Item No: 3.1	Classification: Open	Date: 23 February 2010	Meeting Name: Council Assembly
Report title:		Treasury Management Strategy 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 updated Treasury Management in the Public Services Code of Practice and formally affirm its adoption by agreeing resolutions set out in Appendix A, which include inviting the Constitutional Steering Panel to consider future arrangements for additional review and scrutiny.

   (ii) note the treasury management strategy to be managed by the finance director under financial delegation.

   (iii) agree the Annual Investment Strategy 2010-11 set out in Appendix B, keeping capital preservation as a key objective, in line with updated Government guidance on investments.

   (iv) agree prudential indicators covering capital finance, borrowing and cash management for the years 2010-11 to 2012-13 set out in Appendix C.

   (v) agree the Annual Minimum Revenue Provision Statement 2010-11, for setting aside prudent sums from revenue to reduce debt, as set out in Appendix D.

   (vi) agree a capital allowance of £170m, described in paragraphs 25 - 27 of this report, enabling the council to continue retaining capital receipts for affordable housing and regeneration.

BACKGROUND INFORMATION

2. The council holds some £258m in cash and £762m in debts. The cash earns interest until it is needed in spending and the debt funds current and past capital spend met through borrowing. In managing these activities local authorities should, under the Local Government Act 2003, have regard to guidance on investments and sums set-aside to repay debt issued by the Government and 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 previously agreed, 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. 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 to be agreed.

4. CIPFA's Code of Practice on Treasury Management was updated in November 2009 following problems with Icelandic banks (exposure to which Southwark has never had). It recommends additional reporting to the council assembly, supplemented with further reviews by another committee. Investments carried out by the Pension Fund are outside the scope of this code as they fall under a separate regulatory regime.

5. 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.

KEY ISSUES FOR CONSIDERATION

Updated Government Guidance

6. The Department for Communities and Local Government has also reviewed its investment guidance (first published 2004). Whilst the basis of the guidance remains unchanged, it makes it even clearer that investment priority should be security and liquidity, rather than yield – all principles reflected in Southwark's own investment strategy, discussed further below.

Updated CIPFA's Treasury Management in the Public Services Code of Practice

7. CIPFA's update to its Treasury Management Code restates the importance of risk management and raises the number of reports going to council assembly from two, as now, to three in future. In addition, it recommends further reports on treasury to be presented to another committee, where it may be reviewed and scrutinised further. Which committee is best able to carry out that function can be considered by the Constitutional Steering Panel. But, as of now, the finance director remains responsible for all executive and operational decisions on borrowings and investments.

8. To give effect to the Code's recommendations, the council assembly is asked to adopt a number of formal resolutions. These are set out as Appendix A, and, except for additional reporting and scrutiny, are similar to resolutions adopted in February 2002 when the code was last updated.

9. The Prudential Code for Capital Finance in Local Authorities (first issued in 2003) has also been revised. Some indictors on debt have been moved to the Treasury Code, but otherwise the prudential indicators remain as before. Council assembly remains responsible for determining the prudential indicators and the finance director for monitoring them.

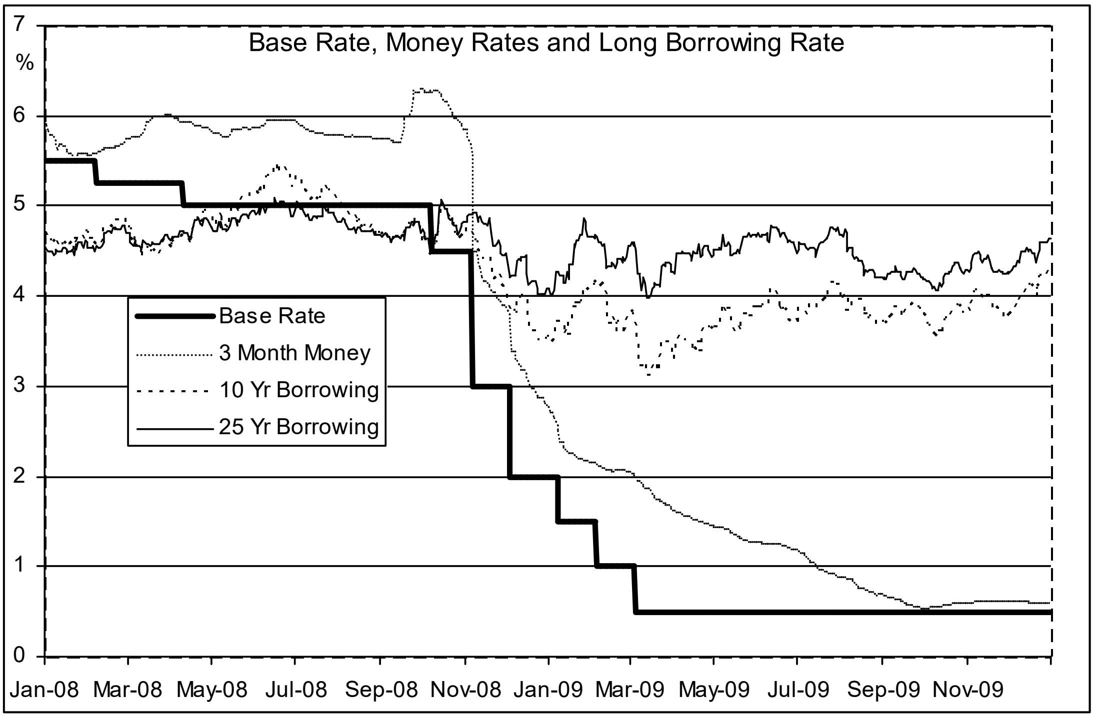
Treasury Management Strategy: Borrowing and Investments

Background - Developments in Financial Markets

10. Financial conditions today are considerably better than a year ago when the markets were dealing with extreme risk aversion following the filing of bankruptcy, in September 2008, by Lehman Brothers, the US investment bank. This was followed by significant pressure on money markets, with the failure or near failure of some major financial institutions. Policymakers across major economies deployed a number of extraordinary tools to contain the panic. Central banks stepped in to provide

commercial banks with unlimited liquidity, cut interest rates aggressively and purchased financial assets. Governments injected capital into banks and provided fiscal stimulus.

11. Money market rates and long term borrowing rates fell, reflecting lower central bank rates and declining economic prospects. In the UK, base rates were lowered to almost nil (just 0.50%) by March 2009, where they have remained since. Rates on new long term borrowing from the Public Works Loans Board (PWLB, a local authority lending arm of HM Treasury) also reflected weakening prospects, see below.



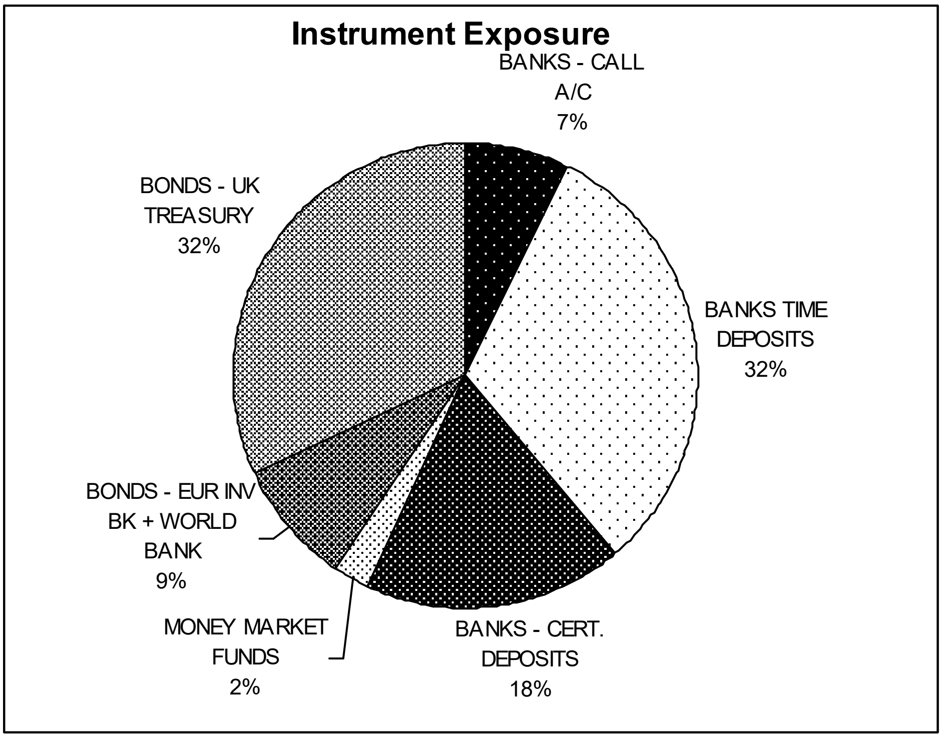
12. Today, whilst money markets are functioning again and the spread of money market rates to base rates has narrowed, access to credit amongst households and businesses that depend on banks remains a problem as banks continue to improve their resilience by strengthening their liquidity and capital base. The outlook for the economy therefore remains uncertain and is balanced between continued weakness as fiscal and monetary support becomes less supportive and improvements arising from continued stabilisation of financial conditions and stronger growth abroad. The outlook for inflation is also uncertain, but over time could be tested by improved global growth and rising commodity prices. Central banks would then come under pressure to raise rates and long term rates would also rise should investors become concerned about public finances and demand higher premiums for holding Government debt.

Investment Management Position and Annual Investment Strategy

13. The sum held in investments at the end of December 2009 was £258m 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. Aberdeen took over the investment business of Credit Suisse Asset Management in July 2009.

14. 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 2009 is set out below.



COUNTERPARTY EXPOSURE AND RATINGS										
Exposure £m	Fund					Fitch Rating				
Counterparty	ABERDEEN	ALLIANCE BERNSTEIN	INVESCO	IN-HOUSE	Grand Total	Long	Short	Sup-port	Sovereign	Sovereign Rating
ABBEY NAT	7.0			15.0	22.0	AA-	F1+	1	U.K	AAA
BARCLAYS	2.5	0.5	5.5	10.0	18.5	AA-	F1+	1	U.K	AAA
BNP			5.6		5.6	AA	F1+	1	France	AAA
DEXIA			3.9		3.9	A+	F1+	1	Belgium	AA+
DNB NOR BK		0.5			0.5	A+	F1	1	Norway	AAA
FORTIS	5.0				5.0	AA-	F1+	1	Belgium	AA+
GLOBAL TR FUND				6.1	6.1		AAA			
HSBC	0.6	0.2			0.8	AA	F1+	1	U.K	AAA
ING			5.5	15.0	20.5	A+	F1+	1	Netherlands	AAA
LLOYDS	4.5			15.0	19.5	AA-	F1+	1	U.K	AAA
NATIONWIDE	7.2	0.4		10.1	17.7	AA-	F1+	1	U.K	AAA
NATWEST				17.6	17.6	AA-	F1+	1	U.K	AAA
NORDEA	4.5		5.5		10.0	AA-	F1+	1	Norway	AAA
SOCIETE GEN			5.5		5.5	A+	F1+	1	France	AAA
IBRD	1.2	5.5			6.7	AAA	F1+		Surpranational	
EIB	7.7	7.6			15.3	AAA	F1+		Surpranational	
GEFCO-UK GUARANTEED	0.3	4.6			4.9				U.K	AAA
LCR-UK GUARANTEED	6.7	4.1			10.8	AAA			U.K	AAA
UK TREAS	9.5	33.4	24.0		66.9	AAA	F1+		U.K	AAA
Grand Total £m	**56.7**	**56.8**	**55.5**	**88.8**	**257.8**					

(In the table, UK guaranteed issues are shown as having the same rating as the UK Treasury. The Global TR Fund is a money market fund.)

15. The average return for the 9 months to December 2009 was 1.2% against part year average base rates of 0.4%. The return reflects past activity and, as investments mature and are reinvested, future returns are expected to be lower - reflecting the

steep fall in base rates and future weaknesses in bonds from uncertain economic prospects.

16. A cautious approach to council lending has been maintained throughout the market turbulence and no investment has experienced credit loss. The focus will remain on preserving capital and liquidity, and the strategy will continue to concentrate bank lending to large high rated institutions in major economies where the likelihood of support, in the event it were needed, is also high. Bank exposure will take the form of time deposits, call accounts and negotiable deposits (known as certificate of deposits). Typically term deposits will be under one year, and any longer exposure will take the form of certificates of deposits or bonds issued or guaranteed by the UK Government and be managed by the three external investment managers, having regard to interest rate expectations.

17. An Annual Investment Strategy for 2010-11 encompassing this approach is set out in Appendix B. It is set out according to the updated Government guidance on local authority investments referred to in paragraph 6 above. The strategy 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. As for 2009-10, the 2010-11 minimum rating criteria is enhanced with the addition of sovereign risk and support rating indicators and for 2010-11 the minimum rating has also been raised. Credit quality is further strengthened by the use of flexible instruments (e.g. call accounts, money market funds, short term deposits, liquid instruments and government securities). This approach is better than waiting for a rating development before responding. The Annual Investment Strategy 2010-11 ensuring the finance director can continue to respond flexibility to market developments and adopt a prudent approach, supplementing rating with information about capital strength and taking note of credit developments is set out at Appendix B for approval. Under Government guidance the strategy is to be published on the council's website.

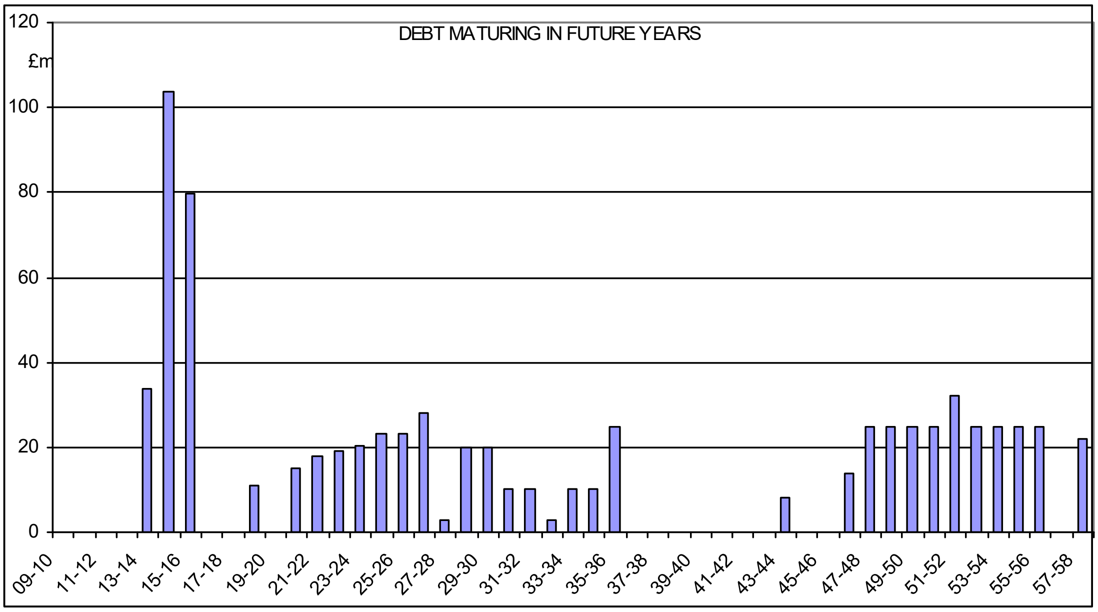
Debt Management Position and Strategy

18. The debt outstanding at the end of December 2009 was £762m and 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 and typically a competitive source of long term borrowing). The average rate of interest across all loans is 6.95% 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. However, around 80% of the debt is attributable to the HRA and reimbursed in subsidy pound-for-pound. An allowance for the remainder is included in Formulae Grant.

19. The most recent new debt drawn was December 2008, and met capital spend up to 2009-10. New loans will soon be needed to pay for future years' capital spend and, with borrowing rates still low by historical standard, the loans are expected to take the form of long maturities at fixed rates from the PWLB. The finance director will however keep under consideration shorter period loans or variable rates from the PWLB and commercial sector loans.

20. The council's debt portfolio is shown in the chart below. No loans fall for repayment until 2014 and, when they do, they are expected to be replaced with new loans. The loans can however be refinanced earlier with new loans from the PWLB or commercial sector, but attract early repayment penalties. These penalties reduce as loan life shortens or loan rates rise, making earlier refinancing more viable. Regulatory and market developments can also influence refinancing. Any borrowing

activity carried out by the finance director to meet new capital spend, refinance debt, or meet temporary cash flow and financing needs will be within existing delegation arrangements under financial standing orders and prudential indicators and limits set out in Appendix C.



21. The council is considering options on funding a new build scheme under the Housing & Communities Agency Challenge Fund. The finance director is currently in discussion with the Agency and the Department of Communities and Local Government on funding the council's contribution. Prudential or self-financed borrowing may be required, though the use of other resources available to the council (reserves, balances, capital receipts) may be a more economic option.

Prudential Indicators

22. The prudential indicators draw out elements of borrowing and investment activities and combine them with capital finance. The indicators set out in Appendix C for council assembly approval, include the authorised borrowing limit, which is a self imposed cap on borrowing outstanding on any one day. This limit will be affected by new accounting standards which require that funding through Private Finance Initiatives and leases be reviewed. These arrangements are currently being assessed and have yet to be reflected in the limit and for the purposes of determination the council assembly is asked to agree that the limit from 2010-11 onwards be treated as increased for any increase in long term liabilities that arises from accounting changes. Approval by council assembly will enable the finance director to carry out his responsibilities in this area.

Annual Minimum Revenue Provision Statement

23. 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.

24. The policy for 2010-11 recommended for approval is set out as Appendix D and is similar to 2009/10. 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

25. 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.

26. 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.

27. The capital allowance agreed by council assembly in February 2009 was £177m and now requires updating to reflect receipts of £7m that have been drawn against it, bringing the total allowance down to £170m. The council assembly is therefore recommended to agree a capital allowance of £170m, 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

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

29. 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 Code of Practice on Treasury Management, 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.

30. Reference should also be made to the Department of Communities and Local Government Guidance on Local Authority Investments updated November 2009. The council assembly should determine borrowing limits annually before the start of the year the limits relate to and approve the prudential indicators and borrowing and investment management strategies.

31. 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.

32. Statutory guidance on the MRP (Minimum Revenue Provision) was 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. The MRP guidance requires the council assembly to determine an annual strategy to prudently set aside sums to repay debt liabilities arising from capital expenditure.

33. 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	Financial Management Services, Strategic Services Department	Dennis Callaghan, Chief Accountant (020 7525 4375)

APPENDICES

No.	Title
Appendix A	Formal Resolutions adopting the updated Treasury Management Code – Recommended for Approval
Appendix B	Annual Investment Strategy 2010-11 – Recommended for Approval
Appendix C	Prudential Indicators 2010-11 to 2012/13 Recommended for Approval
Appendix D	Annual Minimum Revenue Provision Statement 2010-11 – Recommended for Approval

AUDIT TRAIL

Lead Officer	Duncan Whitfield, finance director	
Report Author	Duncan Whitfield, finance director	
Version	Final	
Version Date	10 Feb 2010	
Key Decision	Yes	
CONSULTATION WITH OTHER OFFICERS / DIRECTORATES / EXECUTIVE MEMBER		
Officer Title	**Comments Sought**	**Comments Included**
Strategic Director of Communities, Law & Governance	Yes	Yes
Final Report Sent to Constitutional Support Services		10 Feb 2010