

HERTFORDSHIRE COUNTY COUNCIL

CABINET

MONDAY 10 FEBRUARY 2003 AT 2.00 PM

COUNTY COUNCIL

THURSDAY 13 FEBRUARY 2003 AT 10.30 AM

Agenda Item No.

Cabinet

2

County Council

15

Report of the Finance Director

Author: Nicola Webb, Treasury Manager (01992 555394)

Executive Member: David Beatty

TREASURY MANAGEMENT STRATEGY (including Borrowing Strategy)

1. Purpose of the Report

- 1.1 To report on treasury management performance in 2002/03 to date.
- 1.2 To recommend a treasury management strategy (including borrowing) for 2003/04 in accordance with the CIPFA Code of Practice.
- 1.3 To recommend a change to the Policy for setting lending limits.

2. Summary

- 2.1 Interest was earned at a rate of 4.02% in the nine months to December 2002. New borrowing and rescheduling of loans in 2002/03 to date have increased the total long term borrowing portfolio to £158.3m and reduced the average rate of interest paid on it to 5.68%.
- 2.2 The proposed 2003/04 strategy recommends investing cash for short periods at the beginning of the year and then investing for longer periods later in the year when rates are expected to rise.
- 2.3 It is proposed that long term borrowing of £39.95m is taken to fund 2003/04 credit approvals. In addition it is proposed that a further £20m is borrowed to provide cash to back reserves, while interest rates are low.
- 2.4 Changes to the amount which can be invested with each institution on the lending list are recommended to enable temporary investment of the cash it is proposed is borrowed early in the financial year. The current limits have been in place for the last 8 years. In addition it is proposed to add wholly-owned subsidiaries of the main UK banks to the list.

3. Conclusion

- 3.1 The average rate of interest in 2002/03 to date is 0.25% higher than the generally accepted benchmark, 7 day LIBID. Long term borrowing activity in 2002/03 to date has reduced the average rate paid in the year by 0.23%.
- 3.2 The proposed investment strategy for 2003/04 seeks to maximise interest earned by exploiting interest rate trends. The aim of the proposed strategy for long term borrowing is to protect the Council's financial position at a time when interest rates are at an historic low.
- 3.3 Changes to the lending list criteria will enable the proposed strategy to be achieved.
- 3.4 Cabinet is invited to consider recommending to County Council that the Treasury Management Strategy for 2003/ 2004 is approved.

1. **Background**

- 1.1 CIPFA's Code of Practice "Treasury Management in the Public Services" recommends that an annual strategy for Treasury Management be prepared and approved in advance of the new financial year.
- 1.2 The County Council approved the Treasury Management strategy for 2002/03 on 14 February 2002 and approved a revision to it on 19 November 2002.

2. **Performance in 2002/03 to Date**

Investments

- 2.1 The average cash balance held by HCC during the period April to December 2002 was £93m. This includes pension fund balances, and cash borrowed in advance of the Baldock Bypass Scheme.
- 2.2 The average rate of interest earned in the first nine months of 2002/03 was 4.02% compared to an average base rate of 4% and average benchmark rates of F.T. 7 day LIBID 3.77% and 1 month LIBID 3.85%. The total interest earned in the period was £3.0m.
- 2.3 The Bank of England Monetary Policy Committee (MPC) left base rate unchanged at 4% throughout the year. This resulted in a decrease in long-term rates (up to 364 days). Overnight rates fluctuated between 3.18% and 4.75% as a result of uncertainty in the markets about future base rate cuts.
- 2.4 The decision was taken to continue investing some of the County Council's balances for 364 days. The strategy has been to monitor longer term rates and be prepared to take advantage of intra-day peaks in the rates. Small amounts have been placed each time there has been an upward movement which met the target rate set for longer term investment. The remaining balances have been lent for periods up to six months in order to maximise interest earned whilst ensuring that cash was available to meet the County Council's liabilities on a daily basis.

Long Term Borrowing

- 2.5 At the beginning of the financial year the total long term borrowing was £118.9m and the average interest rate on the portfolio was 5.91%.
- 2.6 So far this year, the County Council has taken advantage of two rescheduling opportunities, detailed below:

| <u>Date</u> | <u>Amount</u> | <u>Original Loan</u> | <u>New Loan</u> |
|-------------|---------------|----------------------|---------------------------------------|
| April 02 | £3,130,000 | Fixed 5.75% | 1 yr variable; average rate 4.02% |
| December 02 | £9,400,000 | Fixed 5% | Fixed 3.6% for 4 years; then 4.99% |

This has resulted in savings of £93k during 2002/03.

- 2.7 In addition new borrowing of £39.4m was taken in December following the County Council's approval at the meeting of 19 November 2002. The average rate of interest for this borrowing is 4.36%.
- 2.8 These changes have resulted in the long term borrowing portfolio increasing to £158.3m, and the average interest rate payable in 2002/03 reducing to 5.68%. The full year effect of these changes is to reduce the average rate to 5.49%.

3. Strategy for 2003/04

Interest Rates

- 3.1 The latest interest rate forecast provided by Butlers, the Council's Treasury Management advisers is shown below:

| | <u>Base Rate</u> |
|--------------|------------------|
| Current | 4% |
| March 03 | 4% |
| June 03 | 3.75% / 4% |
| September 03 | 4% |
| December 03 | 4% |
| March 04 | 4.25% |

- 3.2 The forecast shows that a further cut in interest rates cannot be ruled out early in 2003/04. It is then expected that rates will gradually rise up to 4.25% by the end of the financial year.

Investment Strategy

- 3.3 Given this interest rate background, the proposed investment strategy for 2003/04 is a hybrid one.
- 3.4 At the beginning of the financial year when rates are expected to be falling, cash will be invested for short periods, as short term rates are likely to be higher. As rates start to raise, longer term rates will become more attractive and so cash will be invested for longer periods, whilst ensuring sufficient cash is available to meet short term requirements.
- 3.5 The strategy of investing for short periods in the first half of the financial year will ensure funds are coming back in at regular intervals. This means it will be possible to take advantage of attractive long term rates as soon as they arise.

Borrowing Strategy

- 3.6 The County Council's current level of long term borrowing is £158.3m, and interest paid on it is at an average rate of 5.49%. During 2003/04 it will be possible to borrow £39.95m from the PWLB in respect of credit approvals for capital expenditure.
- 3.7 Long term borrowing rates remain at historic lows – ranging from 4% to 4.5%. It is expected that these rates will increase over the course of the 2003/04 financial year.
- 3.8 Butlers have advised that the funds required for the capital programme are borrowed early in the financial year to take advantage of the attractive interest rates.
- 3.9 There is one loan of £3.13m due to mature during the year – this is the one year variable loan taken as a result of rescheduling, discussed in section 2.6. This loan will be replaced during 2003/04 at a rate lower than the original loan's rate of 5.75%.
- 3.10 In addition, Butlers have undertaken some work on the County Council's financial position. Their analysis shows that there is not enough cash available to cover all the reserves, if they were to be called upon. The Finance Director has reviewed the reserves and has found that around £20m are likely to be called upon over the next three years. Therefore additional cash will be required to cover this.
- 3.11 The Government is in the process of drawing up the new capital financial regulations, which will be implemented in 2004. Whilst it is expected that these will allow authorities more freedom in determining their capital expenditure plans and borrowing locally, it is expected that the government will wish to put an overall limit on the level of borrowing. At present it is not clear how this will be implemented, however one possibility is that the limit will relate to an authority's current level of borrowing.
- 3.12 Given the interest rate background, the analysis of reserves and the prospect of new regulations limiting borrowing in future, Butlers have advised that £20m of borrowing is taken in 2003/04 in addition to the £39.95m credit approvals.
- 3.13 It is also recommended that debt rescheduling opportunities are reviewed constantly, and taken, if significant savings can be made over the medium/long term.

4. Lending Limits

- 4.1 The County Council last approved the Lending List criteria in November 2002. The only alteration at that time was to add Money Market Funds to the list.

- 4.2 Given that it is recommended that long term borrowing is taken early in the year in advance of need, cash balances will be higher at the beginning of the year until capital expenditure takes place. With more cash to invest, it becomes more difficult to place cash at attractive rates. Therefore Butlers have recommended that the amounts the Council lends to each institution be raised. These limits have been static for the last eight years. The table below shows the original limits and the proposed revisions.

Maturity Limits

| Rating/Type of Institution | Revised Maturity Limit | Original Maturity Limit |
|---|--|--------------------------------|
| Main UK Banks | 25 | 20 |
| Local authorities and other public bodies | 15 | 10 |
| Individual rating B/C or above Support rating 3 or above | 15 | 10 |
| Individual rating C or D Support rating 3 or above | 7.5 | 5 |
| Individual rating C or D Support rating 4 or below | 7.5 | 5 |
| Italian/Norwegian/Spanish/ Swedish/ Portuguese banks | 7.5/12.5 (depends on circumstances) | 5/10 |
| Building Societies | | |
| Assets £900m+ | 12.5 | 10 |
| £250 – 899m | 7.5 | 5 |
| £150 – 249m | 5 | 2.5 |

- 4.3 Wholly-owned subsidiaries of the main UK banks do not require credit ratings. However, Butlers consider their risk levels to be similar to those of the parent bank, as it would be not be good for a bank’s reputation to let a subsidiary fail. It is proposed to add wholly-owned subsidiaries of the main UK banks be added to the list at credit limits no more than one third of their parent bank’s. No other subsidiaries can be added without a credit rating.
- 4.4 The full revised policy is attached at Appendix A.

5. Financial Implications

- 5.1 It is anticipated that £3.7m of interest will be earned on investments in 2002/03 at an average rate of 4%. Interest of £7.5m will be paid on long term borrowing in 2002/03 at an average rate of 5.68%.
- 5.2 The average cash balance in 2003/04 is expected to be £93m and the average rate of interest earned 4%, producing interest of £3.72m. It is anticipated that interest of around £10m will be paid on long term borrowing in 2003/04 at an average rate of 5.25%.

**HERTFORDSHIRE COUNTY COUNCIL
POLICY FOR SETTING LENDING LIMITS**

The policy sets a high standard of credit criteria. These are applied to a wide range of financial institutions, so that the Authority can maximise its ability to earn the best interest rates whilst minimising the risk of loss.

MONEY MARKET DEPOSITS & CASH ON CALL

All lending is done in sterling and overseas banks on the list must have branches or incorporated subsidiaries in the UK.

Legal Requirements

- ◇ Bank of England authorisation for each institution
- ◇ Maximum 364 day maturity limit for investments

Minimum Credit Rating Requirements

All approved banking institutions must have a Fitch-IBCA short term rating of F1 or F1+ and a minimum long term rating of A. Many Building Societies do not need a credit rating. Their maturity and credit limits are therefore based on their asset value. Wholly-owned subsidiaries of the main UK banks do not have credit ratings. Their maturity limits are based on the parent bank's and the credit ratings are no more than one third of the parent bank's. No other subsidiaries can be on the list unless they have a minimum credit rating.

The maturity and credit limits (i.e. the maximum period and value of a loan to that institution) depend on the "individual" and "support" ratings as set out below.

If Fitch IBCA do not undertake a credit rating review of an institution, consideration will be given to ratings of an equivalent level issued by other credit rating agencies.

NB Due to ongoing problems in the Japanese banking sector NO Japanese banks are currently on the approved lending list.

Maturity and Credit Limits

| Rating/Type of institution | Maturity Limit | Credit Limit £m |
|---|-----------------------|----------------------------|
| Main UK Banks | 364 days | 25 |
| Local authorities and other public bodies | 364 days | 15 |
| Individual rating B/C or above Support rating 3 or above | 364 days | 15 |
| Individual rating C or D Support rating 3 or above | 364 days | 7.5 |

| Rating/Type of institution | Maturity Limit | Credit Limit £m |
|--|--|--|
| Individual rating C or D Support rating 4 or below | 3/6 months (depends on circumstances) | 7.5 |
| Italian/Norwegian/Spanish/ Swedish/Portuguese banks | 3/6 months | 7.5/12.5 (depends on circumstances) |
| Building societies: Assets £900m+ | 364 days | 12.5 |
| £250-899m | 364 days | 7.5 |
| £150-249m | 364 days | 5 |

These criteria form the basis for the maturity and credit limits.

The credit ratings and status of institutions are regularly monitored and lower maturity and credit limits may be imposed where there are specific concerns not yet reflected in the ratings.

MONEY MARKET FUNDS

All lending is done in sterling and all institutions must be regulated by an officially recognised EU Body.

All approved funds must have at least one of the following credit ratings:

- Moody's Investor Service Ltd Aaa MR1+
- Standard and Poor's Ltd AAAM
- Fitch - IBCA AAA V1+.

The limit for lending to any one Money Market Fund is £20m.

Group Limits

Where a number of banks are part of the same group, there is a total credit limit for the group which is equal to that of the parent bank.

Main UK Banks total group limit £30m.

Group limits for other institutions vary according to their credit rating.

Transaction Limit

No one transaction can exceed £10m except for roll over of interest on renewal of an existing loan.

Breaches of Lending Limits

Breaches of lending limits up to £1m for periods of up to 1 month are permitted in exceptional circumstances where a deal at the maximum credit limit would leave a small, uneconomical sum to place.

Changes to the Lending List

The Finance Director can authorise changes to the limits on individuals institutions or add institutions within the terms of this Policy. Any changes to the criteria in this Policy must be approved by County Council.