City of Westminster

CABINET

Date:	**17 November 2015**
Classification:	**General Release**
Title:	**Treasury Management Strategy Mid-Year Review**
Report of:	**City Treasurer**
Cabinet Member Portfolio:	**Cabinet Member for Finance**
Wards Involved:	**All**
Policy Context:	**The efficient management of the Council's financial affairs**
Financial Summary:	**Treasury Management continues to operate within approved boundaries**
Report Author and Contact Details:	**Jackie Shute, Interim Tri-Borough Head of Treasury jshute@westminster.gov.uk**

1. EXECUTIVE SUMMARY

1.1. This report presents the Council's Half Year Treasury Report for 2015/16 in accordance with the Council's treasury management practices. It is a regulatory requirement for this Half Year report to be presented to Cabinet and Full Council.

1.2. There are two aspects of Treasury performance – debt management and cash investments. Debt management relates to the City Council's borrowing and cash investments to the investment of surplus cash balances. This report covers:

- the treasury position as at 30 September 2015;
- the UK economy and interest rates
- investment strategy and outturn for 2015/16;
- the borrowing strategy and outturn for 2015/16; and
- compliance with treasury limits and prudential indicators.

1.3. The borrowing amounts outstanding and cash investment for the 30th September period are as follows:[1]

	30 September 2015 £m	31 March 2015 £m
Total borrowing	282	284
Total cash balances	(769)	(605)
Net Surplus	**(487)**	**(321)**

2. RECOMMENDATIONS

2.1 That Cabinet:

i) Note the treasury position at 30th September 2015

ii) Approve the inclusion of Bonds within the category of UK deposits and Certificates of Deposit, and

iii) Recommend the Council accordingly.

3. TREASURY POSITION AT 30 SEPTEMBER 2015

Net Position

3.1 The above table shows that during the first six months of the year, net cash inflows of £126m have been received. This significant movement reflects the expected pattern of the Authority’s cash position and largely relates to the timing of grants received.

3.2 The authority is in a significant net cash positive position and as such, the peaks and troughs of cash movements are reflected in changes to the investment balance.

3.3 The revenue outturn position for 2015/16 is as follows:

	General Fund £m	HRA £m
Expected Net Interest Costs / (Income)	(3.716)	11.054
Downside Net Interest Costs / (Income)	(3.192)	11.065
Net Interest Risk	**0.524**	**0.011**

3.4 Net interest comprises interest paid less interest receipts, and the expected outturn represents the current portfolio commitments with maturing investments being reinvested at market expected rates. By modelling alternative interest rate scenarios, it has been possible to quantify the impact of downside rate environments. The table above reflects the position capturing

[1] This amount represents the principal amount invested, rather than the fair values that are reflected in the financial statements

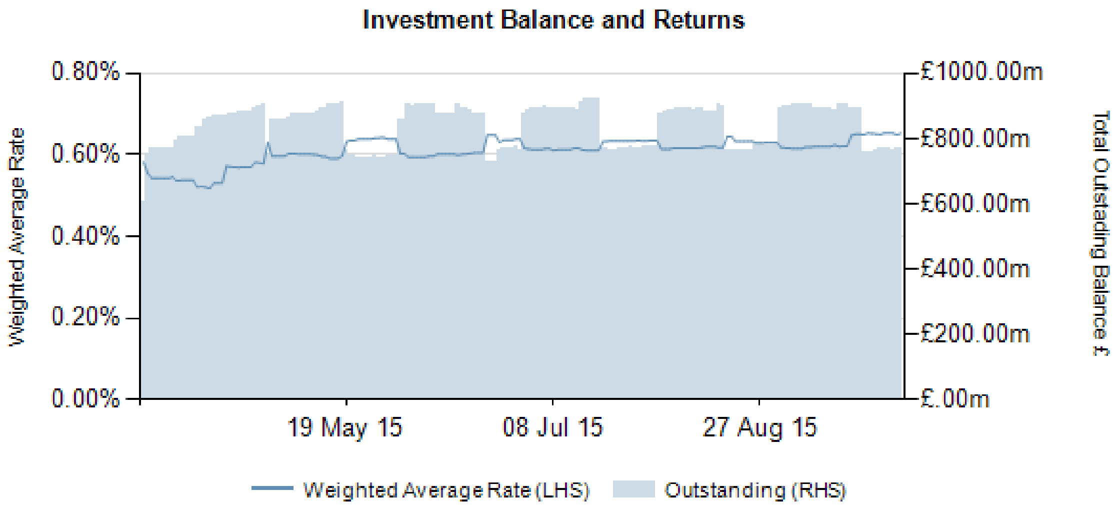
scenarios where only 1 in 10 outcomes could be worse. This is viewed as a reasonable level of confidence given the uncertainty of the interest rate environment. The authority recognises interest rate risk as a key treasury risk and is committed to containing this uncertainty, whilst ensuring credit risk on investments is also actively managed.

Investments

3.5 The table below provides a breakdown of the cash deposits, together with comparisons from the year end.

Investment Type	30 September 2015 £m	31 March 2015 £m
Money Market Funds	32.7	200.0
Call Accounts	31.0	35.0
Notice Accounts	78.8	78.7
Term Deposits	49.0	109.7
Tradable Securities	546.0	149.7
Enhanced Cash Funds	31.5	31.5
Total	**769.0**	**604.6**

3.6 Liquid balances are managed through the Call accounts and Money Market Funds which offer same day liquidity. The balances in these categories of investment were unusually high at the start of 2015/16 largely to ensure sufficient cash was available to meet payments, as the introduction of the new financial system created some uncertainty regarding the timing of cash flows. As the year progressed, cash flows normalised and the levels of liquidity required became more apparent. Consequently, cash was reinvested into alternative, less liquid instruments particularly Tradable Securities.



3.7 The shaded area in the above chart shows the daily investment balance during the first half-year. The line shows the weighted average return of the investment portfolio, which has increased from 0.58% at the start of the year to 0.65% at 30th September. This has been largely attributable to the move away from liquidity trades and into tradable securities.

3.8 All investment limits specified in the 2015/16 investment strategy have been adhered to. The table below shows the limits and exposures as at 30th September 2015.

Category	£ Limit per counterparty	Duration Limit	Counterparty Name	Current Exposure £m	WAD (days)
UK Government	unlimited	unlimited	UK Government	427.07	132.83
Supranationals	£200m	5 years	Council of Europe Development Bank	32.63	68.00
			European Investment Bank	10.08	68.00
European Agencies	£200m	5 years	Kreditanstalt fur Wiederaufbau	28.30	101.69
Network Rail	unlimited	37 years	Network Rail Infrastructure PLC	20.46	246.49
TFL	£100m	5 years	Transport For London	27.47	20.00
Money Market Funds	£70m per fund. £200m in total	n/a	Aberdeen Asset Management	19.25	Instant
			Deutsche	5.50	Instant
			Federated Prime Rate	5.00	Instant
			JP Morgan	1.30	Instant
			Morgan Stanley	1.50	Instant
Enhanced Cash Fund	£25m per fund, £75m in total	n/a	Federated Prime Rate	15.17	1 day notice
			Payden & Rygel	16.45	3 days notice
UK Bank Deposits (higher credit quality)	£75m	5 years	HSBC Bank plc	49.25	1 month notice
			Royal Bank of Scotland plc	14.00	256.43
UK Bank Deposits (lower credit quality)	£50m	3 years	Barclays Bank plc	49.58	73.42
			Lloyds Bank plc	15.00	98.00
Non-UK Banks (higher credit quality)	£50m	5 years	Svenska Handelsbanken	31.00	Instant
Total				**769.01**	**104**

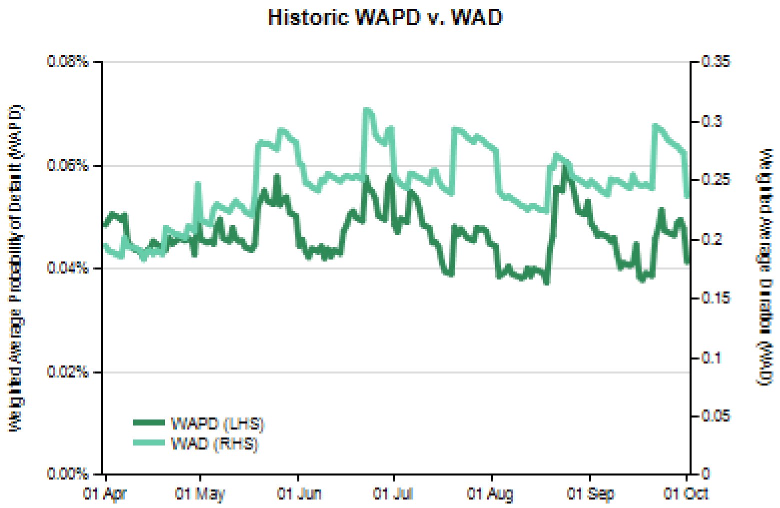
3.9 It should be noted that although the credit rating of Royal Bank of Scotland is lower than Barclays and Lloyds, as a result of the extent of government ownership (currently 73%), the approved strategy for 2015/16 categorises them as a higher credit quality and consequently the higher limit applies.

3.10 The weighted average duration of the portfolio is 104 days, and varies considerably between counterparties. The longest duration investment is a UK Government gilt maturing in July 2018. Stripping this transaction out would reduce the weighted average duration to just 71 days.

3.11 Long term projections of the authority's net surplus suggest that the cash balance is not expected to fall in the foreseeable future, and therefore there is the opportunity to extend the duration of the investments without compromising the liquidity requirements of the authority.

3.12 Officers are currently working on some potential strategies to extend the duration of trades which will increase the returns and reduce interest rate risk. This is discussed further in Section 5 of this report.

3.13 In terms of credit risk, there have been some changes in ratings during 2015/16. In particular, FitchRatings downgraded the Royal Bank of Scotland's long term rating from A- to BBB+ in May 2015. At the same time, Lloyds Bank's long term rating was upgraded from A to A+. Using more dynamic credit risk measures, the first half of the year has shown a more volatile credit risk profile, reflected by the weighted average probability of default (WAPD) for the portfolio.



3.14 The chart above compares the WAPD of the portfolio with the weighted average duration. This shows that the increase in duration has not manifested itself in an increase in credit risk and as at the 30th September 2015, the default risk for the portfolio was lower than at the start of the financial year.

Borrowing

3.15 The table below shows the details around the Council's external borrowing (as at 30 September 2015), split between the General Fund and HRA.

	30th September 2015		31st March 2015	
	Balance £m	**Average rate %**	**Balance £m**	**Average rate %**
HRA External Borrowing	256	4.8%	258	4.8%
General Fund External Borrowing	26	4.1%	26	4.1%
Total borrowing	**282**	**4.7%**	**284**	**4.7%**

3.16 There has been little activity during the first half of 2015/16. Reductions in principal of £1.7m have occurred as a result of the maturity of an HRA loan and small repayments of principal on General Fund annuity loans.

3.17 The Council has complied with the approved 2015/16 Treasury Management Strategy as well as all Prudential Indicators and regulatory requirements for Treasury investment in the year to date.

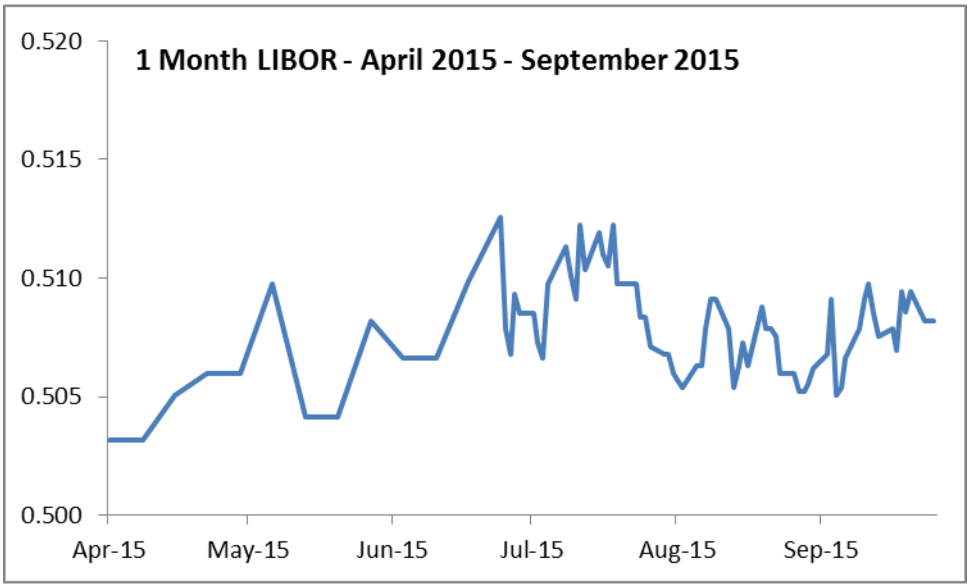
4 THE ECONOMY AND INTEREST RATES

4.1 UK GDP continued to rise in the first quarter of the financial year, posting a 2.4% year on year increase, resulting in the tenth consecutive quarter of increases. Export growth has been hampered by weak domestic growth within the UK's main trading partners, but countered by healthy growth in household real incomes.

4.2 Consumer Price Inflation continued to undershoot the Monetary Policy Committee's (MPC's) target of 2%, largely as a result of external factors but also as a result of domestic cost pressures remaining weak. The Bank of England's quarterly inflation report in August projected inflation to increase to the target in 2 years time. This is largely as a result of past falls in energy and food prices falling out of the annual comparison. However, falls in energy prices since the May 2015 report exerted more downward pressure than was expected earlier in the year.

4.3 At the August meeting of the MPC, the committee voted 8-1 in favour of leaving the Bank Rate on hold, with one member voting for a 25bps increase; the first vote for an increase since December 2014. The MPC felt there were various headwinds facing the UK economy, not least the downside potential of risks to activity in China and Europe. As a result, the committee felt that when interest rate increases do begin to take place, it will be undertaken at a more gradual pace than in previous cycles.

4.4 Short term rates remained relatively stable throughout the first half of the financial year as shown by 1 month LIBOR in the chart below. However, the market's expectations of interest rate movements increased slightly over the first half of the year, which consequently had a positive impact on the Council's Net Interest Income.



5 THE WAY FORWARD

5.1 Officers have been actively considering a variety of treasury initiatives, predominantly focusing on active risk management of the portfolios. Whilst the work is still in progress and will be brought forward as part of the future budget proposals, there are a number of points that can be factored into the current and future years' portfolio management.

5.2 Long term cash flow forecasts have been developed and are being actively used to assist the authority's strategic decision making. These projections are continually updated with the evolving spending plans of the organisation and demonstrate that the level of cash balances held is not expected to fall below £400m despite the relatively ambitious spending plans of the organisation.

5.3 Furthermore, it has being considered that a balance of £150m needs to be retained on a liquid basis to meet peaks and troughs of cash flows on a daily basis. Therefore, there is an expected balance of £250m that is not needed in the foreseeable future and can therefore be invested on a more strategic basis.

5.4 There are several options being explored for the use of this available cash balance, and some of these initiatives are yet to be concluded. However, it is clear at this stage that within the strategy, it would be beneficial if duration was extended on the non-liquid proportion of the investment portfolio. As a result of the upward sloping yield curve shown above in Section 4 of this report, investing for longer duration can lock in gains above short term rates. Furthermore this strategy would reduce interest rate risk and uncertainty as a lower proportion of the portfolio would need to be re-invested at unknown future rates.

5.5 The current strategy permits deposits with UK and non-UK banks for periods up to 5 years, and it is not being proposed that this duration be extended. However, it is felt that a more appropriate way to gain exposure to the banking sector may be through the purchase of bonds rather than deposits. Bonds are highly liquid tradable instruments that carry no additional credit risk over deposits. In the event that the credit quality of the institution deteriorated, with a deposit the authority would only be able to attempt a negotiation with the counterparty to prematurely break the deposit, which may not be possible. With a bond of the same duration, there would be the opportunity to sell the instrument on in the wider market, albeit the price may be affected by any deterioration in credit quality. However, this would be preferable to being unable to negotiate a premature break in the deposit.

5.6 Bonds are currently invested in with very high quality counterparties such as UK Government, TFL, Network Rail and Supranational Banks. And the strategy permits long dated deposits with UK and Foreign banks. Therefore to include bonds with banks will not expose the Authority to any greater credit risk than has been approved in the 2015/16 Investment Strategy yet provide enhanced returns compared to the typical deposit rates offered by the same institutions.

6 COMPLIANCE WITH TREASURY LIMITS AND PRUDENTIAL INDICATORS

6.1 During the half year to September 2015, the Council operated within the treasury limits as set out in the TMS. The position for the Treasury Management Prudential Indicators are shown below.

External debt indicator	Approved limit (£m)	Maximum borrowing	Days exceeded
Authorised limit[2]	516	283	None
Operational boundary[3]	496	283	None

6.2 The Authorised Limit is a level for which the external borrowing cannot be exceeded without reporting back to Full Council. It therefore provides sufficient headroom such that in the event that the planned capital programme required new borrowing to be raised over the medium term, if interest rates were deemed favourable and a thorough risk analysis determined the cost of carry was appropriate, this borrowing could be raised ahead of when the spend took place.

6.3 The Operational Boundary is set at a lower level and should take account of the most likely level of external borrowing. Operationally, in accordance with CIPFA best practice for Treasury Risk Management, a liability benchmark is used to determine the point at which any new external borrowing should take place. As a result of the significant level of cash balances, it is deemed unlikely that any new borrowing will be required in the foreseeable future.

[2] Authorised limit for external debt is the limit above which external debt must not go without changing Council Policy.
[3] Operational boundary for external debt is the limit against which external debt will be constantly monitored.

6.4 The maturity structure of borrowing shows the proportion of loans maturing in each time bucket. The purpose of this indicator is to highlight any potential refinancing risk that the authority may be facing if any one particular period had a disproportionate level of maturing loans. The maturity structure as at 30th September 2015 was well within the limits set and does hot highlight any significant issues.

Maturity structure of borrowing	**Lower limit (%)**	**Upper limit (%)**	**Actual at 30 September 2015 (%)**
Under 12 months	0	40	11
1-2 years	0	35	0
2-5 years	0	35	11
5-10 years	0	50	15
10 years and over	35	100	64

6.5 The purpose of the interest rate exposure indicators is to demonstrate the extent of exposure to the authority from any adverse movements in interest rates. The limits for 2015/16 were set sufficiently wide as to permit all loans to be at fixed rates and all investments to be at variable rates. If the portfolios were managed on this basis, it would exposure the authority to the risk of interest rates being low for an extended period of time.

6.6 Officers recognise that interest rate risk is one of the key risks facing the authority, as demonstrated by the table in paragraph 3.3 which shows that the difference between expected net interest costs and downside net interest costs is over £0.5m in the current financial year alone. As part of the strategic review of the investments outlined in Section 5 of this report and in recognition of the key risk management objective to reduce interest rate exposures, the mis-match between fixed and variable investment returns will be re-balanced in order to reduce interest rate risk to the organisation.

Upper limits on interest rate exposure	**Approved maximum limit**	**Actual as at 30 September 2015**
Borrowing		
Fixed interest rate exposures	100%	79%
Variable interest rate exposures[4]	50%	21%
Investments		
Fixed interest rate exposures[3]	50%	5%
Variable interest rate exposures	100%	95%

[4] For the purposes of this Prudential Indicator variable borrowing and investments include any deals that have a maturity of under a year as well as any trades being capable of being varied within a year..

6.7 The final treasury management prudential indicator relates to containing investment risk by setting a maximum amount which can be invested for more than 364 days. As referred to earlier in this report, the short duration of the portfolio demonstrates that the current position is well within the approved limits.

£ million	**Approved maximum limit £m**	**Actual as at 30 September 2015 £m**
Limit on investments for periods over 364 days	200	40

Background Papers

Cabinet Reports
Treasury Management – Annual Strategy for 2015/16, including Prudential Indicators and Statutory Borrowing Determinations – 23rd February 2015.

If you have any questions about this report, or wish to inspect one of the background papers, please contact Jackie Shute on 020 7641 1804 or jshute@westminster.gov.uk.