Item No: 3.2	Classification: Open	Date: 29 February 2012	Meeting Name: Council Assembly
Report title:		Treasury Management Strategy 2012/13 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 2012/13 to be managed by the finance director under financial delegation.

   (ii) agree the annual investment strategy 2012/13 set out in Appendix A, with capital preservation a key objective, in line with Government guidance on investments.

   (iii) agree prudential indicators covering capital finance, borrowing and cash management for the years 2012/13 to 2014/15 set out in Appendix B.

   (iv) agree the annual minimum revenue provision statement 2012/13, which sets aside prudent sums from revenue to reduce debt, set out in Appendix C.

   (v) agree a capital allowance of £192m, described in paragraphs 28 - 30, 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 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 plus Guidance and the Prudential Code for Capital Finance in Local Authorities, issued by the Chartered Institute of Public Finance and Accountancy (CIPFA). The codes were updated in November 2011 and include developments in Housing Revenue Account self-financing brought in by the Localism Act 2011.

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 recommends a capital allowance of £192m, which enables the council to carry on retaining capital 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. 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.

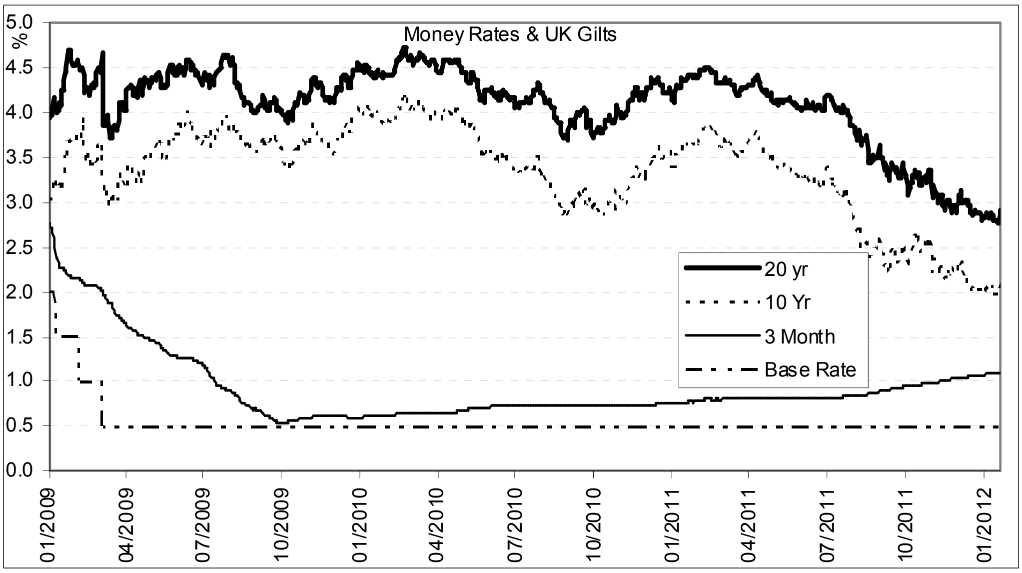
KEY ISSUES FOR CONSIDERATION

Treasury management strategy: Borrowing and investments

6. The investment and borrowing strategy is set out below and is unchanged from the previous year apart from changes in rating (referred to in paragraphs 13 to 16) and the use of cash from 2012 onwards to manage debt costs ahead of refinance with loans (paragraph 23).

Background - Developments in financial markets

7. Since last summer's developments in the Euro area, sovereigns have dominated investor attention. Amid declining expectations of economic growth, and in spite of international financial support, uncertainty over the fiscal path of countries such as Greece, Ireland and Portugal, extended to larger euro-area sovereigns, notably Italy and Spain, where the spread (the additional interest rate) investors demanded over German rates rose above 4%. Other countries considered part of Euro core, e.g. France and the Netherlands also experienced pressure as markets considered the sovereigns would have to step in to support their financial system and weaker countries. In the meantime safe-haven flows kept US treasury and UK long-term gilt rates low (see UK rates on chart 1 below).



8. Fears about the consequences on banks of sovereign risk also increased. Bank shares underperformed equity markets generally, funding costs rose, inter-bank lending remained strained and Dexia, a French-Belgium bank, had to be rescued. Perceptions of UK banks were also affected through their exposure to private sector lending in vulnerable sovereigns and to banking systems that have exposure to those countries.

9. Monetary authorities responded to signs of weaker growth with extra stimulus. The US, UK and Japan all announced additional asset purchase plans. The ECB cut lending rates and purchased sovereign bonds in the market. In December 2011, the European Head of States agreed to put in place tighter fiscal rules on top of earlier measures to improve funding to sovereigns by strengthening the European Financial Stability Facility and requiring banks to strengthen their capital.

10. To ease funding strains, banks received significant support, from domestic central banks and credit lines coordinated between authorities in the US, Europe, Canada, Japan and Switzerland. The European Central Bank (ECB) has been particularly active. It relaxed collateral requirements and in December provided low-cost financing (523 banks accessed 489bn Euros in cheap three year loans). Further support is pledged in February 2012. All together this has helped ease funding pressures on banks and Spanish and Italian sovereign yields have come down.

Investment strategy

11. Throughout the market turmoil, the council has maintained a cautious approach to lending. Exposure to banks is biased in favour of large banks in stronger sovereigns where the likelihood of support, in the event it were needed, is high and the provider of that support has a very high propensity to provide the support. Credit exposure is further reduced by use of money market funds which diversify exposure to any one bank. There is also exposure to UK gilts and supranational bonds (i.e. those issued by the European Investment Bank (EIB) and the International Bank for Reconstruction and Development (IBRD, the 'World Bank'). All exposure beyond one year is in gilts or EIB + IBRD bonds.

12. Although the ECB action has eased financing concerns, the inter-bank markets remains dis-functional and the financial sector remains exposed to unfavourable sovereign developments and slower growth. Close attention to sovereign and funding markets will continue to be required and a flexible, but prudent, approach taken when placing funds. To ensure the council can continue to do this, two changes are needed to the minimum credit ratings referred to in the annual investment strategy. The first is to the long term rating and the second is to sovereign ratings.

13. Ratings agencies have responded to developments in financial markets by lowering the rating of many previously high rated sovereigns and systemically important banks in Europe. The minimum rating referred to in the strategy is A+/A1/A+ (Fitch, Moody's & S&P respectively). One or more rating agencies now assign large UK institutions a long term ratings that is one-notch below that. RBS (including its subsidiary National Westminster plc), falls short of the minimum by one-notch on all three rating agencies, Lloyds TSB on two, and Barclays and Nationwide Building Society on one.

14. It is prudent that the council continues to have flexibility to lend to major high rated banks, including UK banks, where the likelihood of support is very high. To ensure the council can continue to do that, a one-notch reduction in the minimum long term rating is recommended within the annual investment strategy. This would still represent high credit quality, with a strong capacity for timely repayments. It would also be methodologically consistent with the highest short term rating specified in the strategy, i.e. F1/P-1/A-1 (Fitch, Moody's and S&P respectively) a well as Fitch's support rating of 1 (1=extremely high likelihood of support, 2=high likelihood of support). According to S&P's Annual European Global Corporate Default Study 2010, annual default rates of 'A' rated corporates (i.e. banks, financial institutions, and commercial and industrial entities) was between 0% and 0.90% in any one year since 1981 (the average was 0.05%). Default rates across business groupings are likely to vary, particularly given commercial banks' unique access to central bank funding. In the unlikely event that under current central bank support arrangements a major bank proceeded to default, shareholder and subordinated bond holders would typically bear losses before depositors are affected.

15. The second area of rating flexibility concerns sovereigns. At the moment the strategy makes reference to sovereign ratings issued by Fitch. In future reference will also be required to those issued by other rating firms. The minimum sought from any one agency would become AA-/Aa3/AA- (Fitch, Moody's and S&P respectively), indicating very high credit quality and very strong capacity for timely repayment. The reference to short-term sovereign rating is withdrawn as it is not always provided by all three agencies. The table below shows current long term sovereign ratings.

LONG TERM SOVEREIGN RATINGS - Feb 2012			
COUNTRY	FITCH	MOODY'S	S&P
AUSTRALIA	AAA	Aaa	AAA
CANADA	AAA	Aaa	AAA
FINLAND	AAA	Aaa	AAA
GERMANY	AAA	Aaa	AAA
NETHERLANDS	AAA	Aaa	AAA
NORWAY	AAA	Aaa	AAA
SUPRANATIONAL	AAA	Aaa	AAA
SWEDEN	AAA	Aaa	AAA
SWITZERLAND	AAA	Aaa	AAA
UK	AAA	Aaa	AAA
USA	AAA	Aaa	AA+
FRANCE	AAA	Aaa	AA+
BELGIUM	AA	Aa3	AA
SPAIN	A	A1	A
ITALY	A-	A2	BBB+
PORTUGAL	BB+	Ba2	BB
IRELAND	BBB+	Ba1	BBB+
Minimum Proposed from any one agency	AA-	Aa3	AA-

16. It is possible that banks could be downgraded further in the future and should that happen the finance director will, as now, continue to have discretion to vary minimum rating and limits in response to market developments and operational requirements where prudent to protect the council's interests.

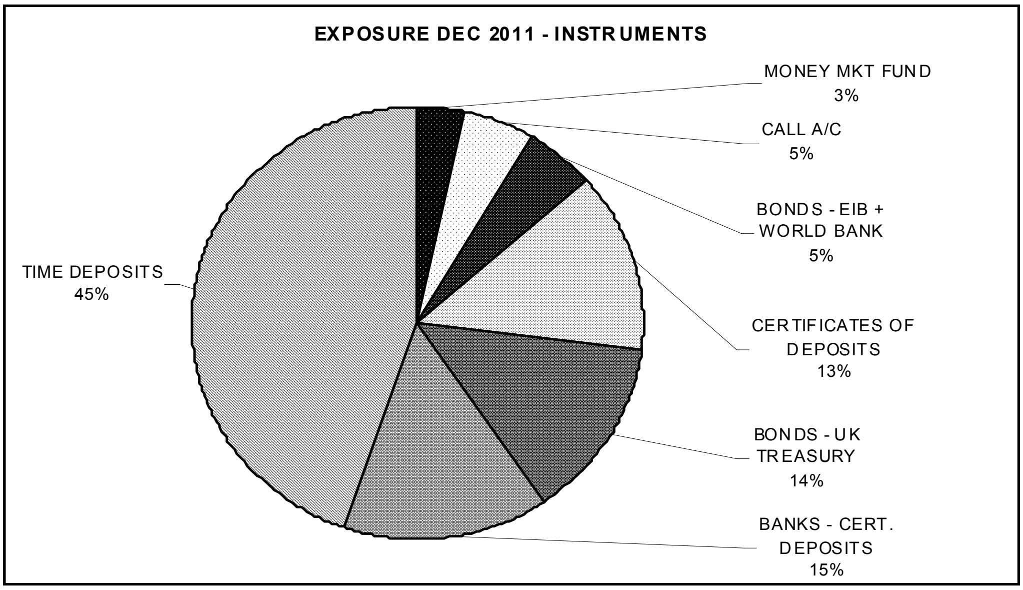
17. The annual investment strategy for 2012/13 encompassing this approach is set out in Appendix A. Except for the rating changes referred to above it is similar to the one currently in force and is set out according to government guidance on local authority investments. Investments are classified into specified and non-specified investments. Specified investments are those in sterling not more than one year in high rated institutions, the UK Government or local authorities. Non-specified ones are all other investments, which in Southwark's case are those that are over a year and in money market bank deposits, certificates of deposit, or UK and supranational bonds. The council assembly is asked to approve the 2012/13 annual investment strategy set out at Appendix A. It is, under government guidance, to be published on the council's website.

Investment position

18. The sum held in investments at the end of December 2011 was £313m 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.

19. 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 2011 is set out below.



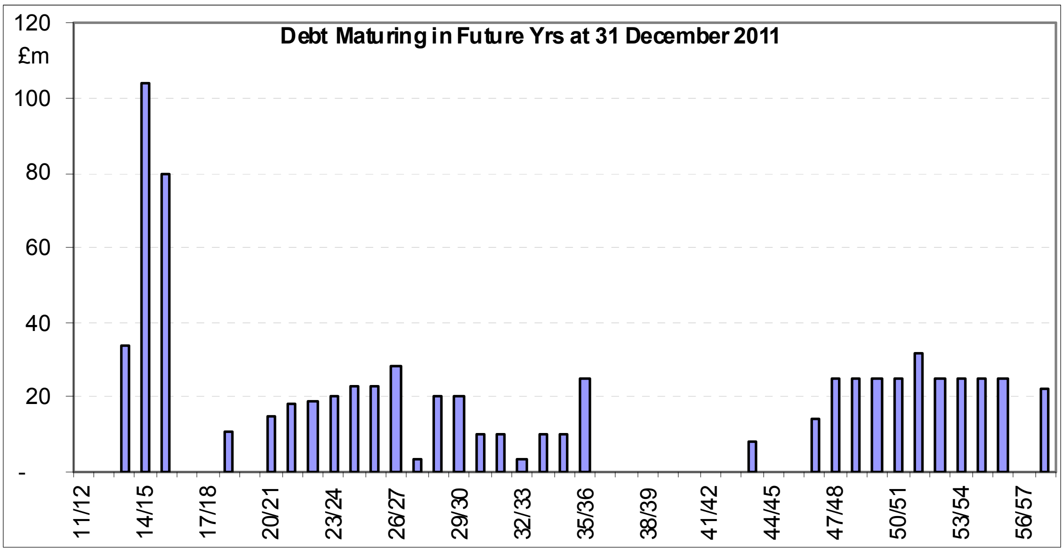
EXPOSURE - DEC 2011 COUNTERPARTY AND RATINGS										
Exposure £m	FUND					Fitch Ratings				
COUNTERPARTY	Aberdeen	Alliance Bernstein	Invesco	In-House	£m	Long	Short	Sup-port	Sovereign	Sovereign Rating
NORDEA BK FINLAND		0.5	6.5	5.0	12.0	AA-	F1+	1	FINLAND	AAA
BANQUE NATIONAL DE PARIS			3.6		3.6	A+	F1+	1	FRANCE	AA+
CREDIT INDUST ET COMRCL	5.5				5.5	A+	F1+	1	FRANCE	AA+
SOCGEN		0.5	6.5		7.0	A+	F1+	1	FRANCE	AA+
DEUTSCHE BK			6.2	15.0	21.2	A+	F1+	1	GERMANY	AAA
GLOBAL TREAS FUNDS-MMF				10.7	10.7		AAA		GLOBAL	
ABN AMRO BK	5.0				5.0	A+	F1+	1	NETHERLANDS	AAA
ING BK	5.1		6.5		11.6	A+	F1+	1	NETHERLANDS	AAA
RABOBANK	4.5	0.5			5.0	AA	F1+	1	NETHERLANDS	AAA
EUROPEAN INV BK	6.2	5.8			12.0	AAA	F1+		SUPRANATIONAL	AAA
INT BK RECONST DEVT		4.3			4.3	AAA	F1+		SUPRANATIONAL	AAA
SVENSKA	2.7	0.5		15.0	18.2	AA-	F1+	1	SWEDEN	AAA
CREDIT SUISSE		0.6			0.6	A	F1	1	SWITZERLAND	AAA
UBS	3.1			15.0	18.1	A	F1	1	SWITZERLAND	AAA
BARCLAYS BK	2.5	0.5	6.5	15.0	24.6	A	F1	1	UK	AAA
HSBC	0.2	0.1	0.1		0.4	AA	F1+	1	UK	AAA
LLOYDS TSB/BK SCOTLAND				15.0	15.0	A	F1	1	UK	AAA
NATIONWIDE BSOC	3.9	0.5		15.0	19.5	A+	F1	1	UK	AAA
SANTANDER UK	6.5			15.0	21.5	A+	F1	1	UK	AAA
UK TREASURY	2.2	36.5	3.9		42.6	AAA	F1+	0	UK	AAA
BK OF NOVA SCOTIA	3.5		4.1	10.0	17.6	AA-	F1+	1	CANADA	AAA
COMMONW BK AUSTRALIA				15.0	15.0	AA	F1+	1	AUSTRALIA	AAA
NATIONAL AUSTRALIA		0.5	6.5	15.0	22.0	AA	F1+	1	AUSTRALIA	AAA
Total £m	51.0	50.8	50.6	160.9	313.2					

20. The average return for the 9 months to December 2011 was 0.83% against part year average base rates of 0.38%. With base rates remaining low for some time and central banks providing ample liquidity, returns under a prudent capital preservation strategy are expected to remain low.

Debt management position and strategy

21. The debt outstanding at the end of December 2011 was £762m and no new loans were taken in 2011. 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, when high capital spending and debt funding coincided with years of high inflation and high interest rates. The chart below sets out the amounts currently maturing in each year and the earliest that loans fall for repayment is 2013/14. The sums maturing will fall when some £199m is paid-off towards the end of March 2012 and Housing Revenue Account (HRA) self-financing begins (referred to further in paragraphs below).



22. Until recently local authorities were able to borrow at rates close to the cost of the government's own borrowing. However following the comprehensive spending review in October 2010, the government decided that councils will have to pay one-percent more for any new borrowing taken from the PWLB. Interest rate risk is further increased under HRA self-financing. Currently around 80% of the debt is attributable to the HRA and reflected in subsidy, which compensates for changes in the actual average rate. Under self-financing, interest rate volatility, together with other costs of running council houses, will have to be met entirely from rental income. The government advised in the final determination issued in February 2012 that it will reduce debt by some £199m to help the council manage under the new regime.

23. The increased sensitivity to interest rates from 2012 will need careful management and the finance director will keep under review options for hedging and mitigating risk, including using cash to manage debt costs ahead of refinancing with lower coupon long term loans. Account will be taken of interest rate expectations when any new debt is taken on to pay for current or future capital spend or when any prudent debt refinancing to manage interest rate exposure is carried out. Any sum borrowed ahead of requirement will be invested prudently until needed and any refinancing that may 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.

24. There was some interest amongst local authorities for sourcing funding though a public bond issue or a private-placement after the government raised the margin it charged for borrowing from the PWLB. Interest in such funding has however fallen since the government decided that it will supply cheap loans to those councils (unlike Southwark) that will have to take on debt as part of HRA

reforms. Demand has also softened as investors seek a higher premium for holding debt in the face of continued turmoil in credit markets.

Prudential indicators

25. 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 and Guidance, which were updated for HRA self-financing, brought in under the Localism Act 2011. Additional debt indicators were added and guidance included about allocating debt financing costs between the HRA and the General Fund.

26. The prudential indicators are set out in detail in Appendix B and the ones needing council assembly approval are those for 2012/13 to 2014/15. The indicators do not affect existing budgets and approval will enable the finance director to carry out his financial responsibilities. The indicators will be updated over the course of 2012/13 to reflect activity and latest developments in HRA reforms. One of the indicators is the authorised limit on debt and includes the cost of long term liabilities like private finance initiatives (e.g. the new build St Thomas the Apostle school and the Old Kent Road waste management facility) and equipment and vehicle leases. The authorised limit is a self-imposed ceiling which the council is required to determine and stay below under the Local Government Act 2003. The council's debt and long term liabilities at 31/3/2012 is projected to be around £863m, within the operational and authorised limits for the year. The council is asked to agree the prudential indicators set out in Appendix B ensuring compliance with the 2003 Act and CIPFA's codes.

Annual minimum revenue provision statement

27. 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 each year, but since 2008 the statutory regulations requiring these payments have been replaced by guidance requiring councils to agree a policy on MRP each year.

28. The MRP policy for 2012/13 recommended for approval is set out at Appendix C and is the same as the one for the current year 2011/12. 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

29. 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.

30. 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.

31. The capital allowance agreed by council assembly in February 2011 was £168m and now requires updating to reflect receipts of £34m that have been drawn against it and additional planned expenditure on affordable housing and regeneration of £58m bringing the total allowance up to £192m. The council assembly is therefore asked to agree a capital allowance of £192m, 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

32. 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.

33. 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.

34. 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 and Guidance, published by the Chartered Institute of Public Finance and Accountancy, when considering borrowing and investment strategies, determining or changing borrowing limits or prudential indicators.

35. 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.

36. 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.

37. 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 and Guidance - 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 2012/13
Appendix B	Prudential Indicators - Recommended for Approval
Appendix C	Annual Minimum Revenue Provision Statement 2012/13

AUDIT TRAIL

Lead Officer	Duncan Whitfield, Finance Director	
Report Author	Jennifer Seeley, Deputy Finance Director	
Version	Final	
Version Date	14 February 2012	
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
Date final report sent to Constitutional Team		16 February 2012