DECISION-MAKER:	AUDIT COMMITTEE COUNCIL
SUBJECT:	TREASURY MANAGEMENT STRATEGY AND PRUDENTIAL LIMITS MID YEAR REVIEW
DATE OF DECISION:	22 SEPTEMBER 2011 16 NOVEMBER 2011
REPORT OF:	HEAD OF FINANCE (CHIEF FINANCIAL OFFICER)
STATEMENT OF CONFIDENTIALITY	
NOT APPLICABLE	

BRIEF SUMMARY

The Council approved a number of indicators on 16 February 2011. Following the September update of the Capital Programme and an analysis of Treasury Management (TM) activity during 2010/11 and between April and August 2011, these have been reviewed for 2011/12 and are reported in accordance with the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on TM and in line with the approved TM Strategy.

These indicators have been reviewed with the assumption that the revised Capital Programme presented to Council on 14 September 2011 was approved. The other Prudential Indicators reported in February are not affected by the update of the capital programme.

The core elements of the 2011/12 strategy were :

- To continue the use of variable rate debt to take advantage of the current market conditions.
- 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 maximise investment returns in line with the Annual Investment Strategy and to constantly monitor global markets to protect the security of our investments.

RECOMMENDATIONS:

AUDIT COMMITTEE

It is recommended that Audit Committee:

(i) Note the current and forecast position with regards to these indicators and endorses any changes.

(ii) Note that the indicators as reported have been set on the assumption that the recommendations in the Capital Programme Update report were approved. Should the recommendations change, the Prudential Indicators may have to be recalculated.

COUNCIL

It is recommended that Council:

(i) Approve any changes to the Council's Prudential Indicators as detailed within the report.

(ii) Note that the indicators as reported have been set on the assumption that the recommendations in the Capital Programme Update report were approved. Should the recommendations change, the Prudential Indicators may have to be recalculated.

(iii) Continue to delegate authority to the Chief Financial Officer (CFO), following consultation with the Cabinet Member for Resources, Leisure and Culture, to approve any changes to the Prudential Indicators or borrowing limits that will aid good treasury management. For example, increase the percentage for variable rate borrowing to take advantage of the depressed market for short term rates. Any amendments will be reported as part of quarterly financial and performance monitoring and in revisions to the TM Strategy.

REASONS FOR REPORT RECOMMENDATIONS

1. The Chartered Institute of Public Finance and Accountancy's Code of Practice for Treasury Management in Public Services (the "CIPFA TM Code") and the Prudential Code require local authorities to determine the Treasury Management Strategy Statement (TMSS) and Prudential Indicators on an annual basis and to report on them mid year and at year end.

ALTERNATIVE OPTIONS CONSIDERED AND REJECTED

2. Alternative options for borrowing would depend on decisions taken on the review of the capital programme, which were taken at Full Council on 14 September 2011.

DETAIL (Including consultation carried out)

CONSULTATION

3. The proposed Capital Programme Update report on which this report is based has been subject to separate consultation processes.

BACKGROUND

4.. The Local Government Act 2003 introduced a system for borrowing based largely on self-regulation by local authorities themselves. The basic principle of the new system is that local authorities are free to borrow as long as their capital spending plans are affordable, prudent and sustainable.

5.. CIPFA has defined Treasury Management as:

> *"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."*

6. The Council is responsible for its treasury decisions and activity. No treasury management activity is without risk. The successful identification, monitoring and control of risk is the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of TM activities will focus on their risk implications for the Council. The main risks to the Council's treasury activities are:

- Liquidity Risk - Inadequate cash resources.
- Market or Interest Rate Risk -Fluctuations in interest rate levels and thereby in the value of investments.
- Inflation Risks - Exposure to inflation.
- Credit and Counterparty Risk - Security of Investments.
- Refinancing Risks - Impact of debt maturing in future years.
- Legal and Regulatory Risk - Non-compliance with statutory and regulatory requirements, risk of fraud..

7. The Council acknowledges that effective TM will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in TM, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management. To aid the Council in carrying out its TM function, it has appointed TM Advisors (Arlingclose), who advise the Council on strategy and provide market information to aid decision making. However it should be noted that the decisions are taken independently by the CFO taking into account this advice and other internal and external factors.

8. All treasury activity will comply with relevant statue, guidance and accounting standards.

COMPLIANCE WITH PRUDENTIAL INDICATORS

9. All indicators to date complied with the Prudential Indicators approved by Council on 16 February 2011. Details of the performance against key indicators and proposed changes are shown below:

Capital Financing Requirement and Actual External Debt

10. The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose. In order to ensure that over the medium term net borrowing will only be for a capital purpose, the Council ensures that net external borrowing does not, except in the short term, exceed the CFR in the preceding year, plus the estimates of any additional capital financing requirement for the current and next two financial years.

It differs from actual borrowing due to decisions taken to use internal balances and cash rather than borrow. The following table shows the actual position as at 31 March 2011 and the estimated position for the current and next two years based on the capital programme submitted to Council on the 14 September:

Capital Financing Requirement	**2010/11 Actual £M**	**2011/12 Estimate £M**	**2011/12 Forecast £M**	**2012/13 Estimate £M**	**2013/14 Estimate £M**
Balance B/F	**310**	**360**	**360**	**369**	**372**
Capital expenditure financed from borrowing	59	11	19	12	10
Revenue provision for debt Redemption.	(6)	(8)	(7)	(7)	(7)
Movement in Other Long Term Liabilities	(3)	(3)	(3)	(2)	(3)
Cumulative Maximum External Borrowing	**360**	**360**	**369**	**372**	**372**

The above limits are set to allow maximum flexibility within TM, for example a full debt restructure. Actual borrowing is significantly below this as it reflects decisions taken to use internal balances and cash rather than to physically borrow and shows the position at a point in time. The table below shows the position as at 1 April 2011 and 31 August 2011 and the estimated position for the current and next two years based on the capital programme submitted to Council on the 14 September:

	Balance on 01/04/2011 £M	**Balance as at 31/8/2011 £M**	**2011/12 Estimate £M**	**2012/13 Estimate £M**	**2013/14 Estimate £M**
Borrowing	224,677	305,345	277,302	279,863	266,858
Other Long Term Liabilities	71,722	71,361	71,657	73,886	78,153
Total Borrowing	**296,399**	**376,706**	**348,959**	**353,749**	**345,011**

Authorised Limit and Operational Boundary for External Debt

11. The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of their indebted status. This is a statutory limit which should not be breached. The Council's Affordable Borrowing Limit, known as the ***Authorised Limit*** was set at £563M for 2011/12 (£486M for borrowing and £77M for other long term liabilities).

12. The ***Operational Boundary*** is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario of the debt position of the Authority, without the additional headroom included within the Authorised Limit. The Operational Boundary for 2011/12 was set at £542M (£471M for borrowing and £71M for other long term liabilities).

13. The CFO confirms that there were no breaches to the Authorised Limit and the Operational Boundary and during the period to the end of August 2011, borrowing at its peak was £309M, and there is no proposal to change these limits at this time.

Upper Limits for Fixed and Variable Interest Rate Exposure

14. These indicators, (shown below for 2011/12) ,set upper limits on the amount of net borrowing (total borrowing less investments) for fixed and variable interest rates and allow the Council to manage the extent to which it is exposed to changes in interest rates.

	Limits for 2011/12 %
Upper Limit for Fixed Rate Exposure	100
Compliance with Limits:	Yes
Upper Limit for Variable Rate Exposure	50
Compliance with Limits:	Yes

15. The upper limit for fixed rate exposure is 100% as in principal it may be necessary /desirable for all borrowing at a point to be at a fixed rate, although in practice this would be unusual.

16. The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of investments. The upper limit represents the maximum proportion of borrowing which is subject to variable rate interest and was set at 50%, although in practice it would be unusual for the exposure to exceed 25% based on past performance and the highest to date is 21%. The limit was set at a higher level to allow for a possible adverse cash flow position, leading to a need for increased borrowing on the temporary market and to take advantage of the low rates available through the Public Works Loans Board (PWLB) for variable debt.

There has been no adverse cash flow to date but it is proposed that the limit remain at 50%, in case of any slippage in expected capital receipts.

Maturity Structure of Fixed Rate Borrowing

17. This indicator sets limits on the amount of borrowing due to be repaid in a given period on fixed rate borrowing, thereby limiting large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

The table below shows the position as at 31 August 2011.

	Lower Limit %	Upper Limit %	Actual Fixed Debt as at 31/8/2011 £000's	Average Fixed Rate as at 31/8/2011 %	% Fixed Rate as at 31/8/2011 %	Compliance with set Limits?
Under 12 months	0	45	67,784	1.85	26.20	Yes
12 months and within 24 months	0	45	5,000	4.08	1.93	Yes
24 months and within 5 years	0	50	10,000	2.78	3.86	Yes
5 years and within 10 years	0	75	110,981	3.23	42.89	Yes
10 years and within 20 years	0	75	0	0.00	0.00	Yes
20 years and within 30 years	0	75	10,000	4.68	3.86	Yes
30 years and within 40 years	0	75	30,000	4.62	11.59	Yes
40 years and within 50 years	0	75	25,000	0.04	9.66	Yes
50 years and above	0	100	0	0.00	0.00	Yes
			258,764	**3.45**	**100.00**	

Total Principal Sums Invested for Periods Longer than 364 days

18. This indicator allows the Council to manage the risk inherent in investments longer than 364 days. This sets a maximum limit on the amount of money than can be invested for more than one year; the current approved limit is set at £50M, as shown below:

Upper Limit for total principal sums invested over 364 days	2010/11 Actual £M	2011/12 Approved £M	2012/13 Estimate £M	2013/14 Estimate £M	2014/15 Estimate £M
	50	50	50	50	50

19. Southampton City Council's core investment portfolio has been identified as being around £40M and on the advice of the Council's TM consultants a rolling programme of 1 year cash deposits was entered into to provide a greater degree of certainty and stability in returns generated. The aim was to place investments with start and maturity dates that are spaced at roughly equal gaps of 1 month, giving the Council the added benefit of the liquidity afforded by the upcoming rolling maturity of deposits to provide opportunities to invest in whichever investments offer the best fit solution to the risk/reward appetite of the Council at that time. This programme has currently been suspended and maturities have been limited to 6 months due to current uncertainties in the market at present and will be kept under review. The amount invested for more than 364 days as at 31 August 2011 was £21M, plus £6M in long term bonds.

Ratio of Financing Costs to Net Revenue Stream

20. The ratio of financing costs to the Council's net revenue stream is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet borrowing costs.

The upper limit for this ratio is currently set at 10% to allow for known borrowing decision in the next two years and to allow for additional borrowing affecting major schemes. The table below shows the likely position based on the proposed capital programme.

Ratio of Financing Costs to Net Revenue Stream	2010/11 Actual %	2011/12 Approved %	2011/12 Estimate %	2012/13 Estimate %	2013/14 Estimate %
General Fund	4.89	7.09	4.87	8.43	9.09
HRA	4..46	5.75	5.62	7.50	8.69
Total	**6.01**	**7.49**	**6.49**	**8.25**	**8.47**

The definition of financing costs is set out at paragraph 87 of the Prudential Code and the ratio is based on costs net of investment income.

SUMMARY

21. In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of TM activity up to the 31 August 2011. As indicated in this report none of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

22. In addition to the CIPFA's requirement to produce a mid and year end report, each quarter as part of corporate monitoring a summary of TM activity is prepared. This is presented to Cabinet as part of the Quarterly Revenue Financial Monitoring report and is available in Members Rooms on request from the report author.

RESOURCE IMPLICATIONS

<u>Capital</u>

23. The Capital implications were considered as part of the Capital Programme Update report submitted to Council on the 14 September 2011.

<u>Revenue</u>

24. The revenue implications are considered as part of ongoing monitoring which is reported to Cabinet each Quarter and as part of the budget setting process.

<u>Property/Other</u>

25. None

LEGAL IMPLICATIONS

Statutory Power to undertake the proposals in the report:

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

Other Legal Implications:

27. None

POLICY FRAMEWORK IMPLICATIONS

28. This report has been prepared in accordance with CIPFA’s Code of Practice on Treasury Management

AUTHOR:	Name:	Alison Chard	Tel:	023 80 4897
	E-mail:	Alison.Chard@southampton.gov.uk		

SUPPORTING DOCUMENTATION

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

Appendices

1.	None

Documents In Members' Rooms

1.	QUARTERLY TREASURY MANAGEMENT REPORT – QUARTER 1 (MONTH 3) 2011/12 – Cabinet 5 September 2011

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 – Council 16 February 2011	

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

WARDS/COMMUNITIES AFFECTED:	