EDINBVRGH
THE CITY OF EDINBURGH COUNCIL

Item no 10(a)
Report no

Treasury Management Effectiveness

Finance and Resources Committee

25 September 2012

1 Purpose of report

1.1 To report on the context within which the effectiveness of the Council's Treasury Management activity should be considered.

2 Summary

2.1 The Annual Report on the Council's Treasury Management activities for 2011/12 was noted by Council on the 23rd of August 2012. However, an amendment was also passed which "Notes the need to provide contextual information which allows members of Finance and Resources to come to a judgement as to the effectiveness of the performance of the Treasury Management function". This report attempts to address that need by outlining what functions are included within Treasury Management, stating the critical success factors against which its effectiveness should be judged, and considering the Treasury function against some of those key factors. The report should be considered in conjunction with the Annual Report to which it refers.

3 Main Report

Background

3.1 Treasury Management is defined as:

> *"The management of the Authority's 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. "*

Treasury Management covers:

- Capital Financing
- Cash Flow Forecasting and Management
- Debt Portfolio Management
- Leasing Portfolio Management
- Investment of Surplus Funds
- Banking Facilities and Services

3.2 The scope of Treasury Management in the Council is substantial with a debt portfolio of around £1.5 billion and investments of between £300 million and £525 million.

Treasury Management – Critical Success Factors

3.3 The overall strategic objective for Treasury Management is:
"The provision of quality treasury services. Effective treasury management ensures that resources are available when required, at the lowest cost and with managed risk. This maximises resources available to the Council for to spend on front line services."

3.4 Within this objective, the critical success factors against which the Treasury Management performance should be judged are the:

- Borrowing Strategy and the timing of its implementation;
- Success of the pro-active debt management;
- Investment performance;
- Cash flow accuracy;
- Best funding options taken for the Council;
- Exploitation of electronic banking and associated services; and
- Management of Risk.

Debt Management

3.5 The detailed objectives of Debt management are to:

- secure new funding at the lowest cost;
- ensure smooth debt profile with a spread of maturities;
- forecast average future interest rates and borrow accordingly; and
- reschedule debt to take advantage of interest rates

3.6 Treasury Management, and management of the debt portfolio in particular, has to be viewed in a long-term context. The decisions taken in the 90s still have a significant effect on the cost to the Council of its debt. Figure 1 below shows interest rates since the end of the 70s. When interest rates came down from 15% to 10% in the early 90s, significant long term debt was taken out at the new ‘attractive’ interest rates.

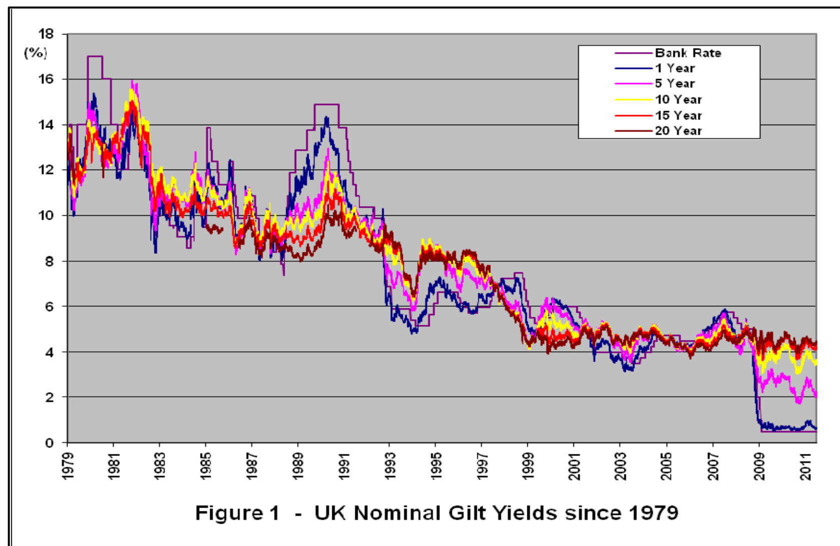

Figure 1 - UK Nominal Gilt Yields since 1979

3.7 Historical decisions such as those taken in the early 90s are one of the reasons it is very difficult to directly compare debt management activities and maturity profiles between authorities. There are a number of reasons why they may vary, including previous debt management decisions, the phasing of previous capital expenditure and the assets which were procured, the anticipated future capital expenditure programme, the Council's view of future interest rates, and its strategy for managing risk.

3.8 Comparing the actual debt servicing costs directly against other authorities is also problematical. In comparing debt servicing costs, you would need to consider other factors such as the debt maturity profile, historical effects, and the wider budgetary context. For example, when the Council had the opportunity to purchase Waverley Court both the absolute level of debt and the cost of servicing debt increased. However, since budgetary provision for leasing the building had already been made, there was a significant overall revenue saving to the Council, even before considering the resultant ownership of the building.

3.9 The Loans Pool Rate is the average interest rate which reflects the cost to the Council of its debt in a given year. Figure 2 below shows the reduction in the Loans Pool Rate since 2001/02 for the Urban Councils, which is the Peer Group for the City of Edinburgh Council, along with the average Council and average Urban Council.

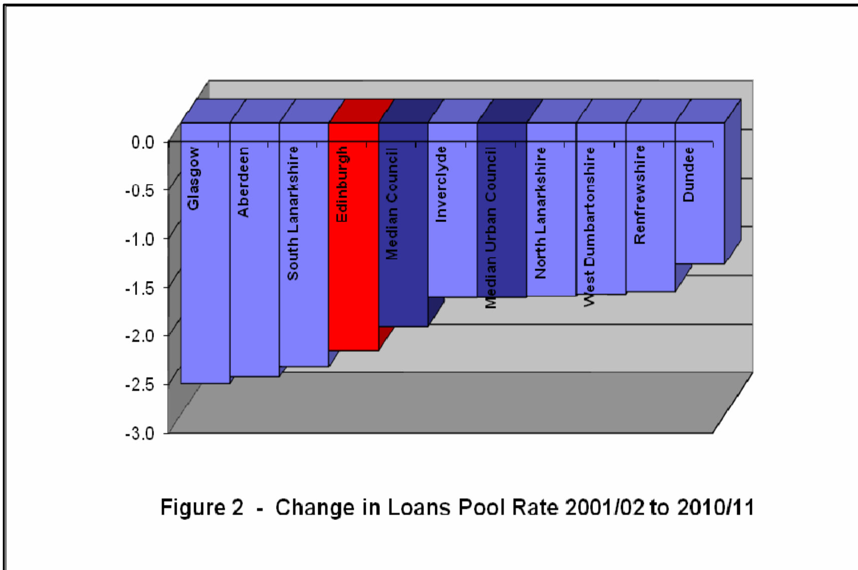

Figure 2 - Change in Loans Pool Rate 2001/02 to 2010/11

3.10 However, even with this comparison, other major considerations have to be taken into account. For example, Glasgow transferred their housing stock out of local authority control in 2003 and this involved HM Treasury writing off a significant amount of PWLB debt including older high coupon debt at no cost to the Council. Also, change in interest rates is only one element of the equation, with others being the maturity period of borrowing and the strategy applied by the authority to manage risk.

3.11 Figure 3 below shows the difference between the first five years following local government re-organisation and the subsequent nine years (as shown in Figure 2).

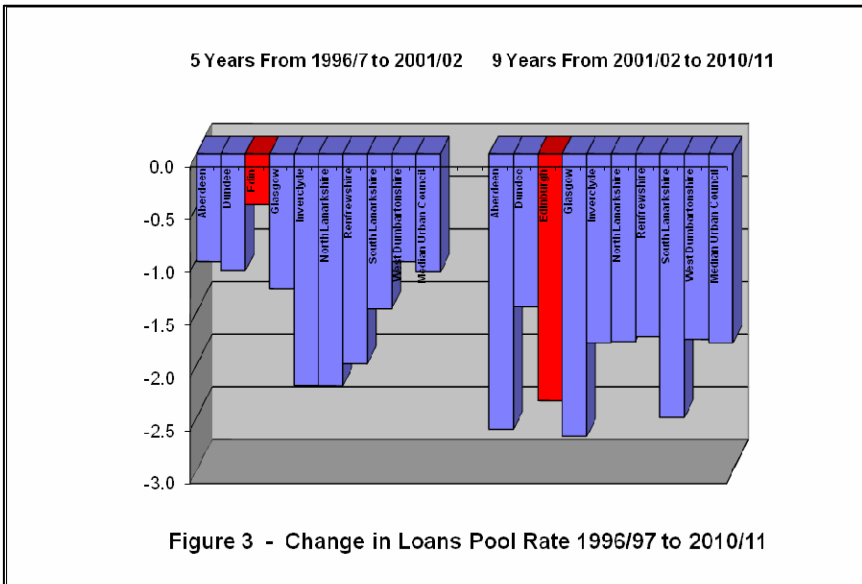

Figure 3 - Change in Loans Pool Rate 1996/97 to 2010/11

3.12 It is clear from the graph that a more pro-active debt management approach can make a substantial difference, depending on market conditions and the interest rate environment.

3.13 It could be thought that in a falling interest rate environment, the cost to the Council of its debt would naturally fall as a result of re-financing old higher interest rate debt at lower levels. However, this is only true if there is a significant amount of maturing debt and the absolute level of debt is not increased. Figure 4 below shows the debt maturity profile at the end of 2001/02.

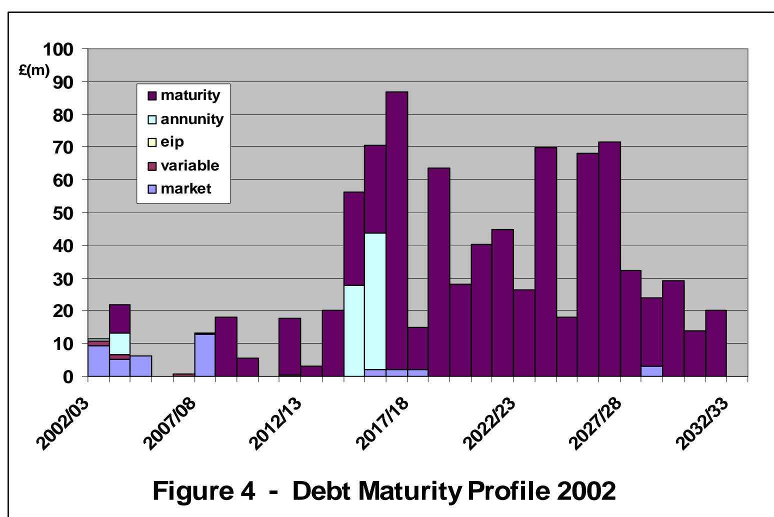

Figure 4 - Debt Maturity Profile 2002

3.14 Since the debt taken out in the 90s generally had a longer maturity to lock in the 'attractive' interest rates of around 10%, there was relatively little debt maturing in the early 2000s. Between 2002/03 and 2006/07 there was only a little over £40m of debt due to mature, and not all of that was high interest rate debt. Even if the debt could have been re-financed at 5% lower than the maturing debt, this would only give an annual saving of £2m. However, Figure 2 in the Annual Report shows an actual annual saving of over £14m. Indeed, Figure 2 in the Annual Report also shows that the Council took on an additional £60m of debt over that period, and if it had been borrowed at 5%, it would have more than wiped out any savings made from re-financing the maturing debt. The savings are therefore attributable to the opportunities which have been taken to pro-actively manage and restructure the Authority's debt portfolio. However, it should be noted that following the UK Government's introduction in 2010 of a separate rate for the premature repayment of PWLB debt, there is little scope for debt restructuring in the short to medium term. For information, Figure 5 below shows the current maturity profile

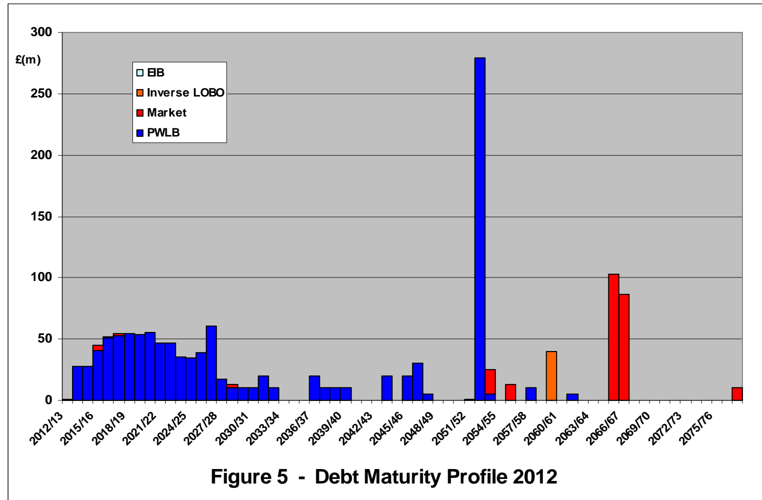

Figure 5 - Debt Maturity Profile 2012

3.15 Figure 6 below summarises the Borrowing by source.

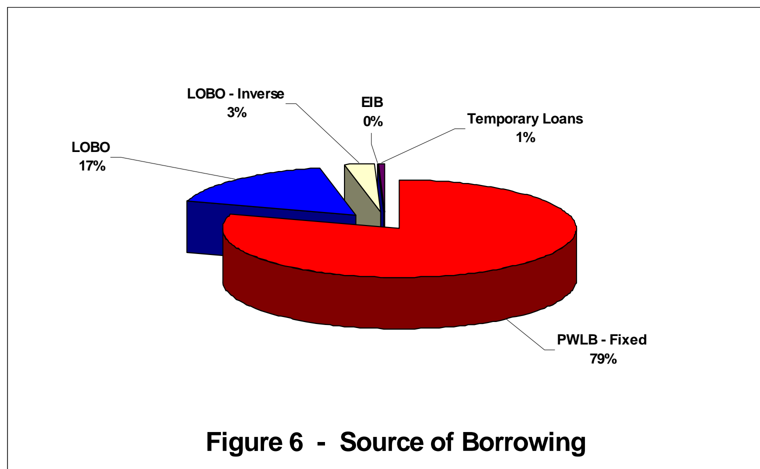

Figure 6 - Source of Borrowing

3.16 This shows that over three quarters of the Council's debt is fixed rate and is borrowed from the UK Government (via the Debt Management Office's Public Works Loans Board). Figure 7 below shows the maturity of this PWLB debt. The blue columns show the value of debt maturing in each financial year on the left hand scale, and the red bar shows the average interest rate of the maturing debt on the right hand scale.

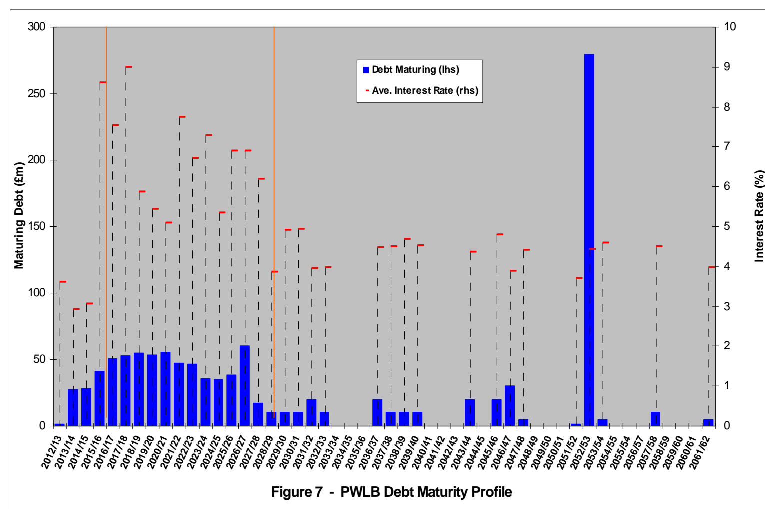

Figure 7 - PWLB Debt Maturity Profile

3.17 The debt maturity falls into three broad categories, delineated by the orange lines. Firstly, a small amount of relatively recently borrowed debt at low interest rates to give some flexibility to the portfolio. Secondly, a tranche of debt with a higher average interest rate which consists of the debt taken out in the 90s, averaged down with some more recent lower interest rate debt. It is probable that a fair proportion of this will have to be re-financed, but at interest rates between 5% and 9%, it is believed that this is likely to be manageable and may produce some further savings. Finally, the third tranche is a substantial amount of lower interest rate debt secured for the longer-term which is a good core element for the debt portfolio.

3.18 It is therefore considered that substantial savings have been released for front-line services through pro-active debt management (as shown in Figure 3 in the Annual Report). The Council also now has a reasonably well balanced debt maturity profile, albeit that some longer term debt will need to be shortened in the medium term when market conditions allow.

Investment of Surplus Funds

3.19 The Council's Cash Management arrangements were completely re-configured in 2007 to set up the Cash Fund to address the needs of Lothian Pension Fund and other key bodies for whom we manage surplus funds. The Council's surplus funds are now invested as part of a Treasury Cash Fund. The Treasury Cash Fund is a novel and innovative approach to managing the surplus funds of the City of Edinburgh Council, Lothian Pension Fund, Lothian & Borders Police Board and Lothian & Borders Fire and Rescue Service, Forth Estuary Transport Authority and other associated bodies. The monies of all the bodies are put together and managed equitably as one fund. The performance of the Cash Fund is measured against a benchmark of 7-day LIBID.

3.20 The key investment objective is to maximise the return on investments while managing the associated risk. However, the Cash Fund operates on a low risk low return basis, considering Security, Liquidity and Yield strictly in that order in line with the local authorities' Treasury Management Code of Practice and the requirements of key stakeholders such as Lothian Pension Fund. Never the less, while maintaining a high level of security, the Cash Fund has consistently returned significantly above both its benchmark and the average Money Market Fund (which is an equivalent private sector fund).

3.21 In the Annual Report, Figure 4 shows the Council's investment performance for 2011/12. To give a longer-term perspective, Figure 8 below shows the investment performance since the inception of the Treasury Cash Fund in April 2007.

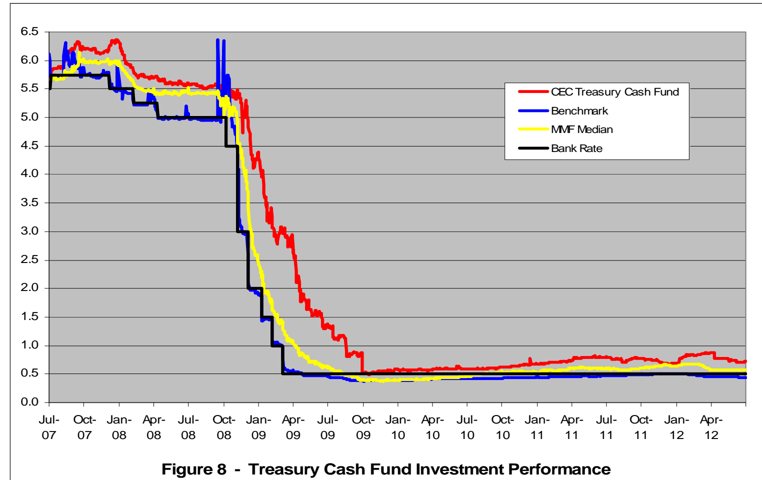

Figure 8 - Treasury Cash Fund Investment Performance

3.22 In the middle of the banking crisis, before interest rates dropped substantially, deposits were placed out longer with the more secure institutions, such as HSBC at attractive interest rates. The effect of this was that the Cash Fund outperformed its benchmark by up to 2.5% during that period.

3.23 Figures 5 and 7 in the Annual Report show the high level of security of the Cash Fund investments. However, not only has the Cash Fund's low risk approach been successful in ensuring the safe return of all principal invested, but as noted above it substantially outperformed the benchmark. Over the first three years since inception the strategy layered on top of the low risk approach for the Cash Fund generated an investment return of over £5.5 million in additional interest compared to performance in line with the benchmark.

3.24 Lothian Pension Fund effectively view Treasury as an external Fund Manager with a cash mandate. They receive quarterly investment report, have quarterly manager meetings and there is external verification of the Cash Fund's performance. Although initially appointed for a three year term in 2007, the Pension Fund renewed the mandate for a further three years in 2010.

Risk Management

3.25 Risk Management is a key role of the Treasury Management function. There are many, sometimes competing, risks which need to be managed. These include:

- Liquidity Risk
- Interest Rate Risk
- Inflation Risk
- Credit & Counterparty Risk

- Legal & Regulatory Risk
- Fraud, Error Corruption and Contingency Management
- Market Risk
- Opportunity Risk

3.26 The most important of these at any given time may vary depending on market conditions and the Council's circumstances. For example, through the banking crisis, managing the counterparty risk was, and indeed still remains, the key requirement for the Council. On the debt management side, at the bottom of the interest rate cycle, you don't want to be exposed to future interest rate rises with the need to finance or re-finance a lot of lower interest rate debt. However, in the right circumstances, some of these risks can also be opportunities. We have used variable rate PWLB in the past as part of debt restructuring to take advantage of a falling interest rate environment. Further, purchasing Waverley Court in 2009 was initially funded by temporary short-term borrowing from other local authorities, as a very flexible proxy for variable rate debt and not secured with longer term borrowing until later in 2010 at much lower interest rates.

Professional Competence

3.27 Treasury is a team of five within the Finance function of Corporate Governance. Between them, the team has the following qualifications:

2 x CIPFA/ACT Certificate in International Treasury Management – Public Finance
1 x CFA's Investment Management Certificate
1 x Chartered Banker
2 x Association of Accounting Technicians

In addition, a further two members of the team are part way through their qualification, having passed some of the required examinations:

1 x CFA's Investment Management Certificate
1 x CISI's Investment Operations Certificate

The Council's Treasury Manager is also Chair of CIPFA Scottish Treasury Management Forum, is a member of CIPFA's UK Treasury Management Panel, and won the 2010 Investment Officer of the Year award in the LGC Investment Awards which are open to all officers in finance and pension functions across the whole of the UK.

4 Financial Implications

4.1 Significant savings have been generated by Treasury Management activities over the last decade.

5 Equalities Impact

5.1 There are no equalities implications as a result of this report.

6 Environmental Impact

6.1 There are no environmental implications as a result of this report.

7 Conclusions

7.1 Substantial savings have been released for front-line services through pro-active debt management over a sustained period of time.

7.2 Additional cash income has been generated by the investment strategy while maintaining a low risk approach to investment.

7.3 It is therefore believed that the Treasury function has performed effectively over an extended period of time.

8 Recommendations

8.1 It is recommended that the Committee:

- notes this report; and
- considers the Treasury Management Annual Report 2011/12 within the context set out in this report.

Alastair Maclean
Director of Corporate Governance

Appendices	None
Contact/tel/e-mail	Innes Edwards (0131 469 6291)
Wards affected	All
Single Outcome Agreement	
Background Papers	Treasury Management Annual Report 2011/12 – 23 August 2012