DECISION-MAKER:	AUDIT COMMITTEE
SUBJECT:	REVIEW OF PRUDENTIAL LIMITS AND TREASURY MANAGEMENT OUTTURN 2010/11
DATE OF DECISION:	22 SEPTEMBER 2011
REPORT OF:	HEAD OF FINANCE (CHIEF FINANCIAL OFFICER)
STATEMENT OF CONFIDENTIALITY	
NOT APPLICABLE	

BRIEF SUMMARY

The purpose of this report is to inform Audit Committee of the Treasury Management activities and performance for 2010/11 against the approved Prudential Indicators for External Debt and Treasury Management.

This report specifically highlights that:

- Borrowing activities have been undertaken within the borrowing limits approved by Council on 16 February 2011.
- The investment portfolio returned £0.82M at an average rate of 1.02% in 2010/11 compared to 1.89% for 2010/11 as a result of continuing low interest rates and the fact that income earned in 2009/10 included deals arranged before the decline in the market which have since matured. The average rate achieved is above the performance indicator of the average 7 day LIBID rate (0.58%) mainly due to the rolling programme of yearly deals which was restarted in October 2010 following advice from our Treasury Advisors.
- In order to balance the impact of ongoing lower interest rates on investment income we have continued to use short term debt which is currently available at lower rates than long term debt. As a result the average rate for repayment of debt, (the Consolidated Loan and Investment Account Rate – CLIA), at 2.99% is lower than that budgeted for (3.17%) but slightly higher than last year (2.82%). It should be noted that the forecast for longer term debt is a steady increase over the next few years and new long term borrowing is likely to be taken out above this rate, leading to an anticipated increase in the CLIA (reaching 4.23% by 2013/14).
- Net loan debt increased during 2010/11 from £183M to £220M.

RECOMMENDATIONS:

It is recommended that Audit Committee:

(i) Notes the Treasury Management (TM) activities for 2010/11 and the outturn on the Prudential Indicators.

(ii) Notes that the continued proactive approach to TM has led to reduced borrowing costs (compared to that estimated) and safeguarded investment income during the year.

REASONS FOR REPORT RECOMMENDATIONS

1. The reporting of the outturn position for 2010/11 forms part of the approval of the statutory accounts. The TM Strategy and Prudential Indicators are approved by Council in February each year in accordance with legislation and the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice. The report was presented to Council in July 2011.

2. The TM Code requires public sector authorities to determine an annual TM Strategy and now, as a minimum, formally report on their treasury activities and arrangements to full Council mid-year and after the year-end. In addition, as part of the approved TM Strategy, the Chief Financial Officer will report to the Audit Committee on treasury management activity / performance as follows:

(a) A mid year review against the strategy approved for the year.

(b) An outturn report on its treasury activity, no later than 30th September after the financial year end.

These reports enable those tasked with implementing policies and undertaking transactions to demonstrate they have properly fulfilled their responsibilities, and enable those with ultimate responsibility/governance of the TM function to scrutinise and assess its effectiveness and compliance with policies and objectives.

ALTERNATIVE OPTIONS CONSIDERED AND REJECTED

3. No alternative options are relevant to this report.

DETAIL (Including consultation carried out)

CONSULTATION

4. Not applicable.

BACKGROUND

5. TM is a complex subject but in summary the core elements of the strategy for 2010/11 are:

- To continue to make use of short term variable rate debt to take advantage of the current market conditions of low interest rates.
- To constantly review longer term forecasts and to lock in to longer term rates through a variety of instruments as appropriate during the year, in order to provide a balanced portfolio against interest rate risk.
- To secure the best short term rates for borrowing and investments consistent with maintaining flexibility and liquidity within the portfolio.
- To invest surplus funds prudently, the Council's priorities being:
  - Security of invested capital
  - Liquidity of invested capital
  - An optimum yield which is commensurate with security and liquidity.
- To approve borrowing limits that provide for debt restructuring opportunities and to pursue debt restructuring where appropriate and within the Council's risk boundaries.

In essence, TM can always be seen in the context of the classic 'risk and reward' scenario and following this strategy will contribute to the Council's wider TM objective which is to minimise net borrowing cost short term without exposing the Council to undue risk either now or in the longer in the term.

6. TM is defined as:

"The management of the local authority'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."

7. Overall responsibility for TM remains with the Council. No TM activity is without risk; the effective identification and management of risk are integral to the Council's TM objectives.

8. This report:
   - is prepared in accordance with the revised CIPFA TM Code and the revised Prudential Code,
   - presents details of capital financing, borrowing, debt rescheduling and investment transactions,
   - reports on the risk implications of treasury decisions and transactions,
   - gives details of the outturn position on TM transactions in 2010/11 and
   - confirms compliance with treasury limits and Prudential Indicators.

   The report is to Audit Committee, which is responsible for scrutiny of the TM function, and was in addition also submitted to Council.

9. Appendix 1 summarises the economic outlook and events in the context of which the Council operated its treasury function for 2010/11 and shows the outlook for 2011/12.

BORROWING REQUIREMENT AND DEBT MANAGEMENT

10. The Council's underlying need to borrow as measured by the Capital Financing Requirement (CFR) as at 31 March 2011 was estimated at £360M. The Council's borrowing requirement during the year was £85M which included £28M for the replacement of maturing debt.

11. Following the Comprehensive Spending Review (CSR) on 20 October 2010, on instruction from HM Treasury, the Public Works Loans Board (PWLB) increased the margin for new borrowing to average 1% above the yield on the corresponding UK Government Gilt. New fixed rate borrowing increased by approximately 0.87% across all maturities and new variable rate borrowing by 0.90%. Premature repayment rates did not benefit from the increase in the margin which potentially makes future rescheduling of PWLB loans more challenging. Appendix 2 summarises interest rate movement during the year.

12. Whilst there are an increasing series of claims that a competitive, comparable equivalent to PWLB is readily available, the Council will adopt a cautious and considered approach to funding from the capital markets. The Council's treasury advisor, Arlingclose, is actively consulting with investors, investment banks, lawyers and credit rating agencies to establish the attraction of different sources of borrowing, including bond schemes, loan products and their related risk/reward trade off.

13. The Council funded £57M of its capital expenditure through new borrowing which included the addition of £25M new debt being taken out for the purchase of Number One Guildhall Square, with the PWLB at an interest rate of 4.62% over 40 years. The PWLB remained the Council's preferred source of borrowing given the transparency and control that its facilities continue to provide. In total, £85M of new long term loans were raised through the PWLB which included the replacement of maturing debt.

14. The Council also undertook short term borrowing as part of the normal day to day cash flow management activities undertaken within the TM function. This included borrowing from a range of organisations as outlined in the approved TM Strategy, including other Local Authorities where the rate available offered the most cost effective source of funds.

15. Activity within the debt portfolio is summarised below:

Capital Expenditure	Balance on 01/04/2010 £000's	Debt maturing or Repaid £000's	New Borrowing £000's	Balance on 31/03/2011 £000's	Increase/ (Decrease) in borrowing for Year £000's
Short Term Borrowing	34,337	(273,698)	274,680	35,319	982
Long Term Borrowing	121,661	(17,303)	85,000	189,358	67,697
Total Borrowing	**155,998**	**(291,001)**	**359,680**	**224,677**	**68,679**

	31-Mar-10 Actual £M		31-Mar-11 Actual £M	31-Mar-12 Estimate £M	31-Mar-13 Estimate £M	31-Mar-14 Estimate £M
External Borrowing:						
Fixed Rate – PWLB Maturity	60		80	105	125	135
Fixed Rate – PWLB EIP	27		63	107	93	81
Fixed Rate – Market	35		38	40	40	40
Variable Rate – PWLB	25		35	35	35	35
Variable Rate – Market	9		9	9	9	9
	156		225	296	302	300
Other Long Term Liabilities						
PFI / Finance leases	54		53	59	64	69
Deferred Debt Charges	19		18	18	17	16
Total Gross External Debt	229		296	373	383	385
Investments:						
Deposits and monies on call and Money Market Funds	(40)		(70)	(40)	(40)	(40)
Supranational bonds	(6)		(6)	(6)	(6)	(6)
Total Investments	(46)		(76)	(46)	(46)	(46)
Net Borrowing Position	**183**		**220**	**327**	**337**	**339**

16. The Council's use of internal resources (£80M) in lieu of borrowing has been the most cost effective means of funding past capital expenditure to date. This has lowered overall treasury risk by reducing both external debt and temporary investments. However, this position will not be sustainable over the medium term.

17. £35M of PWLB variable rate loans have been borrowed at an average rate of 0.70% which mitigates the impact of changes in variable rates on the Council's overall treasury portfolio - the Council's investments are deemed to be variable rate investments due to their short-term nature. The Council's variable rate loans were borrowed prior to 20 October 2010 (the date of change to the PWLB's lending arrangements post CSR) and are maintained on their initial terms and are not subject to the additional increased margin. This strategic exposure to variable interest rates will be regularly reviewed and if appropriate, reduced by switching into fixed rate loans.

18. Given the large differential between short and longer term interest rates, which is likely to remain a feature for some time in the future, as well as the pressure on Council finances; the debt management strategy sought to lower debt costs within an acceptable level of volatility (interest rate risk). Loans that offered the best value in the prevailing interest rate environment were PWLB variable interest rates loans, PWLB medium-term Equal Instalments of Principal (EIP) loans and temporary borrowing from the market.

INVESTMENT ACTIVITY

19. The Department for Communities and Local Government's (CLG) revised Investment Guidance came into effect on 1 April 2010 and reiterated the need to focus on security and liquidity, rather than yield. It also recommended that strategies include details of assessing credit risk, reasons for borrowing in advance of need and the use of treasury advisers.

20. Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its TM Strategy Statement for 2010/11. Investments during the year included:

- Deposits with the Debt Management Office
- Deposits with other Local Authorities
- Investments in AAA-rated Stable Net Asset Value Money Market Funds
- Call accounts and deposits with UK Banks and Building Societies
- Bonds issued by Multilateral Development Banks

21. The table below summarises activity during the year:

Capital Expenditure	Balance on 01/04/2010 £000's	Investments Repaid £000's	New Investments £000's	Balance on 31/03/2011 £000's	Increase/ (Decrease) in investment for Year £000's
Short Term Investments	30,580	(333,490)	332,210	29,300	(1,280)
Money Market Funds	9,645	(97,515)	128,445	40,575	30,930
EIB Bonds	6,000			6,000	0
Long Term Investments	36			36	0
Total Investments	**46,261**	**(431,005)**	**460,655**	**75,911**	**29,650**

22. The core element of the investment strategy is invest surplus funds prudently, the Council's priorities being:

- Security of invested capital
- Liquidity of invested capital
- An optimum yield which is commensurate with security and liquidity.

23. **Security / Credit Risk: The possibility that one party to a financial instrument will fail to meet their contractual obligations, causing a loss for the other party** Counterparty credit quality was assessed and monitored with reference to credit ratings (Council's minimum long-term counterparty rating of A+ across all three rating agencies, Fitch, S&P and Moody's); credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; any potential support mechanisms and share price. A maximum limit of £15M can be invested with a single counterparty subject to this being no more than 15% of total investments and in the case of money market funds being no more than 0.5% of any one individual fund. The Council also sets a total group investment limit for institutions that are part of the same banking group. 60% of total investments up to a limit of £50M can be invested for periods over one year.

The Council has no historical experience of counterparty default and does not expect any losses from non-performance by any counterparties in relation to its investments. Throughout 2010/11 the minimum criteria for new investments has been a long term rating of A+/A1/A+ (Fitch/Moody's/S&P) and a short term rating of F1/P-1/A-1 (Fitch/Moody's/S&P).

The table below summarises the nominal value of the Council's investment portfolio at 31 March 2011, and confirms that all investments were made in line with the Council's approved credit rating criteria:

Outstanding Investments as at 31 March 2011

Counterparty	Credit Rating Criteria Met When Investment Placed	Credit Rating Criteria Met on 31 March 2011	Under 1 Month	1-3 Months	3-6 Months	6-9 Months	9-12 Months	Over 12 Months	Total
	YES/NO	YES/NO	£'000's	£'000's	£'000's	£'000's	£'000's	£'000's	£'000's
UK									
Bank Deposits	YES	YES			8,000	7,000	4,000		**19,000**
Building Societies	YES	YES		2,000	2,000				**4,000**
Gov't & Local Authority Deposits	YES	YES	5,300				1,000		**6,300**
Money Market Funds	YES	YES	40,575						**40,575**
Bonds								6,036	**6,036**
Total Investments			45,875	2,000	10,000	7,000	5,000	6,036	75,911

24. **Liquidity: The possibility that a party will be unable to raise funds to meet the commitments associated with Financial Instruments.** In keeping with the CLG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds.

There is no perceived risk that the Council will be unable to raise finance to meet its commitments. The Council also has to manage the risk that it will not be exposed to replenishing a significant proportion of its borrowing at a time of unfavourable interest rates. The Council would only borrow in advance of need where there is a clear business case for doing so and will only do so for the current capital programme or to finance future debt maturities.

The maturity analysis of the nominal value of the Council's debt at 31 March 2011 was as follows:

Outstanding 31 March 2009	% of total debt portfolio	Outstanding 31 March 2010	% of total debt portfolio	Total borrowing	Outstanding 31 March 2011	% of total debt portfolio
£000's	%	£000's	%	Source of Loan	£000's	%
99,000	78	112,661	72	Public Works Loan Board	177,733	79
28,438	22	43,337	28	Other Financial Institutions	46,944	21
127,438	100	155,998	100		224,677	100
				Analysis of Loans by Maturity		
48,717	38	51,078	33	Less than 1 Year	48,413	22
17,066	13	9,357	6	Between 1 and 2 years	18,121	8
20,555	16	19,834	13	Between 2 and 5 years	19,561	9
1,159	1	36,729	24	Between 5 and 10 years	64,582	29
941	1			Between 10 and 15 years		
				Between 20 and 25 years	6,000	3
16,000	13			Between 25 and 30 years	10,000	4
8,000	6	21,000	13	Between 30 and 35 years	8,000	4
				Between 35 and 40 years	25,000	11
5,000	4			Between 40 and 45 years	10,000	4
10,000	8	18,000	12	Over 45 years	15,000	7
127,438	100	155,998	100		224,677	100

25. **Yield:** The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate was maintained at 0.5% since March 2009 and Short-term money market rates have remained at very low levels. The Council's investment income for the year was £0.82M against a budget of £0.64M. New deposits for periods up to one year have been made at an average rate of 0.73%. We have also reintroduced a rolling programme of yearly deals to support our core balances, to date we have invested £15M at an average rate of 1.6%.

COMPLIANCE WITH PRUDENTIAL INDICATORS

26. The Council can confirm that it has complied with its Prudential Indicators for 2010/11, approved by Council on 17 February 2010. The 2010/11 TM Strategy can be as Item 6 on the Council Meetings Agenda found via the following web link:

http://www.southampton.gov.uk/modernGov/ieListDocuments.aspx?CId=122&MId=249&Ver=4

These were subsequently revised as part of the Council's TM Strategy Statement for 2011/12 on 16 February 2011.

27. In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the TM activity during 2010/11. None of the Prudential Indicators has been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield. Details can be found in Appendix 3.

REFORM OF COUNCIL HOUSING FINANCE

28. In its publication Implementing self-financing for council housing issued in February 2011 the CLG set out the rationale, methodology and financial parameters for the initiative. Subject to the Localism Bill receiving Royal Assent and a commencement order being passed, the proposed transfer date is Wednesday 28 March 2012 - this fits with PWLB timetables on the payment/receipt of funds to clear by 31 March 2012.

29. The self-financing model provides an indicative sustainable level of opening housing debt. As the Council's debt level generated by the model is higher than the Subsidy Capital Financing Requirement (SCFR), the Council will be required to pay the CLG the difference between the two, which is currently estimated to be approximately £63M. This will require the Council to fund this amount in the medium term through internal resources and/or external borrowing. The Council has the option of borrowing from the PWLB or the market.

30. The TM implications of HRA reform and an appropriate strategy to manage the process are being actively reviewed with the Council's Treasury Advisor including the issues surrounding any early prefunding of the significant settlement payment (primarily the powers to borrow and the cost of carry).

RESOURCE IMPLICATIONS

Capital/Revenue

31. The report is a requirement of the TM Strategy, which was approved at Council on 16 February 2011.

32. The interest cost of financing the Authority's long term and short term loan debt is charged corporately to the Income and Expenditure account. The interest cost of financing the Authority's loan debt amounted to £5.7M in 2010/11 compared with an estimate of £6.2M, a reduction of £0.5M. This was mainly due to savings as a result of refinancing long term debt through the use of variable interest rates and 10 year EIP borrowing which currently remain significantly lower (0.88% and 2.46% as opposed to the estimated rate of 5.3% for a 30 year fixed maturity loan).

33. In addition, interest earned on temporary balances invested externally is credited to the Income and Expenditure account. In 2010/11, £0.8M was earned against a budget of £0.6M, an increase of £0.2M. This was a result of lower than expected interest rates in the depressed financial market and Appendix 1 gives further details surrounding the economic climate during 2010/11.

34. The expenses of managing the Authority's loan debt consist of brokerage and internal administration charges. These are pooled and borne by the HRA and General Fund proportionately to the related loan debt. Debt management expenses amounted to £139,100 in 2010/11 compared to an estimate of £132,000. This increase was mainly due to additional PWLB commission paid as a result of increased borrowing needs arising from additions to the capital programme, for example One Guildhall Square.

<u>Property/Other</u>

35. There are no specific property implications arising from this report.

LEGAL IMPLICATIONS

<u>Statutory Power to undertake the proposals in the report</u>:

36. Local Authority borrowing is regulated by Part 1, of the Local Government Act 2003, which introduced the new Prudential Capital Finance System.

37. From 1 April 2004, investments are dealt with, not in secondary legislation, but through guidance. Similarly, there is guidance on prudent investment practice, issued by the Secretary of State under Section 15(1)(a) of the 2003 Act. A local authority has the power to invest for "any purpose relevant to its functions under any enactment or for the purposes of the prudent management of its financial affairs". The reference to the "prudent management of its financial affairs" is included to cover investments, which are not directly linked to identifiable statutory functions but are simply made in the course of TM. This also allows the temporary investment of funds borrowed for the purpose of expenditure in the reasonably near future; however, the speculative procedure of borrowing purely in order to invest and make a return remains unlawful

<u>Other Legal Implications:</u>

38. None.

POLICY FRAMEWORK IMPLICATIONS

39. This report has been prepared in accordance with CIPFA's Code of Practice on TM and the TM Strategy approved by Council on 16 February 2011.

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SUPPORTING DOCUMENTATION

Non-confidential appendices are in the Members' Rooms and can be accessed on-line

Appendices

1.	Summary of the 2010 Economic Background and Outlook for 2011
2.	Summary of Interest Rates Movement During 2010/11
3.	Compliance with Prudential Indicators during 2010/11

Documents In Members' Rooms

1.	N/A

Integrated Impact Assessment

Do the implications/subject/recommendations in the report require an Integrated Impact Assessment to be carried out.	No

Other Background Documents

Title of Background Paper(s)		Relevant Paragraph of the Access to Information Procedure Rules / Schedule 12A allowing document to be Exempt/Confidential (if applicable)
1.	ANNUAL TREASURY MANAGEMENT STRATEGY AND PRUDENTIAL LIMITS 2011/12 TO 2013/14 – Audit Committee 3 February 2011 and Council 16 February 2011	

Integrated Impact Assessment and Other Background documents available for inspection at:

WARDS/COMMUNITIES AFFECTED:	None