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Wednesday, 14th November 2012
at 2.00 pm

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MEMBERS' ROOM DOCUMENTS

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20 TREASURY MANAGEMENT STRATEGY AND PRUDENTIAL LIMITS MID YEAR REVIEW

Quarterly Treasury Management Report – Month 3

Tuesday, 6 November 2012 DIRECTOR OF CORPORATE SERVICES

APPENDIX 11

QUARTERLY TREASURY MANAGEMENT REPORT – MONTH 3

1. Background

Treasury Management (TM) is a complex subject but in summary the core elements of the strategy for 2012/13 are:

- To make use of short term variable rate debt to take advantage of the continuing 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.

The main activities undertaken during 2012/13 to date are summarised below:

- Investment returns during 2012/13 will continue to remain low as a result of low interest rates, with interest received estimated to be £0.7M. However, the average rate achieved to date for fixed term deals (1.39%) exceeds the performance indicator of the average 7 day LIBID rate (0.76%) mainly due to residual deals from the rolling programme of yearly deposits placed last year which is currently suspended due to uncertainty in the market place. New investments are placed in instant access accounts or term deposits up to 100 days depending on advice of our Treasury advisors.
- In order to continue 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 due to the depressed market. As a result the average rate for repayment of debt, (the Consolidated Loans & Investment Account Rate – CLIA), at 3.26% is lower than that budgeted for but slightly higher than last year which is in line with reported strategy. The predictions based on all of the economic data are that this will continue for an extended period. However, it should be noted that the forecast for longer term debt is a steady increase in the longer term and so new long term borrowing is likely to be taken out above this rate, leading to an anticipated increase in the CLIA (reaching 3.52% by 2013/14).

2. Economic Background

The UK economy contracted by 0.3% in the first calendar quarter of 2012 and by 0.2% in the twelve months to March 2012. Surveys and employment data had, however, shown a stronger tone than official figures (CIPS surveys were more consistent with positive quarterly GDP growth of around 0.2%), prompting questions about data accuracy. There was an expectation that growth would once again register a fall in the second quarter. Looking forward into the rest of the year, it is difficult to forecast GDP gaining any significant positive traction whilst uncertainty over Europe persists.

Inflation which had remained stubbornly sticky throughout 2011 slowly began to fall. CPI for May fell to 2.8%, the lowest level since November 2009, the first time it had dipped below 3% in two and a half years. The fall added strength to the argument for further Quantitative Easing (QE), particularly as the minutes of the Bank of England's June meeting revealed that additional QE was only narrowly outvoted by five to four; the four dissenting Committee members had voted for an increase in QE of between £25 billion and £50 billion. The close vote indicated that further monetary policy loosening would not be far away.

Banks' funding costs remained high, not least due to the capital requirements imposed by regulators. Tight credit conditions were one of the factors constraining growth. A new "funding for lending" scheme, announced by HM Treasury and the Bank of England, is intended to lower banks' funding costs, but with the economic outlook still so uncertain, its impact is likely to be muted if banks remained reluctant to lend and corporates and households refrained from taking on additional debt. Banks were embroiled in the scandal to manipulate LIBOR rates during the abnormal market conditions at the height of the 2007/08 financial crisis. Barclays was fined a record £290 million, the FSA was also investigating HSBC, RBS, Citicorp and UBS; Lloyds was named in a lawsuit in the US. The big-four UK banks were also being investigated for mis-selling interest rate swaps to small businesses.

The US Federal Reserve extended quantitative easing through 'Operation Twist', in which it buys longer-dated bonds with the proceeds of shorter-dated US Treasuries. In Europe, the formation in Greece, after a second round of parliamentary elections, of an alliance of pro-euro parties prevented an immediate and disorderly exit from the Euro. The region suffered a renewed bout of stress when Italian and Spanish government borrowing costs rose sharply and Spain was also forced to officially seek a bailout for its domestic banks. At the European summit in June, some progress was made after it was agreed to create a Europe-wide banking regulator, and change the rules to allow the ESM (the future permanent bailout fund) to inject capital directly into banks. The latter would be effected after a single supervisory mechanism for Eurozone banks had been established, implying it was not a near-term prospect.

3. Outlook for Quarter 2

The economic interest rate outlook provided by the Council's treasury advisor, Arlingclose Ltd, as at June 2012 is detailed below. Economic growth remains elusive; the economy contracted by 0.3% in the first quarter of 2012, and further downward revisions were made to Quarter 4 2011 GDP. Tight credit conditions, weak earnings growth and an uncertain employment outlook are constraining consumer and corporate spending. Therefore, the outlook is for official interest rates to remain low for an extended period. As a result of this revised forecast the Council will reappraise its strategy and, if needs be, realign it with evolving market conditions and expectations for future interest rates.

	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
Official Bank Rate													
Upside risk				0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk		-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25

4. Debt Management

Activity within the debt portfolio up to Quarter 1 is summarised below:

	Balance on 01/04/2012 £M	Debt Maturing or Repaid £M	New Borrowing £M	Balance as at 30/6/2012 £M	Increase/ (Decrease) in Borrowing for Year £M
Short Term Borrowing	0	0	0	0	0
Long Term Borrowing	300	(3)	0	297	(3)
Total Borrowing	**300**	**(3)**	**0**	**297**	**(3)**

Public Works Loan Board (PWLB) Borrowing: The PWLB remained an attractive source of borrowing for the Council as it offers flexibility and control. The continued low gilt yields during the quarter have resulted in PWLB rates remaining at close to historically low rates. The 5, 20 and 50 year PWLB rates fell by 23 basis points (bp), 43bp and 25bp respectively. However affordability and the “cost of carry” remained an important influence on the Council’s borrowing strategy alongside the consideration that for any borrowing undertaken ahead of need, the proceeds would have to be invested into a distressed financial market (credit risk) at rates of interest significantly lower than the cost of borrowing.

Alternative Sources: Whilst there are several claims that a competitive, comparable equivalent to PWLB is readily available, the Council will continue to 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.

As at the 31 March 2012 the Council used £66.5M of internal resources in lieu of borrowing which 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 and the Council will need to borrow to cover this amount as balances fall. The strategy set for 2012/13 expected to borrow £62 M for capital purposes by 2014/15 of which £29M related to externalising internal debt to cover the expected fall in balances and also to lock back into longer term debt prior to interest rises. However due to the continued and increased uncertainty in the markets and the expectations of interest rates staying lower for longer it may be appropriate to maintain the council use of internal resources for part or all of this amount; providing that balances can support it.

No borrowing is expected to be taken until the second half of the year when the 20 basis points discount on loans from the PWLB (announced in 2012 Budget Report) is expected to be implemented.

The Council has £35M variable rate loans which were borrowed prior to 20 October 2010 (the date of change to the lending arrangements of the PWLB post CSR) and are maintained on their initial terms and are not subject to the additional increased margin, they are currently averaging 0.70% and are helping to keep overall borrowing costs down.

Variable rate borrowing (currently between 1.46% and 1.48% for new borrowing) is expected to remain attractive for some time as the Bank of England maintains the base rate at historically low levels and the Council is currently expected to borrow an addition £25M at variable rates at an estimated 1.9% during 2012. Whilst in the current climate of low interest rates this remains a sound strategy, at some point when the market starts to move, the Council will need to act quickly to lock into fixed long term rates which may be at similar levels to the debt it restructured. Furthermore, the volatility in the financial markets means that interest costs and investment income will continue to fluctuate for some time.

In order to mitigate these risks the Council approved the creation of an Interest Equalisation Reserve in 2009. At that point a major debt restructuring exercise was undertaken in order to take advantage of market conditions and produce net revenue savings. The Interest Equalisation Reserve was created to help to manage volatility in the future and ensure that there was minimal impact on annual budget decisions or council tax in any single year. However, it should be noted that the sum set aside in the Interest Equalisation Reserve is a one off sum of money to help manage the initial transitional period during which the council will convert its variable rate loan portfolio to longer term fixed rate debt. The actual ongoing recurring revenue impact of switching to fixed rate long term debt will still need to be factored in to the budget forecasts for future years. Based on the current predictions of lower for longer interest rate forecasts, it is unlikely that this pressure will emerge in the short term, but it is likely to become a reality towards the back end of the Council's current medium term forecast horizon.

Debt rescheduling: The fall in PWLB repayment rates enlarged the premium / diminished the residual discounts on the premature repayment of debt, reducing the attractiveness of debt rescheduling during the quarter. No rescheduling activity was undertaken.

5. Investment Activity

The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles. The table below summarises activity during the year to date:

	Balance on 01/04/2012 £M	Investments Repaid £M	New Investments £M	Balance as at 30/6/2012 £M	Increase/ (Decrease) in Investment for Year £M
Short Term Investments	10	(11)	11	10	0
Money Market Funds	52	(94)	116	74	22
EIB Bonds	6	0	0	6	0
Long Term Investments	0	0	0	0	0
Total Investments	**68**	**(105)**	**127**	**90**	**22**

Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its TM

Strategy Statement for 2012/13. This has restricted new investments to the following institutions:

- Other Local Authorities;
- AAA-rated Stable Net Asset Value Money Market Funds;
- Deposits with UK Banks and Building Societies
- Debt Management Office.

Counterparty credit quality is assessed and monitored with reference to: Credit Ratings. The Council's minimum long-term counterparty rating is A+ (or equivalent) across 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; sovereign support mechanisms /potential support from a well-resourced parent institution; share price.

A break down of investments as at 30 June 2012 by credit rating at the end of the quarter and maturity profile can be seen in following table.

Current Rating	Initial Rating	Less than 1 Month £000's	1 - 3 Months £000's	3 - 6 Months £000's	6 - 9 Months £000's	9 - 12 Months £000's	Over 12 Months £000's	Total £000's
BBB	A+	0	0					0
A-	A-							0
A	A+	9,000	0					9,000
A	AA-		1,000					1,000
A+	A+	8,000						8,000
AA-	AA-							0
AA+	AA+							0
AAA	AAA	65,926	0			3,000	3,036	71,962
		82,926	**1,000**	**0**	**0**	**3,000**	**3,036**	**89,962**

Counterparty Update

Moody's completed its review of banks with global capital market operations, downgrading the long-term ratings of all of them by between one to three notches. The banks on the Council's lending list which were affected by the ratings downgrades were Barclays, HSBC, Royal Bank of Scotland, as well as Royal Bank of Canada, JP Morgan Chase, BNP Paribas, Societe Générale, Credit Agricole/Credit Agricole CIB, Credit Suisse and Deutsche Bank. Separately, the agency also downgraded the ratings of Lloyds Bank, Bank of Scotland, National Westminster Bank and Santander UK plc. None of the long-term ratings of the banks on the Council's lending list were downgraded to below the Council's minimum A-/A3 credit rating threshold.

Maturities for new investments with the residual banks on the Council's list were restricted as follows:

- Santander UK, Bank of Scotland, Lloyds TSB, NatWest and Royal Bank of Scotland for overnight deposits;
- Barclays Bank and Nationwide Building Society for a maximum period of 100 days;
- HSBC Bank and Standard Chartered for a maximum period of 6 months;

Please note that as a result of the down rating of Lloyds Bank to overnight, we currently have £9M of fixed term deposits which are outside these recommended limits. All of these deposits mature in July and our Advisors do not have any current concerns regarding these investments and do not advise clients to break existing term.

Authority Banking Arrangements: Along with many other authorities the Council uses the Co-op as its banker, which at the current time does not meet the minimum credit criteria of A+ (or equivalent) long term. However, there are not many banks actively in the tendering process for local authority banking, which would meet our criteria and it is a costly and complicated process. With this in mind, despite the credit rating being below the Authority's minimum criteria, it will continue to be used for short term liquidity requirements (overnight and weekend investments) and business continuity arrangements.

Budgeted Income and Outturn: The authority does not expect any losses from non-performance by any of its counterparties in relation to its investments. The Council's investment income for the year is currently estimated to be £0.7M. The UK Bank Rate has been maintained at 0.5% since March 2009 and short-term money market rates have remained at very low levels.

6. Compliance with Prudential Indicators

All indicators in Quarter 1 complied with the Prudential Indicators approved. Details of the performance against key indicators are shown below:

6.1. Capital Financing Requirement

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 2012 and the estimated position for the current and next two years based on the capital programme submitted to council:

Capital Financing Requirement	2011/12 Actual £M	2012/13 Approved Estimate £M	2012/13 Estimate £M	2013/14 Estimate £M	2014/15 Estimate £M
Balance B/F	**360**	**444**	**441**	**444**	**443**
Capital expenditure financed from borrowing	17	15	13	8	8
HRA Debt buyout	74	(8)	0	0	0
Revenue provision for debt Redemption.	(7)	(8)	(7)	(8)	(7)
Movement in Other Long Term Liabilities	(2)	(2)	(3)	(1)	(3)
Cumulative Maximum External Borrowing	**441**	**441**	**444**	**443**	**441**

6.2. Balances and Reserves

Estimates of the Council's level of overall Balances and Reserves for 2012/13 to 2014/15 are as follows:

	2010/11 Actual £M	2011/12 Actual £M	2012/13 Estimate £M	2013/14 Estimate £M	2014/15 Estimate £M
Balances and Reserves	56	70	33	33	33

6.3. Authorised Limit and Operational Boundary for External Debt

- 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 Authorised limit for borrowing was set at £832M for 2012/13.
- The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit.
- The Operational Boundary for borrowing 2012/13 was set at £794M.
- The Chief Financial Officer (CFO) confirms that there were no breaches to the Authorised Limit and the Operational Boundary and during the period to the end of June 2012 borrowing at its peak was £300M.

The above limits are set to allow maximum flexibility within TM, for example, a full debt restructure, actual borrowing is significantly below this as detailed below:

	Balance on 01/04/2012 £M	Balance as at 30/6/2012 £M	2012/13 Estimate £M	2013/14 Estimate £M	2014/15 Estimate £M
Borrowing	300	297	351	348	342
Other Long Term Liabilities	72	72	74	78	83
Total Borrowing	**372**	**369**	**425**	**426**	**425**

6.4. Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

- These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates.
- 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.

	Limits for 2012/13
Upper Limit for Fixed Rate Exposure	100%
Compliance with Limits:	Yes
Upper Limit for Variable Rate Exposure	50%

Compliance with Limits:	Yes

6.5. Total principal sums invested for periods longer than 364 days

- This indicator allows the Council to manage the risk inherent in longer term investments.
- The limit for 2012/13 was set at £50M
- Due to the current uncertainly in the market no more investments will be made unless the markets settle down and our advisors recommend it.

6.6. Maturity Structure of Fixed Rate Borrowing

This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

	Lower Limit %	Upper Limit %	Actual Fixed Debt as at 30/6/2012 £M	Average Fixed Rate as at 30/6/2012 %	% of Fixed Rate as at 30/6/2012	Compliance with set Limits?
Under 12 months	0	45	10	2.67	4.10	Yes
12 months and within 24 months	0	45	3	1.97	1.18	Yes
24 months and within 5 years	0	50	0	0.00	0.00	Yes
5 years and within 10 years	0	75	101	3.23	39.94	Yes
10 years and within 15 years	0	75	0	0.00	0.00	Yes
15 years and within 20 years	0	75	0	0.00	0.00	Yes
20 years and within 25 years	0	75	0	0.00	0.00	Yes
25 years and within 30 years	0	75	10	4.68	3.95	Yes
30 years and within 35 years	0	75	5	4.60	1.97	Yes
35 years and within 40 years	0	75	25	4.62	9.86	Yes
40 years and within 45 years	0	75	53	3.61	20.87	Yes
45 years and within 50 years	0	75	46	0.35	18.13	Yes
50 years and above	0	100	0	0.00	0.00	Yes
			253	**3.47**	**100.00**	

Please note: the TM Code Guidance Notes (page 15) states: "The maturity of borrowing should be determined by reference to the earliest date on which the lender can require payment. If the lender has the right to increase the interest rate payable without limit, such as in a LOBO loan, this should be treated as a right to require payment". For this indicator, the next option dates on the Council LOBO loans will therefore determine the maturity date of the loans.

6.7. Ratio of Financing Costs to Net Revenue Stream

This 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 definition of financing costs is set out at paragraph 87 of the Prudential Code.

The upper limit for this ratio is currently set at 10% for the General Fund 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 capital programme approved in February 2012 adjusted for actual borrowing made to 30 June 2012.

Ratio of Financing Costs to Net Revenue Stream	2011/12 Actual %	2012/13 Approved %	2012/13 Estimate %	2013/14 Approved %	2014/15 Approved %
General Fund	6.30	6.84	6.62	7.42	7.17
HRA	4.65	10.92	9.08	11.05	10.84
Total	**7.12**	**8.84**	**8.27**	**9.36**	**8.93**

7. Summary

In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the TM activity up to the 30 June 2012. 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.