DEVON AND CORNWALL POLICE AUTHORITY
21 MAY 2004

Report of the Treasurer

TREASURY MANAGEMENT

(i) Report on Treasury Management Activities for 2003-04

Introduction

1. The Resources Committee, through the Budget Working Party sub group, approved the Treasury Management Strategy for 2003-04 in March 2003. This report provides information on progress and outcomes against the approved strategy.

Summary of Approved Strategy for 2003-04

2. The approved strategy incorporated a brief economic overview. This envisaged that small downward movements in interest rates were likely, at least until the autumn. It also stated that conditions were likely to favour low risk assets. In the event, both these statements proved correct. Interest rates fell to 3.5% in July 2003, followed by increases in November 2003 and February 2004 to a rate of 4% at the end of the financial year.

3. The strategy determined that:

- Investec and Morley were to be retained as external investment managers
- Devon County Council was to be retained to provide day to day cash management
- Investments were to be transferred from the external investment managers to Devon County Council in or around May 2003 in order to support the day to day cash balances, in line with cash flow forecasts
- There should be an option to undertake long term external borrowing in order to provide for capital expenditure
- Barclays were to be retained as the Authority's bankers
- The Authority was to operate within defined borrowing limits
- Quarterly Treasury Management monitoring reports were to be produced for the Resources Committee

Implementation and Outcomes of the Strategy

<u>External Investment Managers</u>

4. The investment managers were set a target of exceeding a benchmark rate of return, the 7 day LIBID rate. In effect, the 7 day rate is the rate of return that can be achieved on the interbank market for cash deposits of 7 days and is regarded as a standard benchmark. The 7 day rate is calculated on a daily basis and averaged over the year.

5. The performance for the year, in respect of rates of return, is noted below.

	Rate of Return %
Benchmark	3.5900
Investment Manager A	2.7577
Investment Manager B	3.3290

6. Overall, the performance of both investment managers has been disappointing. The main issue was the exposure of both managers to government bonds, with manager A having a greater exposure than manager B. The issuance of significant levels of bonds world wide in the early part of the financial year, combined with improving economic activity, resulted in a marked reduction in the capital value of bonds. There was little prospect of this reversing in the short term and, consequently, bonds were sold during the year and losses taken. Neither manager has held bonds on our behalf for some months. It is worth noting that the performance of both managers for the final quarter of the year was close to benchmark.

7. The overall performance since inception in May 2001 has been more encouraging and the results are noted below.

	Rate of Return %
Benchmark	11.7218
Investment Manager A	12.1828
Investment Manager B	12.1790

8. Since inception, the Authority has benefited from an additional income of some £102,000 by exceeding the benchmark, after accounting for the losses in 2003-04. It should be noted that much of this has been achieved through investment in government bonds in earlier years.

9. In cash terms, the investment managers earned some £800,000 for the Authority during the year.

<u>Day to Day Cash Management</u>

10. Daily cash management by Devon County Council involves short term borrowing in order to cover temporary shortfalls in cash and short term lending in order to improve returns from temporary surpluses of cash. The County Council undertakes low risk cash deposits only. They do not invest in government bonds. £4 million was transferred from the investment managers in May, in order to support the day to day cash balances.

11. The performance of Devon County Council has been excellent. Their rate of return on temporary lending was 3.6124%, which exceeded the benchmark of 3.59% set for the investment managers. The cost of borrowing was 3.5711%. The level of cash balances available for temporary investment increased as the year progressed. This meant that borrowing was only undertaken for one day during the last two months of the year and significant balances were available for temporary investment on most other days. Under other circumstances, this may have prompted a transfer of funds to the two external investment managers. However, these funds were retained within the Authority's bank accounts, reflecting the relative performance on investments over the year. This helped Devon County Council to achieve cash returns of £136,000 for the year on behalf of the Authority.

12. Short term borrowing limits were not exceeded during the year. The maximum level of short term borrowing was around £8.5 million, against a borrowing limit of £15 million. This was in line with normal daily cash flow fluctuations.

Long Term Borrowing

13. The Authority undertook long term external borrowing of £2.328 million in November 2003, maturing in 25 ½ years and at an average interest rate of 5.004%. This was to provide for capital expenditure on land and buildings with an estimated life cycle to match the length of the loan. The level of borrowing was within the long term borrowing limit of £7.5 million.

14. At the end of the financial year, the Authority had used some £5.1 million of 'internal' borrowing in order to support previous capital expenditure (subject to approval of 2003-04 outturn in July). This will need to be financed at some stage, but there is no immediate requirement to do so.

Other Issues

15. The overall result for the year was that the net income arising from investment and borrowing activities was marginally better than the budget, with both income returns and debt repayments lower than anticipated.

16. Following approval of the strategy, a three year contract was negotiated with Barclays from 1 April 2003, at moderately reduced charge rates, for the provision of banking services. Feedback from users is that the service is operating effectively.

17. Detailed quarterly monitoring reports have been presented to the Resources Committee during the year. These have included information on the performance of investment managers, forecasts of income levels and the cost of borrowing compared to the budget, cash flow analysis and rates of long term borrowing.

Conclusion

18. The strategy was implemented as agreed. Generally, the strategy was successful, although the returns for the year from the investment managers were disappointing. The decision was made to borrow long term for the first time, although in the context of the Police Authority budget, the annual repayments are modest. The current strategy is of a continuation of existing policies, subject to performance.

Recommendation: That the report be noted

(ii) The 2004-05 Treasury Management Strategy

Classification of specified and non specified investments

1. The approved investment strategy was based upon draft guidance issued by the Office of the Deputy Prime Minister, which was finalised subsequent to the Authority meeting in February. There was some confusion within the guidance as to what constituted a specified or non specified investment. Authorities are free to use both, but are required to be more explicit about their use of non specified investments, as these can carry more risk.

2. The strategy determined that the Authority would use only specified investments, reflecting our attitude to risk. This was intended to cover UK government bonds and certificates of deposits with a maturity date in excess of one year. However, clarification has been received in recent weeks that such investments are now to be categorised as non specified.

3. Therefore, it is recommended that the external investment managers be allowed to trade in non specified investments, limited to UK government bonds with maturity dates in excess of one year and certificates of deposit with maturity dates in excess of one year but no more than two years. This reflects previously agreed practice.

4. The performance of the investment managers since inception has highlighted the potential greater level of risk and return associated with longer term investments. The current treasury management policy allows the investment managers to place up to 50% of the fund into government bonds. Given that the Authority must take into account security, liquidity and yield in its investment policies, it is proposed that this figure be reviewed.

5. It is recommended that each investment manager be allowed to trade up to 30% of its portfolio value in non specified investments. In effect, neither manager has exceeded the 30% limit in its activities to date. The use of longer dated certificates of deposit will be restricted to the approved lists already with the investment managers or any approved amendments.

6. Other investment instruments are available to the Authority which would come under the category of non specified. The use of these could be considered in the future and would be discussed with members before being employed. However, at this stage, it is intended that non specified investments will be limited to UK government bonds and certificates of deposit.

Credit Ratings

7. The Authority is required to define what it considers to be a ‘high’ credit rating. The strategy stipulated credit ratings of at least AA- for specified investments. This is suitable for all current transactions undertaken by the investment managers and for most of the transactions undertaken by Devon County Council. For cash managed by the County Council, there are instances where institutions will not accept levels of investments that are below their threshold. However, there is an opportunity to place deposits with other institutions who will accept smaller levels of cash. Typically, these are high street building societies that have a long term credit rating of A and short term credit rating of Fitch 1 (Fitch is a credit rating agency). The risk associated with these investments is low, but there is an opportunity to achieve better returns than would otherwise have been available. Ratings of A or better long term and Fitch 1 or better short term can safely be treated as ‘high’.

8. Therefore, it is recommended that, for Devon County Council, the credit ratings to be used for specified investments are A for long term and Fitch 1 for short term, as is the case for the County Council's own investments.

Recommendations:

(i) **That the external investment mangers be allowed to use non specified investments in respect of UK government bonds with a maturity date in excess of one year and certificates of deposit with a maturity date in excess of one year but not more than two years;**

(ii) **that such investments constitute a maximum of 30% of the value of the portfolio for each fund manager;**

(iii) **that, for Devon County Council, the credit ratings to be used for specified investments are A for long term and Fitch 1 for short term and that these ratings be defined as 'high' for this purpose.**

John Glasby
Treasurer