

Treasury Management Indicators for Interest Rate Exposures

1. Background

The CIPFA Treasury Management Code of Practice obliges local authorities to set, monitor and report on several treasury management indicators, including the setting of upper limits on the level of exposure to both fixed and variable interest rates. This is an important tool in managing the financial affairs of the Council as it is intended to limit the risks the Council is exposed to through by short term borrowing and long-term investments i.e. the risk that changes in interest rates will create an unexpected or unbudgeted burden on the Council's finances.

The indicator currently reported for fixed and variable rate exposures is a maximum of £220m on both fixed and variable exposures. This indicator has a dual purpose – it provides management information to the County Treasurer on a monthly basis in order to consider as part of the financial health of the organisation, but also provides assurance to members on treasury management activity. It is important therefore, that the indicator provides an appropriate measure which can be relied upon.

2. Current Position

The Council's investment strategy is designed to reduce credit risk by accessing high credit quality institutions through bond investments as opposed to placing fixed term deposits directly with banks. This continues to be the County Council's preferred strategy given the continued difficult credit environment.

However, following advice received from the County Council's treasury management advisers, Arlingclose Ltd, the way that the Council's bond portfolio should be reflected in the calculation of the indicator means as a consequence of this, the current methodology of calculating the Council's exposure to fixed and variable interest rates is no longer fit for purpose. The indicator currently reported for fixed and variable rate exposures is a maximum of £220m for both fixed and variable interest rate exposures. As a result of the inclusion of the bond portfolio as a variable rate investment, the Council has been over the limit for the variable rate exposure since June 2013. In addition, the Council is required to treat both borrowing and investments that mature within the financial year as variable, even though the interest rate on these instruments is at a fixed rate.

It is vital that the indicators used support the oversight of the treasury management strategy, and do not cause a change in strategy as a result of no longer being fit for purpose. The current strategy remains appropriate within the current economic context and it must be stressed that the above is an indicator not a limit.

However the Council's advisers, Arlingclose have been consulted on how to revise this indicator within the Code of Practice in order to effectively manage and have oversight of the Council's treasury management activities.

3. Interest Rate Risk Indicators Options for measurement

The Code of Practice gives four options for indicators on interest rate exposures.

- Option A - Amount of net principal borrowed – which is the current measurement
- Option B - Proportion of net principal borrowed
- Option C - Amount of net interest payable
- Option D - Proportion of net interest payable.

All the options are calculated based on net figures, recognizing that interest rate risk can be minimized by matching the maturity profiles of the borrowing and investment portfolios, so the interest rate risk of variable rate borrowing can be offset by holding variable rate investments.

Options B and D are considered unsuitable because the method of calculation does not reflect adequately the bond portfolio and would result in percentages that are either negative or greater than 100% which would not support the management process or provide assurance to members.

Arlingclose recommend the use of option C – expressing upper limits for interest rate exposure in terms of net interest payable. The advantage of this method is that it will allow more short-term and variable rate borrowing while market rates are low, but force the Council to progressively more short term and variable rate borrowing while market rates are low but force progressively more to be borrowed at fixed rates as rates rise, which is in underlying principle behind the Council's approach.

The fixed rate indicator would need to be set high enough to enable all borrowing to be at fixed rates. The County Council currently holds a total of £536m of variable rate borrowing, and £312m at a fixed rate of 3.45%. The fundamental premise is that once interest rates begin to rise, the Council will "lock" its borrowing at the lowest rate possible in order to minimise debt costs. To achieve this there must be a clearly defined trigger point at which the move from variable rate borrowing to fixed rate borrowing is made. It is the recommendation of the Chief Investment Officer that this be set at 5%. An upper limit of £37.6m would allow the current variable borrowing to be taken at a fixed rate of 5% in addition to the fixed rate borrowing already in place.

4. Additional Local Indicator – impact of a 1% rise

The Code of Practice encourages local authorities to set additional local indicators, where these would be more suited to local circumstances and would assist local management processes. A local indicator suggested by Arlingclose is to measure the exposure to interest rate risk using the same method as in the Council's annual statement of accounts.

This shows the theoretical impact on the revenue account of an immediate 1% rise in all interest rates over the course of one financial year, covering both investments and borrowings and clearly sets out the level of exposure to financial risk, which must then be considered alongside the probability of interest rate changes.

Annex 2 - Appendix A

One of the principles of the Treasury Management strategy is to enable the Council to manage financial risk, but to do so effectively it must consider the risk to the Council's financial position. This "local indicator" is currently considered as part of the County Treasurer's management of the treasury management strategy, but is suggested is incorporated into reports to members. Whilst this approach does not reflect accurately the complexity of the financial markets as interest rates do not unilaterally move by the same percentage, it is a good proxy for the overall impact.

As at 30 September, the calculation of the indicator demonstrates that the overall financial impact of a 1% increase in interest rates is £7.3m, taking into account the impact on both borrowing and investment.

The current treasury management strategy assigns a maximum limit of £25m for short term fixed deposit investments with UK and overseas banks holding current minimum credit ratings of P1/A1/F1. Arlingclose suggest that a similar limit could be put against the impact of a 1% rise indicator as the maximum amount of interest rate risk allowable under the policy.

Alongside this the Council should present the local indicator 'impact of an immediate interest rate rise of 1%' with a limit of £25m.

The County Treasurer monitors the interest rate situation closely to ensure that action is taken to ensure the Council's revenue budget is safeguarded; this indicator will give an additional means of assurance for members in relation to this.

If agreed by Cabinet, the revised indicators will be included in a revised Treasury Management Strategy which will be presented to the meeting of the Full Council for approval on 12 December 2013.