| Item No: 5.1 | Classification: Open | Date: 29 November 2011 | Meeting Name: Council Assembly |
|---|---|---|---|
| **Report title:** | | Treasury Management – Mid-year update 2011/12 | |
| **Wards or Groups affected:** | | All | |
| **From:** | | Finance Director | |

## RECOMMENDATION

1. That the council assembly note this 2011/12 treasury management mid-year update.

## BACKGROUND INFORMATION

2. This report is one of a series of reports on treasury management to the council assembly by the finance director. In February 2011, the council assembly considered the treasury strategy for 2011/12 and in July 2011 it received a report on 2010/11 treasury performance. This report is a half-year update on the council's borrowing and investments and prudential indicators.

3. Quarterly updates on treasury activity are also considered by cabinet and a report reviewing treasury policy and strategy was considered by the audit and governance committee on 15 November 2011.

4. The council holds some £762m in long term loans and £299m in cash. The loans reflect past borrowing to pay for capital spend and in the interest of capital preservation the cash is placed in deposits with major banks and bonds issued by the UK government and supranational entities until it is needed in spending.

5. Treasury activity is carried out under powers set out in 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). The council assembly is responsible for agreeing treasury strategy and under financial standing orders, responsibility for implementing the strategy and managing activity falls to the finance director.

## KEY ISSUES FOR CONSIDERATION

### Treasury Management Borrowing and Investments

### Financial Market Backdrop

6. The financial markets have remained volatile since the summer and funding concerns in peripheral Euro sovereigns (Greece, Portugal and Ireland) have dominated trading. Downward revisions to growth in major economies have added to concerns, making it more difficult to meet deficit reduction plans. Problems in peripheral sovereigns have even raised funding costs in larger states, notably Italy and Spain, whilst safe haven flows have benefited yields in other sovereigns, e.g Germany, UK and the USA. Monetary policy in Western economies remains accommodative - UK base rates remain at 0.50% and a further monetary stimulus in the form asset purchase was announced in October 2011 to help the economy.

7. Problems in peripheral eurozone sovereign debt are also raising funding costs of banks. And although the ECB remains supportive, supplying banks unlimited liquidity, term funding and in co-ordination with other central banks access to US$ markets, rating agencies have pressed ahead with downgrading European banks. In some cases the changes have been triggered by a downgrade of the sovereign rating and agencies have been keen to point out challenges from slower economic growth, sovereign funding stress and some political pressure to reduce implicit state support. The Fitch rating of the Italian state is below AA- (as at 11 November 2011) and the council has no deposits with banks there. No deposits were held in Dexia Bank Belgium, which is part of a group that had to be rescued by France, Belgium and Luxembourg.

**Investments**

8. Against this background the council continues to take a cautious approach when placing funds. Short-term investments are in deposits with major banks and building societies and in UK Treasury securities. Investments beyond one year are in listed bonds issued by the UK Government and supranational entities such as the European Investment Bank and the International Bank for Reconstruction and Development (the World Bank). The council has some £299m placed in financial institutions at 30 September 2011 (£236m at March 2011); this is analysed further in tables 1, 2, and 3 below. Investment management is carried out by an in-house operation and three fund managers (AllianceBernstein Ltd, Aberdeen Fund Management Ltd and Invesco Asset Management). The managers, each with an initial £50m, provide the council with access to short term certificate of deposits (liquid banks deposits) and exposure to bonds. The in-house operation focuses on managing day to day cash volatility using call accounts, short term deposits, or money market funds.

| Table 1 | Investment Counterparty Exposure at 30 Sept 2011 and Fitch Ratings | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Sovereign | Counterparty | Fitch Long Term | Fitch Short Term | Aberdeen | Alliance Bernstein | Invesco | In-House | Total |
| FINLAND | NORDEA BK FINLAND | AA- | F1+ | | 0.5 | 6.5 | | 7.0 |
| FRANCE | BANQUE NAT. DE PARIS | AA- | F1+ | | | 5.2 | | 5.2 |
| | CREDIT AGRIC CIB | AA- | F1+ | 4.4 | | 6.5 | | 10.9 |
| | CREDIT INDUST ET COMRCL | AA- | F1+ | 5.6 | | | | 5.6 |
| | SOCGEN | A+ | F1+ | | 0.5 | 6.5 | 15.0 | 22.0 |
| GLOBAL | GLOBAL TREAS FUNDS-MMF | | AAA | | | | 15.6 | 15.6 |
| NETHERLANDS | ABN AMRO BK | A+ | F1+ | 4.9 | | | | 4.9 |
| | ING BK | A+ | F1+ | 5.1 | 0.5 | 6.5 | 15.0 | 27.1 |
| | RABOBANK | AA+ | F1+ | | 0.5 | | | 0.5 |
| SUPRANATIONAL | EUROPEAN INV BK | AAA | F1+ | 6.3 | 5.9 | | | 12.1 |
| | INT BK RECONST DEVT | AAA | F1+ | | 4.3 | | | 4.3 |
| SWEDEN | SVENSKA | AA- | F1+ | | | 4.0 | | 4.0 |
| SWITZERLAND | UBS | A+ | F1+ | 3.1 | | | | 3.1 |
| UK | BARCLAYS BK | AA- | F1+ | 6.6 | 0.5 | 6.5 | 15.0 | 28.6 |
| | HSBC | AA | F1+ | 0.1 - | 2.3 | 0.0 | | - 2.2 |
| | LLOYDS TSB/BK SCOTLAND | A | F1+ | 6.1 | | 4.0 | 15.0 | 25.2 |
| | NATIONWIDE BSOC | AA- | F1+ | | 0.5 | | 15.0 | 15.5 |
| | RBS/NATWEST | A | F1+ | | | | 26.0 | 26.0 |
| | SANTANDER UK | AA- | F1+ | 6.6 | | | 15.0 | 21.6 |
| | UK TREASURY | AAA | F1+ | 2.1 | 39.9 | | | 42.0 |
| AUSTRALIA | NATIONAL AUSTRALIA | AA | F1+ | | | | 15.0 | 15.0 |
| SPAIN | BBVA | A+ | F1 | | | 4.6 | | 4.6 |
| Grand Total | | | | 50.8 | 50.7 | 50.4 | 146.7 | 298.7 |

(Notes: Global Treasury Funds is a money market fund placing short term funds with other banks and has a short term fund rating of AAA/Aaa. The fund is managed by RBS and is not associated with any sovereign. The £2.2m debit against HSBC includes a sum of £2.4m in respect of a purchase of UK Treasury which settles on 3 October 2011.)

| Table 2 | Long Term Sovereign Ratings | | | |
|---|---|---|---|---|
| Sovereign | Fitch | Moody's | S&P | Total |
| FINLAND | AAA | Aaa | AAA | 7.0 |
| FRANCE | AAA | Aaa | AAA | 43.7 |
| GLOBAL (MMF) | | | | 15.6 |
| NETHERLANDS | AAA | Aaa | AAA | 32.5 |
| SUPRANATIONAL | AAA | Aaa | AAA | 16.4 |
| SWEDEN | AAA | Aaa | AAA | 4.0 |
| SWITZERLAND | AAA | Aaa | AAA | 3.1 |
| UK | AAA | Aaa | AAA | 156.7 |
| AUSTRALIA | AA+ | Aaa | AAA | 15.0 |
| SPAIN | AA- | A1 | AA- | 4.6 |
| Grand Total £m at 30 Sept 2011 | | | | 298.7 |

Minimum Sovereign Rating from Fitch AA-

| Table 3 | Period Remaining and Fitch Ratings | | | | |
|---|---|---|---|---|---|
| Yr Band | Short Term Fund Rating | Long Term Ratings | | | Total |
| | AAA | A to A+ | AA- to AA+ | AAA | |
| 2-5 Yrs | | | | 6% | 6% |
| 1-2 Yrs | | | | 1% | 1% |
| 6-12 Mths | | 3% | 1% | | 4% |
| 0-6 Mths | 4% | 35% | 37% | 13% | 89% |
| Grand Total | 4% | 38% | 38% | 20% | 100% |

9. UK banks have not been insulated from rating actions. Agencies have revisited the support environment for banks and have decided to downgrade several institutions including some of the largest ones used by the council, namely RBS/NatWest, Lloyds and Nationwide Building Society. Their ratings still remain high, although the long term rating of some institutions against some agencies is now slightly below those set out in the strategy report, see table 4. However, the strategy accepts that ratings are opinions and not advice and therefore does not insist that ratings on all three agencies be satisfied. RBS/NatWest, Lloyds and Nationwide Building Society still meet both the long and short term rating from Standard and Poor's (i.e. long term rating A+ and short-term A-1) and have a Fitch support rating above 2 (a high or very high likelihood of support in the event it were needed). Also the rating of the UK sovereign, at AAA, is well above AA- set out in the strategy. All three institutions are of systemic importance and have access to central bank liquidity facilities if needed. The Government's stake in RBS/NatWest and Lloyds also gives the two a significant advantage.

| Table 4 | Fitch | | | Moody's | | S&P | |
|---|---|---|---|---|---|---|---|
| Counterparty | Long Term | Short Term | Support | Long Term | Short Term | Long Term | Short Term |
| LLOYDS/TSB | A | F1 | 1 | A1 | P-1 | A+ | A-1 |
| NATIONWIDE | AA- | F1+ | 1 | A2 | P-1 | A+ | A-1 |
| RBS/NATWEST | A | F1 | 1 | A2 | P-1 | A+ | A-1 |
| Minimum from at least one agency | A+ | F1 | 2 | A1 | P-1 | A+ | A-1 |

10. With financial conditions likely to remain volatile for a prolonged period, rating actions and market developments are monitored closely. The finance director continues to follow the investment strategy agreed by council assembly in February 2011, which needs no amendment at this time. There is no exposure to peripheral sovereigns or Italian banks, and in the interest of capital preservation the strategy continues to prefer major banks in high rated sovereigns.

**Borrowing**

11. The council holds some £762m in debt at 30 September 2011, where it has stood throughout the year. No new borrowing is needed to fund this year's capital spend.

12. All loans are from the Public Works Loans Board (a lending arm of the Government). Around 80% of the debt is attributable to the Housing Revenue Account (HRA) and 2011/12 will be the final year that interest on it will be included in Housing Subsidy. Towards the end of March 2012, some £267m in housing debt will be paid off by the Government, which will lower the interest bill and help the HRA prepare for self-financing from April 2012, when no more subsidy will be receivable and all expenditure will have to be met from HRA's own income. This repayment will not initially reduce the council's average rate of interest, though in future years the debt portfolio will be more manageable in achieving a lower overall rate of interest.

13. There was some interest amongst local authorities for sourcing funding though a public bond issue or a private-placement, following the raising of the margin that the Government charges over its own borrowing when lending to councils through the Public Works Loans Board. Interest in such funding has however fallen since the Government decided that it will lower the premium it now charges councils that have to take on debt as part of HRA reforms (Southwark will not benefit as it will see its debt fall). Demand has also softened somewhat as investors demand a higher premium for holding debt under continued market volatility. This remains a developing area of interest, particularly with a view to managing debt maturities falling due in 2013-16.

**Prudential indicators**

14. 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.

15. One of the indicators is the authorised limit on debt. It was set at £910m for 2011/12 in February 2011 and is made up of a limit on borrowing and long term liabilities like private finance initiatives (PFI) and finance leases. The long term liabilities limit is affected by new international accounting standards which require that PFI and certain leases be recorded on the balance sheet as liabilities together with the assets funded by these arrangements. The potential value of such liabilities was still to be assessed when the limit was set in February 2011 and to ensure it was not exceeded, it was treated as if it was increased by the liabilities affected by the accounting changes. The value of those liabilities was £25m at 31/3/2011 and these will increase by as much as £78m as two PFI schemes become operational (the new build St Thomas the Apostle school and the Old Kent Road waste management facility). The council's debt and long term liabilities at 31/3/2012 is projected to be around £865m, well within both the operational and authorised limits for the year (£880m and £910m respectively).

16. Other indictors affected by the new accounting standards on PFI and leases are capital expenditure estimates, the capital financing requirement and the ratio of financing cost to net revenue stream. The latest estimates for each indicator is set out in Appendix A. The changes do not have a bottom line impact on budgets, rents or council tax.

## SUPPLEMENTAL ADVICE FROM OTHER OFFICERS

### Strategic Director of Communities, Law & Governance

17. The constitution determines that agreeing the treasury management strategy is a function of the council assembly and that review and scrutiny of strategies and policies is the responsibility of the audit and governance committee.

18. Financial standing orders require the finance director to set out the treasury management strategy for consideration and decision by council assembly, and report on activity on a quarterly basis to cabinet and at mid and year-end to council assembly. Furthermore all executive and operational decisions are delegated to the finance director.

19. The Local Government Act 2003, requires that councils have regard to the Treasury Management in the Public Services Code of Practice and the Prudential Code for Capital Finance both published by the Chartered Institute of Public Finance and Accountancy when considering or developing the treasury management strategy.

20. Local Government Act 2003, section 15(1), 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 there is 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.

## BACKGROUND DOCUMENTS

| Background Papers | Held at | Contact |
|---|---|---|
| Prudential Code for Capital Finance in Local Authorities - CIPFA.<br><br>Treasury Management in the Public Services Code of Practice - CIPFA<br><br>DCLG Guidance on Local Authority Investments.<br><br>Guidance on Minimum Revenue Provision - Issued by the Secretary of State. | Finance and Resources Department, 160 Tooley Street, London SE1 2QH | Dennis Callaghan, Chief Accountant 020 7525 4375 |

## APPENDICES

| No. | Title |
|---|---|
| Appendix A | Prudential Indicators 2011/12 – Mid-year Update |

**AUDIT TRAIL**

| | | | |
|---|---|---|---|
| **Lead Officer** | Duncan Whitfield, Finance Director | | |
| **Report Author** | Dennis Callaghan, Chief Accountant | | |
| **Version** | Final | | |
| **Version Date** | 16 November 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 | Yes |
| **Final Report Sent to Constitutional Team** | | | 16 November 2011 |

**APPENDIX A**

**PRUDENTIAL INDICATORS 2011/12 – Mid-year Update**

## PRUDENTIAL INDICATORS – Mid-year Update

The prudential indicators are drawn from the Prudential Code for Capital Finance in Local Authorities and the Treasury Management in the Public Services Code of Practice both published by CIPFA and updated in November 2009. The Local Government Act 2003 requires that councils have regard to these codes.

This appendix updates the 2011/12 indicators presented to council assembly in February 2011. Actuals are drawn from the council's final audited accounts for the year. The indicators fall in three broad areas: affordability, prudence and treasury management.

## CRITERIA ONE: AFFORDABILIY AND PRUDENTIAL INDICATORS ON AFFORDABILITY

### INDICATOR ONE: RATIO OF FINANCING COSTS TO NET REVENUE STREAM

The financing ratio reflects financing costs arising from capital expenditure funded from borrowing and long term financing arrangements (like private finance initiatives and leases) and income from cash balances as a proportion of the net revenue stream. The ratio for the HRA and the General Fund (GF) are set out below. The different level of the HRA and GF ratios reflect the different way the two services are organised under law. The indicators have been updated to capture new international accounting changes requiring certain leases and PFI arrangements to be treated as if they are like borrowing. The changes have no bottom line impact on budgets, rents or council tax.

| Financing Ratios | 2010/11 Actual | **2011/12 Projection** |
|---|---|---|
| **HRA** | 34% | **32%** |
| **GF** | 4% | **5%** |

### INDICATOR TWO: THE INCREMENTAL IMPACT OF CAPITAL INVESTMENT ON THE COUNCIL TAX AND HOUSING RENTS

This ratio is about the impact on council tax and rents of the capital programme. No increase in council tax or rent in 2011/12 arose as a result of the programme.

## CRITERIA TWO: PRUDENCE AND PRUDENTIAL INDICATORS FOR PRUDENCE

### INDICATOR THREE: CAPITAL EXPENDITURE

The latest capital expenditure projections are set out below. The substantial rise in GF capital expenditure in 2011/12 is due to accounting changes which require that PFI funded assets and associated liabilities be recorded on the balance sheet. The third quarter 2011/12 will see a phase of a new private finance initiative funded school (St Thomas the Apostle) and the waste management facility at the Old Kent Road site become operational and the major capital asset associated with those projects (total £78m) will count as capital expenditure.

| Capital Expenditure | 2010/11 Actual £m | **2011/12 Projection £m** |
|---|---|---|
| **HRA** | 71 | **78** |
| **GF** | 118 | **193** |
| **Total** | 189 | **271** |

**INDICATOR FOUR: CAPITAL FINANCING REQUIREMENTS.**

The capital financing requirement (CFR) reflects borrowings and long term liabilities to pay for past capital expenditure, net of sums set aside as minimum revenue provision (MRP) in accordance with the MRP policy agreed by council assembly annually.

| CFR | 2010/11 Actual £m | **2011/12 Projection £m** |
|---|---|---|
| **HRA** | 650 | **650** |
| **GF** | 157 | **231** |
| **Total** | 807 | **881** |

As with capital expenditure, the CFR figures include the cost of leases and PFI arrangements which now fall on the balance sheet (this amounts to £78m in 2011/12). The changes have no additional bottom line impact on budgets, rents or council tax.

**INDICATOR FIVE: ACTUAL DEBT- THE AUTHORISED AND OPERATIONAL LIMITS**

These limits are the maximum sum that may be outstanding on debt and long term liabilities on any one day. The limit on long term liabilities is affected by PFI and lease accounting changes and as the value of those liabilities was still to be assessed when the limit was set by the council assembly in February 2011, it was acknowledged that it would be treated as if it was increased for those liabilities. The increase required is £103m (£25m in 2010/11 and £78m in 2011/12), principally arising from the two school PFI projects (St Michael's Catholic College, which became operational in 2010/11, and St Thomas the Apostle School, which becomes part operational in 2011/12) and the waste management facility at the Old Kent Road site.

As no new borrowing has been taken or refinanced so far this year, the actual level of debt has remained unchanged over the year. The 2011/12 projected borrowing and long term liabilities remains within the total authorised limit of £910m.

| Operational Boundary and Authorised Limits for External debt - | 2010/11 Actual £m | 2011/12 Limit £m | **2011/12 Projection £m** |
|---|---|---|---|
| **Operational Boundary for Debt** | | | |
| Borrowing | 762 | 860 | 762 |
| Other long term liabilities(*) | 25 | 20(*) | 103 |
| Total Operational | 787 | 880 | **865** |
| **Authorised Limit for Debt -** | | | |
| Borrowing | 762 | 890 | 762 |
| Other long term liabilities(*) | 25 | 20(*) | 103 |
| Total Authorised | 787 | 910 | **865** |

Note* - The limits from 2011/12 are treated as increased for increase in long term liabilities arising from accounting changes in leasing and PFI, which are estimated at £103m in 2011/12.

## *CRITERIA THREE: TREASURY MANAGEMENT*

### INDICATOR SIX: ADOPTION OF THE CIPFA CODE OF PRACTICE ON TREASURY MANAGEMENT IN THE PUBLIC SERVICES

This indicator is about confirming that CIPFA's treasury management code has been adopted. The code was updated in November 2009 and council assembly agreed its additional recommendations on reporting and scrutiny at its meeting in February 2011.

### INDICATOR SEVEN: INTEREST RATE EXPOSURES – FIXED
### INDICATOR EIGHT: INTEREST RATE EXPOSURES - VARIABLE
### INDICATOR NINE: MATURITIES

Council debt currently consists entirely of fixed rate loans, with very little falling for repayment over the next few years. As with the authorised and operational limits, the interest rate exposure limits include flexibility for debt to vary prudently in a controlled way should financing conditions prove favourable. As no new borrowing or refinancing was carried out, the 2011/12 mid-year indicators, set out below, reflect the existing debt structure.

| LIMITS ON FIXED AND VARIABLE RATES | 2010/11 Actual £m | 2011/12 Limit £m | **2011/12 Mid-year position £m** |
|---|---|---|---|
| **Upper limit for fixed interest rate exposure** | 762 | 890 | **762** |
| **Upper limit for variable rate exposure** | 0 | 225 | **0** |

| Maturity structure of fixed rate borrowing | 2010/11 Actual | 2011/12 Lower Limit | 2011/12 Upper Limit | **2011/12 Mid-year position** |
|---|---|---|---|---|
| **Under 12 months** | 0% | 0% | 30% | **0%** |
| **12 months and within 24 months** | 0% | 0% | 30% | **0%** |
| **24 months and within 5 years** | 18% | 0% | 60% | **29%** |
| **5 years and within 10 years** | 12% | 0% | 80% | **3%** |
| **10 years and above in each 10 year period** | 70% | 0% | 100% | **68%** |

## INDICATOR TEN: TOTAL PRINCIPAL SUMS INVESTED FOR PERIODS LONGER THAN 364 DAYS

Cash balances are invested across a number of counterparties which include the government and major high rated banks and building societies. Exposures to investments beyond one year were managed within a risk controlled framework by fund managers and were held in UK Government debt or supranational bonds. Actual exposure against the limits is set out below.

| Upper limit on investments greater than 1 yr | 2010/11 Actual | 2011/12 Limit | **2011/12 Mid-year position** |
|---|---|---|---|
| **Upper limit / Actual** | Actual max exposure 16% of investments greater than 1 year<br><br>Overall maximum average maturity 7 months<br>Longest Investment 5 years | Up to 50% of investments. Greater than 1 year<br><br>Overall average maturity 3 years, but any one investment may be longer as referred to in the Annual Investment Strategy | **14% of investments greater than 1 year**<br><br>**Overall maximum average maturity 7 months**<br><br>**Longest investment 5 yrs** |