Item No: 7.1	Classification: Open	Date: 6 July 2011	Meeting Name: Council Assembly
Report title:		Treasury Management Performance - 2010/11 Annual Report and Prudential Indicators for Capital Finance and Treasury Management	
Wards or Groups affected:		All	
From:		Finance Director	

RECOMMENDATION

1. That the council assembly note this 2010/11 outturn report on debt, investments and prudential indicators.

BACKGROUND INFORMATION

2. The council holds some £762m in debt as at 31 March 2011. The debt arises from past borrowing to pay for capital spend not otherwise financed from capital receipts, grants or revenue. A sum is paid off, in the form of minimum revenue payments, each year, but the bulk is replaced with new borrowing as it matures. Cash received and not yet spent is placed on deposit with banks or held in UK government or supranational bonds until it is spent. As at 31 March £236m was held in such investments.

3. The borrowing and investment activity is supported by a series of prudential indicators (estimates and limits on capital finance, debt and investments) and a treasury strategy agreed by council assembly. The 2010/11 indicators and strategy were reported to council assembly in February 2010 and this report sets out the economic background, the outturn indicators and the treasury activity carried out, under financial delegation by the finance director, over the course of the year. This area of finance falls under the Local Government Act 2003, supplemented by investment guidance issued by the government and codes of practice issued by the Chartered Institute of Public Finance and Accountancy (CIPFA).

4. In November 2009 CIPFA published updates to its Treasury Management in the Public Sector Code of Practice and Prudential Code for Capital Finance in Local Authorities. The codes recommended extended formal reporting and scrutiny of treasury management. At Southwark, the council assembly agreed, as part of 2010 constitutional changes, that in addition to a strategy report (which it considers before the start of each year and an annual report after the close of the year), it would also receive a mid year report, with additional quarterly monitoring of treasury management going to cabinet and review and scrutiny being carried out by the audit and governance committee. Council assembly remains responsible for agreeing the policy and strategy, which the finance director manages.

KEY ISSUES FOR CONSIDERATION

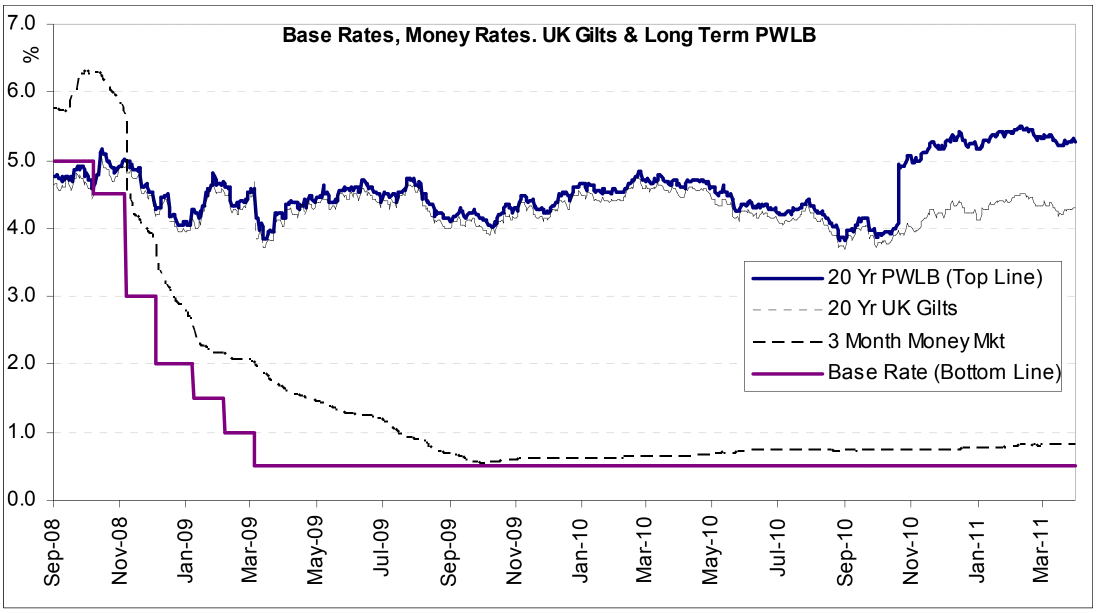
Treasury Management Borrowing and Investments

Financial Market Backdrop

5. Over the course of the financial year markets were dominated by expectations of changes to monetary policy and concerns about the economic outlook of some euro-area periphery countries.

6. Weaker euro economies experienced significant increases in funding costs but in the US and UK expectations of further monetary stimulus in the second half of 2010 initially helped lower government bond yields. The US announced an increase its purchase of government bonds, but in the UK there were no further asset purchases, and better than expected economic data and inflationary pressure raised hopes of a base rate increase. However the release of negative growth figures (-0.50%) for the quarter to December 2010 pushed back expectations of base rate increases to much later in 2011. Against the combination of high inflation, weak growth and the squeeze on public spending announced by the new government, UK monetary policy remained accommodative - base rates were held at 0.50% through the financial year, the level they have been at since March 2009.

7. With base rates very low, rates available on cash invested in the money markets also remained low throughout 2010/11. A chart of recent base rates and long term UK government bond yields is set out below. Also charted is the cost of borrowing from the Public Work Loans Board (PWLB, a local authority lending division of HM Treasury). Prior to October 2010, the rates on borrowing from the PWLB closely tracked the cost of the government's own borrowing. But since then the government has decided to charge councils one-percent more than the cost of its own borrowing on any new borrowing taken from the PWLB. The change does not affect the rate on existing loans.



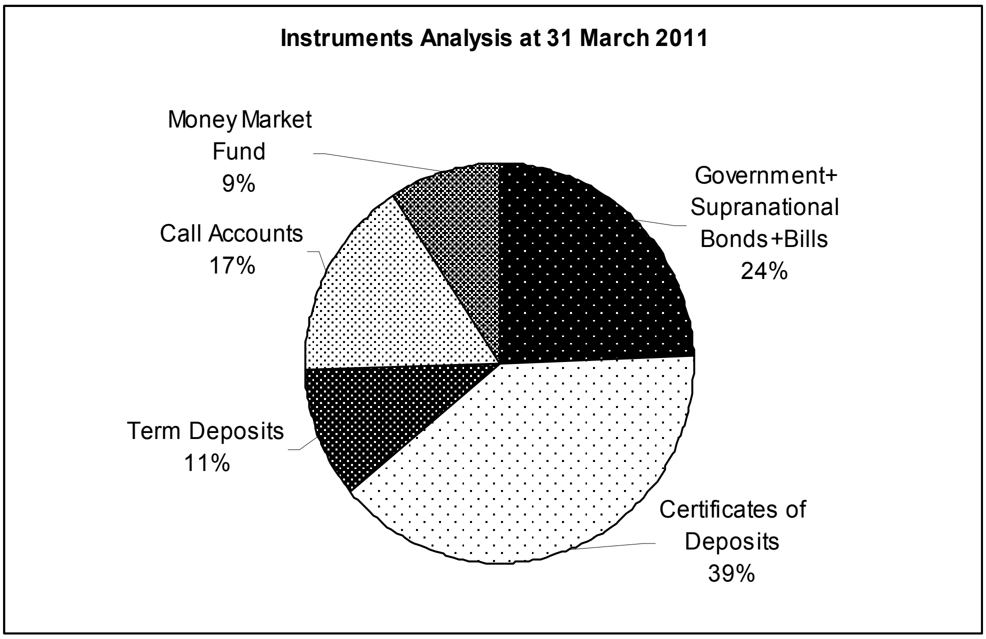
Investment Activity and Position

8. Cash held in investments averaged £238m over the course of 2010/11 (£274m in 2009/10) and a cautious approach to lending was maintained throughout in view of ongoing concerns over sovereign risk in some euro-member states. Investments continued to be managed prudently, with capital preservation a high priority as required by the Annual Investment Strategy agreed by council assembly. Exposure was diversified across major high rated banks in the UK and abroad. Bank exposure

was in the form of short term sterling deposits and certificates of deposits (CDs – liquid deposits up to 1 year).

9. Investments are managed by an in-house operation and three investment management firms: Invesco Asset Management Ltd, AllianceBernstein Ltd and Aberdeen Fund Management Ltd. The fund managers provide access to liquid instruments, sovereign bonds and maturities beyond one year and expertise to help the council enhance long term returns, with capital preservation, liquidity and low market risk as priorities. In-house funds focus on meeting day to day cash volatility using a number of call accounts and short term deposits. In September 2010 the sum managed externally was reduced by £20.9m and brought in-house to ensure that future cash demands can readily be met.

10. The cash held in investments at the end of March 2011 was £236m (£212m at March 2010). The counterparty, instrument, rating and maturity analysis of those investments is set out below. The average return for 2010/11 was 1.08% (1.57% in 2009/10), reflecting the prolonged period of very low money market rates.



COUNTERPARTY EXPOSURE AND RATING at 31 March 2011										
	FUND					RATING				
COUNTERPARTY	ABER DEEN	ALLIANCE BERN STEIN	INVESCO	IN HOUSE	Total £m	Long	Short	Sup port	Country	Country Rating
BARCLAYS BK	6.6	0.5	6.5		13.6	AA-	F1+	1	UK	AAA
BK NATIONAL DE PARIBAS	5.2	0.5	6.5		12.2	AA-	F1+	1	FRANCE	AAA
CREDIT AGRIC CIB	4.4		6.5		10.9	AA-	F1+	1	FRANCE	AAA
CREDIT INDST COMRCL	5.5				5.5	AA-	F1+	1	FRANCE	AAA
DANSKE		0.5			0.5	A+	F1	1	DENMARK	AAA
DEUTSCHE BK		0.8		10.0	10.8	AA-	F1+	1	GERMANY	AAA
EUROPEAN INVST BK	3.3	7.4			10.7	AAA	F1+		SUPRANATIONA	AAA
GLOBAL TREAS FNDS PLC MMF				21.4	21.4	0	AAA		GLOBAL	
HSBC	0.1	0.1	0.4		0.6	AA	F1+	1	UK	AAA
ING BK	5.0	0.5	3.4		8.9	A+	F1+	1	NETHERLANDS	AAA
INTL BK RECON & DEV		4.7			4.7	AAA	F1+		SUPRANATIONA	AAA
LANDESBK BADEN WUERTBG	3.2				3.2	A+	F1+	1	GERMANY	AAA
LLOYDS/BK SCOTLAND	6.0	0.5	4.0	15.0	25.5	AA-	F1+	1	UK	AAA
NATIONWIDE B/SOC		0.5			0.5	AA-	F1+	1	UK	AAA
NORDEA BK		0.5	4.4		4.9	AA-	F1+	1	FINLAND	AAA
RABOBANK		0.5			0.5	AA+	F1+	1	NETHERLANDS	AAA
RBS/NATWEST				25.0	25.0	AA-	F1+	1	UK	AAA
SANTANDER UK	6.5			15.0	21.5	AA-	F1+	1	UK	AAA
SOCIETE GENERALE		0.5	6.5		7.0	A+	F1+	1	FRANCE	AAA
SVENSKA HANDELSBKN		0.5	4.0		4.5	AA-	F1+	1	SWEDEN	AAA
UBS	2.6				2.6	A+	F1+	1	SWITZERLAND	AAA
UK TREASURY	2.0	32.3	7.9		42.2	AAA	F1+	1	UK	AAA
Total £m	**50.4**	**50.2**	**50.2**	**86.4**	**237.2**					

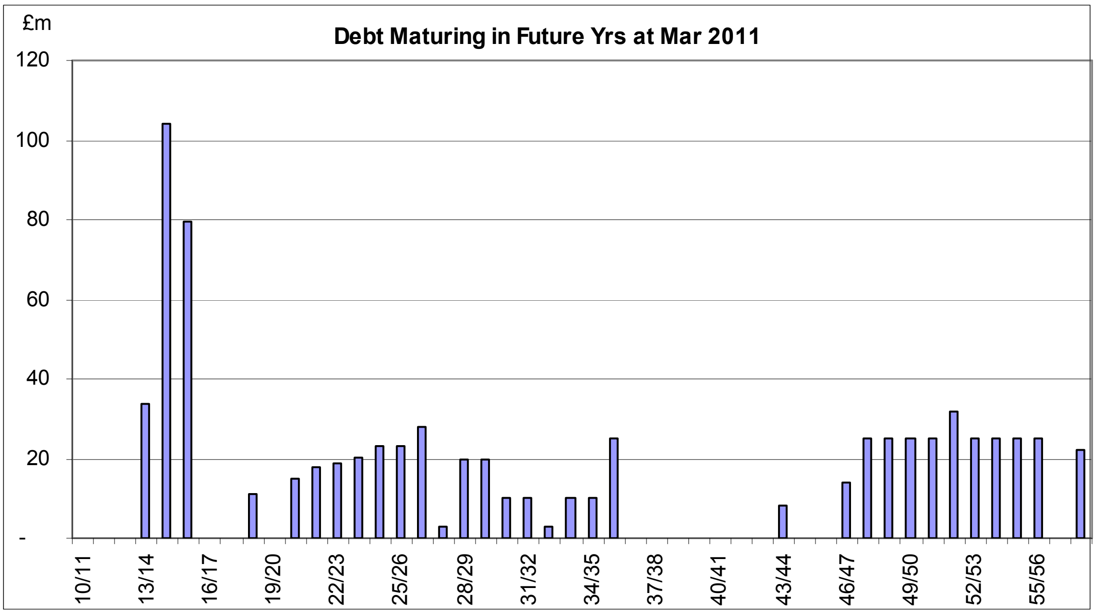
Note: The table above shows all investments and includes £1.5m held on behalf of trust funds. The council’s own investments totalled £235.7m.

Fitch Long Term Rating as at 31 March 2011				
Rating	AAA	AA+ to AA-	A+	Total
Period Remaining				
2-5 years	11%			11%
1-2 years	3%			3%
Less than 1 year	20%	57%	9%	86%
Total	34%	57%	9%	100%

Debt Activity and Position

11. The debt outstanding at the end of March 2011 was £762m. No new loans were taken during the year.

12. All debt is at fixed rates from the PWLB. The average life of the debt is 21 years and the amounts falling for repayment in the future are set out in the chart below. Loans do not fall for repayment until 2014 and, when they do, they can be replaced with new loans unless refinanced earlier. The average rate of interest across all loans is 6.94% and reflects a long period between the 1970’s and early 1990’s when high capital spending and debt funding (backed by government support) coincided with years of high inflation and high interest rates.



13. Currently interest on around 80% of the debt is attributable to the housing revenue account (HRA), which has been reimbursed through subsidy, and an allowance for the remainder is included in Formula Grant. However under proposals issued in March 2011 and confirmed in the Localism Bill, the current national systems for supporting housing will be replaced by a locally run self funding arrangement from 2012/13. Under it councils will keep their rental income and use it to maintain their homes. A one off debt settlement will be made between the government and each council. Some councils will take on additional debt, but Southwark will have its debt level reduced, which will bring debt interest costs and running costs closer to rent income.

14. According to the Department of Communities and Local Government, the estimated reduction in HRA debt is around £274m – the precise sum will not be known until the Localism Bill is enacted towards the end of 2011. The Department envisages reducing a proportion of each loan the council has with the PWLB. This will leave the average rate of interest unchanged and will mean that the council will have £139m in maturing debt to refinance between 2014 and 2016 instead of £217m under the existing debt maturity profile. It would be advantageous for the council to have some control over which debt is reduced, as this could reduce overall interest rates, but so far this has not been agreed by government.

15. The decision by the government to charge councils one-percent more for borrowing from the PWLB, referred to above, potentially helps commercial banks and institutional bond investors offer competitive terms. The market for such alternatives is only just beginning to develop but it will be boosted by demand for funds from those local authorities that under HRA subsidy reforms will be taking on substantial sums from April 2012. Ideas being considered by those councils include bond issue and private placement with institutional investors. All have significant upfront costs (in the form of advisory, legal, investment banking and possibly rating) and ongoing investor servicing requirements. Southwark, which has no immediate necessity for funds, should therefore be able to get a clearer insight into the terms and conditions being offered by commercial banks and institutional investors and compare and contract with loans offered by the PWLB. Members will be kept appraised of developments in these funding alternatives through the quarterly monitoring reports to cabinet.

Prudential Indicators

16. Prudential indicators bring together elements of capital finance, borrowing and investment in a series of estimates and limits to give a general picture of the affordability, prudence and sustainability of financing activities. The outturn for each indicator is set out in Appendix A and includes the authorised debt limit, which is a self imposed cap on borrowing and other long term liabilities outstanding (such as finance leases and private finance initiatives) on any one day. The limit for 2010/11 was £910m and included operational flexibility for temporary borrowing and prudent refinancing in a risk controlled framework. With no new borrowing taken in 2010/11 actual debt remained at £762m throughout the year. For the first time this year, as a result of new international accounting standards, certain vehicle and equipment leases and a residential care property finance initiative from 2000 have had to be brought on the balance sheet. The value of these arrangements at 31 March 2011 was £10m (£11m in 2009/10). The total borrowing and other long term liabilities (£772m) was therefore below the £910m limit. These accounting changes have been reflected in the prudential indicators and have no bottom line impact on budgets or the revenue position of the HRA or the General Fund.

SUPPLEMENTAL ADVICE FROM OTHER OFFICERS

Strategic Director of Communities, Law & Governance (NC 23.06)

17. The constitution determines that agreeing the treasury management strategy is a function of council assembly.

18. 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.

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

20. 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 2QH	Dennis Callaghan, Chief Accountant (020 7525 4375)

APPENDICES

No.	Title
Appendix A	Prudential Indicators 2010/11 Outturn

AUDIT TRAIL

Lead Officer	Duncan Whitfield, Finance Director	
Report Author	Dennis Callaghan, Chief Accountant	
Version	Final	
Version Date	22 June 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
Finance Director	Yes	Yes
Cabinet Member	Yes	No additional comments
Final Report Sent to Constitutional Team		23 June 2011