Item No: 3.2	Classification: Open	Date: 22 February 2011	Meeting Name: Council Assembly
Report title:		Treasury Management Strategy 2011/12 Including - Annual Investment Strategy, Prudential Indicators, and Annual Minimum Revenue Provision Statement	
Wards or Groups affected:		All	
From:		Finance Director	

RECOMMENDATIONS

1. That the council assembly:

   (i) note the treasury management strategy 2011/12 to be managed by the finance director under financial delegation.

   (ii) agree the annual investment strategy 2011/12 set out in appendix A, keeping capital preservation as a key objective, in line with Government guidance on investments.

   (iii) agree prudential indicators covering capital finance, borrowing and cash management for the years 2011/12 to 2013/14 set out in appendix B.

   (iv) agree the annual minimum revenue provision statement 2011/12, which sets aside prudent sums from revenue to reduce debt, set out in appendix C.

   (v) agree a capital allowance of £168m, described in paragraphs 22 - 24, enabling the council to continue retaining capital receipts for affordable housing and regeneration.

BACKGROUND INFORMATION

2. Each year the council assembly agrees a treasury management strategy to manage it investments and debt. The investments represent balances, provisions and working capital to support the council's financial management and the debt funds the capital spending carried out in the past or due to be carried out in the near future. Investment and borrowing activity must be carried out in accordance with the Local Government Act 2003 and have regard to Government guidance on investments and sums set-aside as minimum revenue payment to repay debt as well as the Treasury Management in the Public Services Code of Practice and the Prudential Code for Capital Finance in Local Authorities, issued by the Chartered Institute of Public Finance and Accountancy, CIPFA.

3. Whilst the finance director is responsible for all executive and operational decisions on borrowings and investments under financial delegation, the council assembly remains responsible for approving a debt and investment management strategy, and prudential indicators on capital finance, which includes limits on investments and borrowing before the start of each year. The indicators help assess the affordability, prudence and

sustainability of financing activities and are part of a self-regulating regime brought in by the 2003 Act. An annual minimum revenue provision statement on sums to be set aside from revenue to reduce debt also needs agreeing each year.

4. The report further asks for a formal decision concerning capital allowances, which enable the council to carry on retaining receipts for affordable housing and regeneration that would otherwise pass to the Government under pooling arrangements. The council relies on securing these exemptions from pooling to invest in affordable housing and regeneration.

5. In 2010 additional reporting on treasury management was put in place, (following publication of CIPFA's update to its Treasury Management in the Public Services Code of Practice). As well as this annual strategy report, the council assembly also receives a mid year report and an annual outturn report after the end of the year. Quarterly updates are presented to cabinet and the audit and governance committee is asked to review and scrutinise treasury policies and strategy.

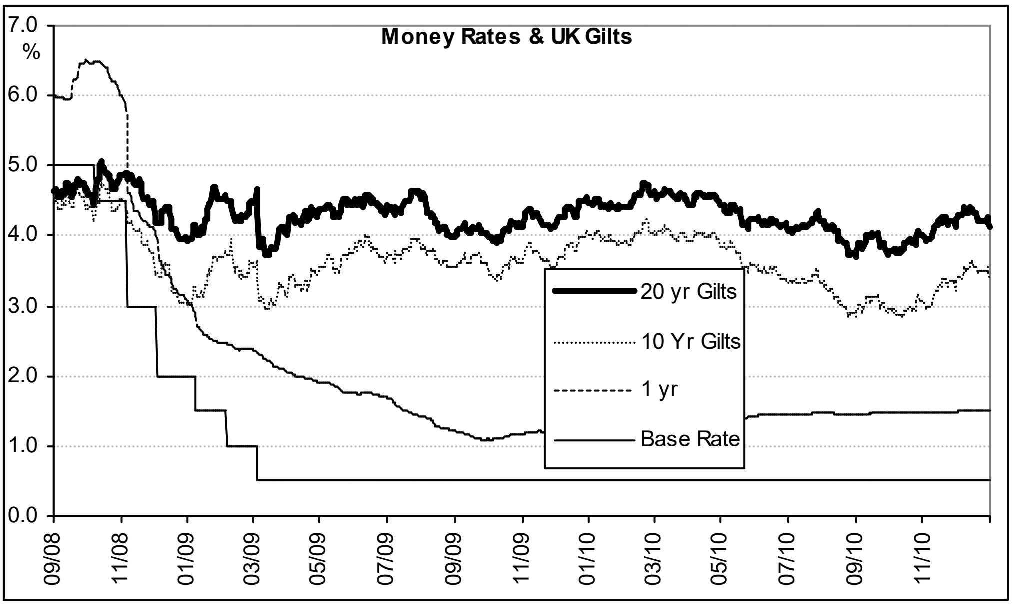
KEY ISSUES FOR CONSIDERATION

Treasury Management Strategy: Borrowing and Investments

Background - Developments in Financial Markets

6. Treasury management was carried out against a background of a slow recovery in major advanced economies, which followed a deep recession that created severe financial pressure not only for households and business but also for governments. In the US and UK expectations of further monetary stimulus initially helped lower government bond yields. But from November 2010 as market focus shifted to risks from adverse inflationary developments, yields experienced upward pressure; refer chart below. In the euro area, member states facing deteriorating economic prospects saw sovereign yields increase further and for Ireland market pressure was so high that it had to submit to an EU-IMF rescue package.

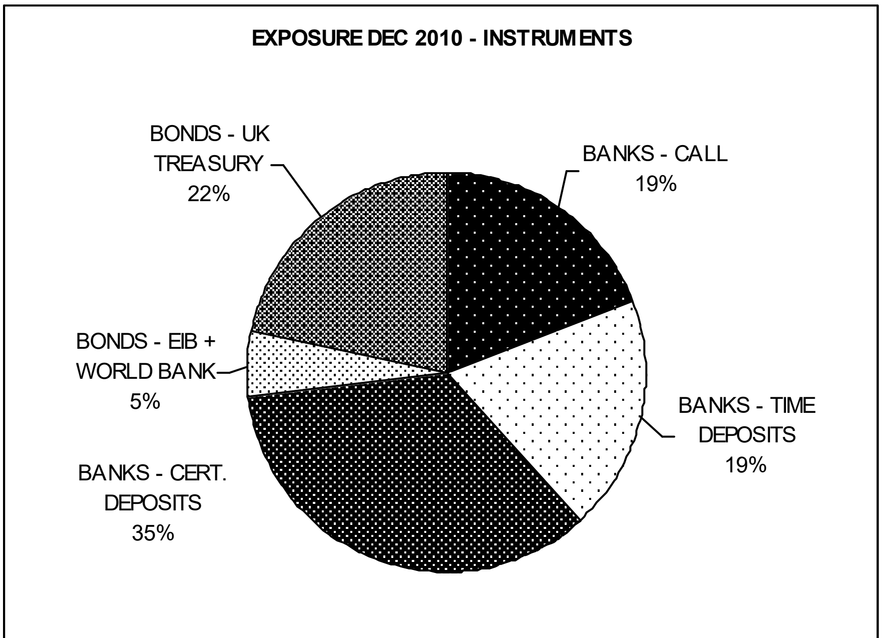
7. In the UK, the slow pace of growth came before a programme of substantial multi-year public spending cuts. In itself, the scale of the tightening has a dampening effect on the recovery, but against this the expansionary monetary policy which has been in place since the financial crisis intensified in September 2008 continues to benefit growth. Further monetary stimulus in the form of quantitative easing now seems less likely unless fiscal tightening has a bigger negative impact on growth than the market believes. Base rates, which have been almost nil since March 2009, are not expected to rise until the second quarter of 2011 at the earliest. But bond yields remain at risk, as investors anticipate withdrawal of monetary stimulus and seek protection from stronger inflationary developments.



Investment Management Position and Annual Investment Strategy

8. The sum held in investments at the end of December 2010 was £239m and is managed by an in-house operation and three external investment management firms: Invesco Asset Management Ltd, AllianceBernstein Ltd and Aberdeen Fund Management Ltd.

9. External managers provide access to liquid instruments and maturities beyond one year and expertise to help the council enhance long term returns, with capital preservation, liquidity, low market risk and prudence as priorities all within an agreed investment strategy. The exposure to long investments takes the form of liquid bank deposits and bonds issued or guaranteed by the UK Government or issued by multilateral banks. In-house funds focus on meeting day to day cash volatility using a number of call accounts and short term deposits. The investment holdings and instrument analysis at the end of December 2010 is set out below.



EXPOSURE - DEC 2010 COUNTERPARTY AND RATINGS										
Exposure £m	Fund					Fitch Ratings				
Counterparty	ABERDEEN	ALLIANCE BERNSTEIN	INVESCO	IN-HOUSE	Total	Long	Short	Sup-port	Sovereign	Sovereign Rating
BARCLAYS BK	6.5	0.5	6.5		13.5	AA-	F1+	1	UK	AAA
BANQUE NATIONAL DE PARIS		0.5			0.5	AA-	F1+	1	FRANCE	AAA
CREDIT AGRIC CIB	4.3		6.5		10.8	AA-	F1+	1	FRANCE	AAA
CREDIT INDUST ET COMRCL	5.4				5.4	AA-	F1+	1	FRANCE	AAA
DEUTSCHE BK				10.0	10.0	AA-	F1+	1	GERMANY	AAA
EUROPEAN INV BK	3.3	7.4			10.7	AAA	F1+		SUPRANATIONAL	AAA
FORTIS BK	5.1				5.1	A+	F1+	1	BELGIUM	AA+
GLOBAL TREAS FUNDS-MMF				5.0	5.0	AAA	F1+		GLOBAL	
HSBC	0.1	0.1	0.5		0.7	AA	F1+	1	UK	AAA
ING BK	5.0	0.3	3.4		8.7	A+	F1+	1	NETHERLANDS	AAA
INT BK RECONST DEVT		2.3			2.3	AAA	F1+		SUPRANATIONAL	AAA
LLOYDS TSB/BK SCOTLAND	6.0	0.5	6.5	15.0	28.0	AA-	F1+	1	UK	AAA
NATIONWIDE BSOC	3.2	0.5			3.7	AA-	F1+	1	UK	AAA
NORDEA BK FINLAND		0.5			0.5	AA-	F1+	1	FINLAND	AAA
RABOBANK		0.5			0.5	AA+	F1+	1	NETHERLANDS	AAA
RBS/NATWEST				33.9	33.9	AA-	F1+	1	UK	AAA
SANTANDER UK	6.5			15.0	21.5	AA-	F1+	1	UK	AAA
SOCGEN		0.5	6.5	10.0	17.0	A+	F1+	1	FRANCE	AAA
SVENSKA		0.6	6.5		7.1	AA-	F1+	1	SWEDEN	AAA
UBS	2.6				2.6	A+	F1+	1	SWITZERLAND	AAA
UK TREASURY	2.1	35.9	13.6		51.6	AAA	F1+		UK	AAA
Total	50.2	50.1	50.0	88.9	239.1					

10. In September 2010 the sum managed externally was reduced by £20.9m and brought in-house to ensure that cash demands over the course of the year can readily be met. This brings the sum managed externally down to £150m. Further sums may be brought in-house in 2011/12 if needed.

11. The average return for the 9 months to December 2010 was 0.79% against part year average base rates of 0.38%. The return reflects past activity and as investments mature and are reinvested, future returns are expected to remain low - reflecting uncertain economic prospects.

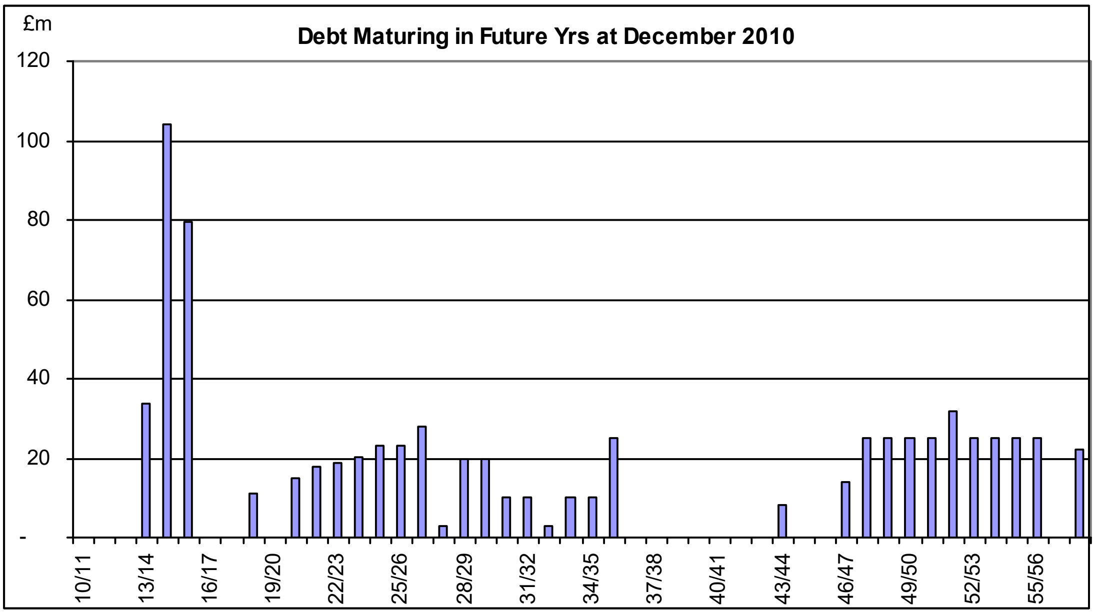
12. Throughout 2010, when market concern over sovereign risk in some euro countries increased, a cautious approach to council lending was maintained. No investment experienced credit loss and the focus remained on preserving capital and ensuring liquidity. Bank exposure was with major entities and in maturities not exceeding one year. It took the form of fixed term deposits, certificate of deposits (liquid short term deposits), call accounts or money market funds. Longer maturities took the form of UK government debt and supranational bonds such as with the IBRD (the World Bank) or the European Investment Bank.

13. This cautious approach to lending with focus on capital preservation and liquidity will continue into 2011/12. An investment strategy encompassing this approach and allowing the finance director flexibly to respond prudently to market developments is set out in appendix B. It is set out according to Government guidance on local authority investments and classifies investments into specified and non-specified investments. Specified investments are investments in sterling not more than one year in high rated institutions, the UK Government or local authorities. Non-specified investments are all other investments. The 2011/12 annual investment strategy requiring council assembly approval is set out at appendix B. It is the same as the annual strategy currently in force, but does require approval each year. Under Government guidance the strategy is to be published on the council's website.

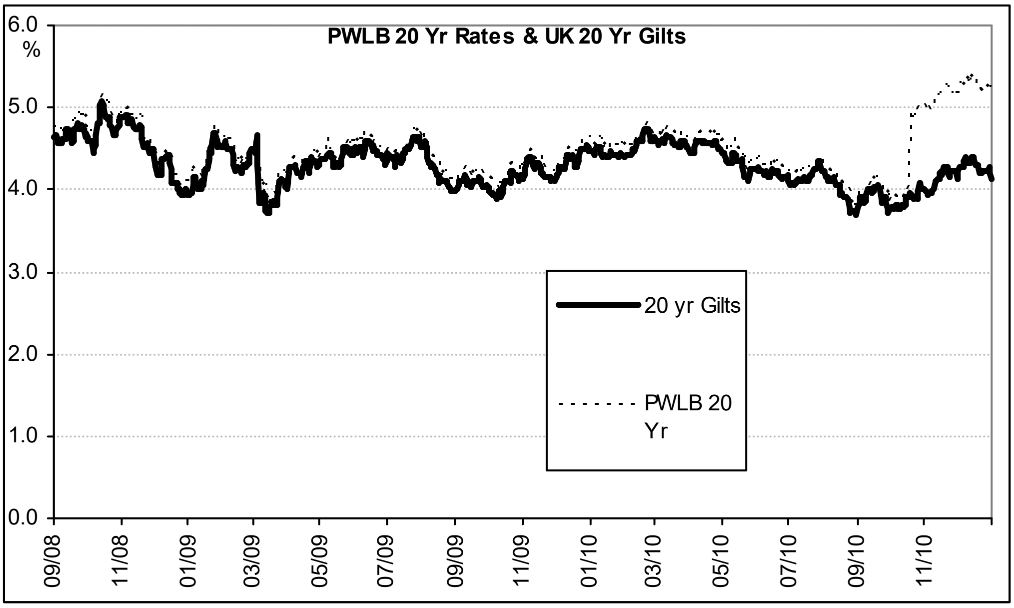
Debt Management Position and Strategy

14. The debt outstanding at the end of December 2010 was £762m and no new loans were taken in 2010. The debt represents sums borrowed to pay for current and past capital

expenditure. All debt is at fixed rates from the Public Works Loans Board (PWLB, HM Treasury's local authority lending arm). The average rate of interest across all loans is 6.94% and reflects a long period between the 1970's and early 1990's, unlike now, when high capital spending and debt funding coincided with years of high inflation and high interest rates. The chart below sets out the amounts maturing in each year and the earliest that loans fall for repayment is 2014. Loans falling for repayment are typically replaced with new loans unless they have been refinanced earlier.



15. Until recently local authorities were able to borrow at rates close to the rates the Government itself borrowed at. However following the comprehensive spending review in October 2010, the Government decided that councils will now have to pay one-percent more for any new borrowing taken from the PWLB. A chart showing how the margin above Government yields has changed is set out below.



16. The change does not affect the rate on existing loans but does mean that new loans to finance the capital programme will be more expensive than they would otherwise have been. The cost of refinancing maturing loans, for example the £200m or so maturing

between 2014 and 2016, would also be higher than otherwise – although the actual rate of interest between 2014 and 2016 will also be subject to developments in financial markets where the risk is that rates move higher from current levels than remain at historically low levels.

17. Interest rate risk is further increased by reforms to the system for supporting the Housing Revenue Account's (HRA) confirmed in the October 2010 comprehensive spending review and the 2010 Localism Bill. Currently around 80% of the debt is attributable to the HRA and reflected in subsidy at the actual average rate of interest prevailing each year. The reforms which come into effect in 2011/12 will replace the current national system for subsidising council housing with a locally run system. Under it, councils will keep their rental income and use it locally to maintain their homes. This will follow a one-off debt adjustment between the Government and each council. In Southwark's case, as the rental income is currently insufficient to maintain the homes and service the debt, there will be one-off a reduction in debt, bringing debt service costs and running costs closer to rental income. The current system compensates Southwark for changes in the average rate of interest on its debt, but under the new system, the effects of interest rate changes will have to be absorbed entirely by rental income.

18. This increased sensitivity to interest rates will need careful management and the finance director will in 2011/12 keep under review options for mitigating risk. Account will be taken of interest rate expectations when any new debt is taken to pay for capital spend or any prudent debt refinancing is carried out to manage interest rate exposure from existing debt or HRA reforms. Any refinancing that may prudently be carried out, under existing arrangements for financial delegation, will be within a risk controlled framework as well as prudential indicators and limits discussed below.

Prudential Indicators

19. Prudential indicators consist of a series of estimates and limits to give a general picture of the affordability, prudence and sustainability of capital finance and treasury management. The indicators are drawn from the Prudential Code for Capital Finance for Local Authorities and the Treasury Management in the Public Services Code of Practice. The indicators are set out in detail in appendix B and those needing council assembly approval are the ones for 2011/12 to 2013/14. Approval will enable the finance director to carry out his responsibilities in this area. The indicators will be updated over the course of 2011/12 to reflect activity and latest developments in housing revenue account reforms. One of the indicators is the authorised limit on debt and as last year this limit will be treated as increased for any private finance initiative and leases that under accounting rules applying in 2010/11 may have to be reclassified as long term liabilities.

Annual Minimum Revenue Provision Statement

20. When the council funds its capital programme through borrowing (rather than from asset sales, grants or revenue contributions), a minimum revenue provision (MRP) is made each year to pay-off some of the borrowing. The council has been making these provisions as required by the Local Authorities (Capital Finance and Accounting) regulations issued under the Local Government Act 2003. However from April 2008 these regulations were replaced by statutory guidance.

21. The MRP policy for 2011/12 recommended for approval is set out as appendix C and is the same as the one for the current year 2010/11. The main idea is for the provision to be over a period bearing some relation to that over which the asset continues to provide a service, particularly in relation to assets funded out of prudential or self-financed borrowing, as opposed to borrowing supported by the Government.

Capital Allowances

22. Under the Local Government Act 2003, a proportion of the proceeds from HRA asset sales are paid over to a Government ‘pool’. The percentage paid differs according to the type of receipt: 50% for land and 75% for buildings.

23. Receipts from social homebuy, non right to buy dwellings, land, shops and other assets can be exempt from pooling provided the money is used in affordable housing or regeneration programmes. This exemption does not apply to right to buy sales. The amount which may be exempt from pooling is known as the capital allowance. Council spending relies on securing these exemptions from pooling.

24. The capital allowance agreed by council assembly in February 2010 was £170m and now requires updating to reflect receipts of £30m that have drawn against it and additional planned expenditure on affordable housing and regeneration of £28m bringing the total allowance down to £168m. The council assembly is therefore asked to agree a capital allowance of £168m, ensuring that capital receipts that would otherwise pass to the Government under pooling continue to be retained for affordable housing and regeneration.

SUPPLEMENTAL ADVICE FROM OTHER OFFICERS

Strategic Director of Communities, Law & Governance

25. The constitution determines that agreeing the treasury management strategy is a function of council assembly [Part 3A].

26. The Local Government Act 2003 and supporting regulations require local authorities to determine annual borrowing limits and have regard to the Prudential Code for Capital Finance, and the Treasury Management in the Public Services Code of Practice, both published by the Chartered Institute of Public Finance and Accountancy, when considering borrowing and investment strategies, determining or changing borrowing limits or prudential indicators.

27. Section 15(1) of the 2003 Act requires a local authority “to have regard (a) to such guidance as the Secretary if State may issue”. This guidance is found in the Department of Communities and Local Government Guidance on Local Authority Investments updated March 2010 and there is statutory guidance on the Minimum Revenue Provision (MRP) produced under amendments made to section 21(1A) of the 2003 Act by section 238(2) of the Local Government and the Public Involvement in Health Act 2007.

28. Regulations under the 2003 Act specify that the council may retain certain capital receipts provided they are used in affordable housing or regeneration. Council assembly is being asked to agree the capital allowance to enable receipts to be retained by the council.

29. Members are advised to give approval to the recommendations contained in paragraph one of this report ensuring compliance with Government guidance and CIPFA’s codes.

BACKGROUND DOCUMENTS

Background Papers	Held at	Contact
Prudential Code for Capital Finance in Local Authorities - CIPFA. Treasury Management in the Public Services Code of Practice - CIPFA DCLG Guidance on Local Authority Investments. Guidance on Minimum Revenue Provision - Issued by the Secretary of State – SI No. 2008/414	Finance and Resources Department, 160 Tooley Street London SE1 2TZ	Dennis Callaghan, Chief Accountant (020 7525 4375)

APPENDICES

No.	Title
Appendix A	Annual Investment Strategy 2011/12 – Recommended for Approval
Appendix B	Prudential Indicators Recommended for Approval
Appendix C	Annual Minimum Revenue Provision Statement 2011/12 – Recommended for Approval

AUDIT TRAIL

Lead Officer	Duncan Whitfield, Finance Director	
Report Author	Jennifer Seeley, Deputy Finance Director	
Version	Final	
Version Date	9 February 2011	
Key Decision	Yes	
CONSULTATION WITH OTHER OFFICERS / DIRECTORATES / CABINET MEMBER		
Officer Title	**Comments Sought**	**Comments Included**
Strategic Director of Communities, Law & Governance	Yes	Yes
Final Report Sent to Constitutional Team		9 February 2011