, provide a benchmarking service that compares Westminster's treasury portfolio with 15 other London funds. The London average returns of 0.85% for June compared with Westminster's 0.68%, with four Council's having returns in excess of 1% (highest 1.4%).

9. Special Projects

9.1 In addition to core treasury investments, there are a number of interesting opportunities that have arisen that can make a substantial contribution to Westminster's income. Each of these is described below.

Lending Against LOBO Loans

9.2 Lender Option Borrower Option debt was popular in the 2000s as they offered cheaper finance compared with PWLB loans. These were structured as flat rate debt with options after five years (and six monthly thereafter) for the lender to reset (increase) the rate of interest but the borrower (the Council) able to repay at no additional cost.

9.3 Westminster borrowed £10 million from Dexia in 2005 for 50 years at 3.66%. This loan is expensive to finance for Dexia due to its current status and there is an opportunity to lend against the security of Westminster's own borrowing. Dexia is not an approved counterparty, however by having the loan secured on Westminster's own debt there is 100% security of capital as any default by Dexia will be offset against Westminster's loan from Dexia by way of a netting agreement.

9.4 The prospective return is UK 10 year gilts plus 80bps or libor (0.6%) plus 80bps. The income option is based on floating which generates 1.32% (52bps libor + 80bps uplift) in the first year, adjusted in line with market rates each six months.

9.5 Westminster has £70 million of LOBO loans in aggregate, and one other lender, FMS (debt £15 million), has expressed an interest in a similar arrangement. In addition, both banks have proposed lending against the security of loans to other UK Council's. No income has been projected for the latter opportunity.

Solar Farm

9.6 A consortium of local authorities including Warrington, Thurrock, Newham are proposing to invest £80 million in a solar farm based in Swindon. The solar farm is newly constructed and the developer has signed a 15 year power sale agreement with HSBC. The solar panels have an estimated life of over 30 years. The investment will generate a 5% return in the first four years and 8% thereafter reflecting the contractual prices agreed with HSBC. The bond can be called after 5 years but also has the option of being extended.

9.7 The scale of the investment shown is £18 million. The security of the project is akin to a direct loan to HSBC, for whom the Council's current counterparty limit is £75 million.

Local Government Association

9.8 The LGA approached Westminster to act as an intermediary to enable the LGA to effectively borrow from the soon to be operational Municipal Bond Agency. The LGA is unable to borrow directly, as it is not a local authority, and in thus seeking to use three local authorities to borrow from the MBA agency and on lend. The LGA is offering 0.25% to 0.5% above PWLB rates. The borrowing will be secured on properties owned by the LGA and is to be used to refurbish the properties. The loan is for a term of 10-12 years. A total of £20 million is required, of which Westminster's share is £7 million.

9.9 As an alternative the LGA is seeking to direct borrowing from the Council. The income projection used is based on 10 year PWLB (1.75%) plus 0.25% margin i.e. 2%.

Loan to Leisure Centre Operator

9.10 The operator of Westminster's leisure centres is seeking to borrow £1.25 million to finance a refurbishment of the leisure centres at an interest rate of 6.8%. As the funds will be expended on Westminster owned buildings, the Council directly benefits from the expenditure. Similar opportunities are also progressing for larger sums.

9.11 These are a flavour of the opportunities that have recently been identified. If these can be successfully closed, it is likely that further opportunities will arise.

9.12 In summary, these additional opportunities, are projected to earn at least £1.75 million in 2017/18 and 2018-19. As these are current opportunities further options will be explored in the coming months and may lead to additional income which it has been assumed for 2018/19 only could produce a further notional £1.75m

9.13 Interest rates and cash balances are volatile and the exact income that will be earned from these opportunities is subject to alteration prior to the projects being finalised.

10 Aggregate Income Projections

10.1 Aggregating the above opportunities provides income estimates for future years of £4.7m for 2016/17, £7.15m for 2017/18 and £8.6m in 2018/19

10.2 This indicates that treasury can continue to contribute to Council income even in an environment in which interest rates are at historic lows and liable to fall further and stay low for longer. Looking further into the future, interest income will benefit when interest rates do eventually normalize.

11 Conclusion

11.1 Local Government treasury functions have historically adopted a narrow scope of activity. The above examples indicate that there are opportunities in non-traditional areas to contribute to the Westminster's overall income while maintaining security of capital.

12 Financial Implications

Financial implications are central to the report, which considers the ability to generate revenue from the treasury short-term cash balances.

13. Risks and Mitigations

Risk management is central to treasury operations. Permitted counterparties, individual and class limitations (minimum credit quality, scale and maturity) are set out in the annual TMSS. Daily reports on credit ratings with suggested maturity limits are received from the Council's treasury advisor.

Treasury activity is scrutinised quarterly by Members and weekly by the City Treasurer.

If you have any queries about this Report or wish to inspect any of the Background Papers please contact George Bruce x2258 gbruce@westminster.gov.uk

BACKGROUND PAPERS

There are no background papers. The 2016-17 TMSS provides additional guidance as to best practice when setting and monitoring treasury strategy.