

# SECTION 1

## Introduction

### 1.1 PURPOSES OF THE TREASURY RISK MANAGEMENT TOOLKIT

---

This publication provides a toolkit of techniques and reports that local authorities can use to identify, benchmark and manage their treasury risks.

Risk management is at the centre of public service treasury management. CIPFA's Treasury Management Code<sup>1</sup> defines treasury management in risk management terms:

*The management of the organisation's investments and 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.*

This expects a 'best value' approach in which authorities seek to minimise the cost of borrowing (or maximise the returns from investment), subject to the overriding management of risks, with risk limitation being more important than return.

However, the culture, techniques and measurement of treasury management often seem still to focus more on return than on risk management, perhaps because return is easier to quantify and the short-term revenue impact is more obvious.

CIPFA's Treasury Management Panel has for some time been promoting the risk management basis of treasury management, including a discussion paper in October 2008 and section 7 of the Code's Guidance Notes from 2009 onwards.<sup>2</sup>

The Treasury Management Code and its accompanying Guidance Notes provide a procedural and governance framework. But little has been published that provides guidance on the professional tools, techniques and analysis appropriate to public service organisations, which they should be using to manage their treasury exposures. This toolkit aims to address this gap.

The toolkit proposes the following risk management methodology for treasury decision making:

1. establish the organisation's risk appetite
2. establish quantified risk benchmarks which represent the agreed risk appetite, against which to measure the level of risk in the portfolio
3. take treasury decisions and manage the portfolio, relative to the agreed risk benchmarks
4. review outcomes and performance relative to the risk benchmarks.

---

1. *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes (2011 Edition)*, CIPFA, 2011.

2. *Treasury Management in the Public Services: Guidance Notes for Local Authorities including Police Authorities and Fire Authorities (2011 Edition)*, CIPFA, 2011.

Unless an acceptable level of risk is defined and benchmarked in this way, authorities cannot know clearly what level of risk they are trying to manage to.

Benchmarking risk and return in this way is familiar in investment portfolio management (in particular, asset allocation benchmarks). However, benchmarks are not generally used to risk-manage debt portfolios. This publication therefore encourages authorities to develop their own **liability benchmark** as a means of managing debt risks.

In this context, 'risk benchmarks' refers to the organisation setting its own measures or standards for risk monitoring and management; it does not mean benchmarks in the sense of comparative statements with other organisations.

Standardisation of terminology will also help authorities express and discuss their treasury risks in a more consistent way, and encourage sharing and understanding between authorities. The glossary in this toolkit suggests some key terms so that a shared language can be developed.

The techniques and analysis in this publication aim to be practical and accessible, so that organisations can produce the risk management reports in house. We hope that external advisers and consultants will find the use of standard risk management reports to be helpful for their local authority clients, and will supplement them as appropriate with the use of more complex market inputs and analysis.

The proprietary treasury management systems used by local authorities should play a key role in providing risk management information. Such systems should produce a full reporting suite including risk management reports, and should also enable more sophisticated portfolio modelling and simulation tools.

This publication is intended mainly for treasury practitioners in local authorities. However, we hope that other public service organisations will find that the general methodology for managing treasury risks is relevant, and that the analysis covered by the templates is transferable even if the precise presentation needs adaptation.

Three recent developments are likely to have a significant impact on the conduct of local authorities' treasury management and the treasury risk they face.

First, in October 2010 the Government increased Public Works Loan Board (PWLB) loan margins to a full 1% over gilts (although it seems to be back-tracking from this at the time of writing in 2012). For many authorities, this introduces the possibility that market loans will be available at interest rates below the PWLB's, and this has the potential to fundamentally change the practice of treasury management in local authorities. Liquidity risk, for example, may become more of a concern for authorities seeking to avoid expensive PWLB borrowing, as it may not be possible to arrange market loans as quickly or reliably as PWLB loans. Authorities may need to develop skills relating to raising debt from market sources. In addition, authorities had previously managed interest rate risks in changing circumstances by the practice of prematurely repaying PWLB loans and replacing them at a different interest rate and maturity. This way of managing treasury risks is now effectively closed due to the PWLB's penal early repayment terms. Authorities are now left with few ways of rebalancing the risks in their loans portfolios.

Second, the Government's reform of the housing finance system now allows treasury risk management for the Housing Revenue Account (HRA) to be separated from the General Fund. Some housing authorities will have their loan debt substantially reduced. Most will have their loan debt significantly increased. Either way, there will be significant implications for the risk profile inherent in the revised debt portfolios. (This is discussed further in section 10.) Housing authorities will need to consider how to adapt these templates to take account of the way treasury risks and costs are shared between the HRA and the General Fund.

Third, the general power of competence included in the Localism Act 2011 suggests that it may in future be lawful for local authorities to use derivatives. Any authority that considers using derivatives will need to decide for itself whether it is lawful and appropriate. It is not in the scope of this publication to offer guidance on the use of derivatives. While derivatives are a powerful tool for risk management, they can also substantially increase risk in a portfolio. Authorities wishing to consider the use of derivatives should take appropriate advice and training in depth before developing any strategy that uses derivatives. The 2011 edition of the Treasury Management Code includes high-level requirements relating to the control and management of derivatives.

As part of its work on treasury risk management, CIPFA (through its Treasury Management Network) established the Treasury Management Risk Study in 2010. It was repeated in 2011 and will hopefully become a regular event. Authorities are encouraged to take part in the survey, which makes use of key concepts in this publication including the use of liability benchmarks, and provides advanced quantitative analysis of debt and investment portfolios that is not readily available elsewhere.<sup>3</sup>

This publication does not constitute statutory guidance, and it is not intended to be mandatory; we hope that the proposed methodology and reports will be of practical help to treasury practitioners in analysing and managing treasury risks. Authorities are invited to adapt and supplement them as appropriate for their own circumstances.

CIPFA's Treasury Management Panel does not consider this toolkit to be the final word by any means. It is work in progress in a developing field, and the panel hopes it will be used, debated and improved on by authorities themselves. The Treasury Management Panel and the Treasury Management Network would therefore welcome comments from local authorities, other users and interested parties, to improve the content for the future.

---

3. See [www.cipfanetworks.net/treasurymanagement](http://www.cipfanetworks.net/treasurymanagement)