Item No: 3.1	Classification: Open	Date: 23 February 2009	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 treasury management strategy.

   (ii) agree the annual investment strategy 2009/10 set out in Appendix A, keeping capital preservation as a key objective.

   (iii) agree prudential indicators covering capital finance, borrowing and cash management for the years 2009/10 to 2011/12 set out in Appendix B.

   (iv) agree the annual minimum revenue provision statement 2009/10, about prudent sums set aside from revenue to reduce debt, as set out in Appendix C.

   (v) agree a capital allowance of £177m, described in paragraphs 45 - 48 of this report, enabling the council to continue retaining capital receipts for affordable housing and regeneration.

BACKGROUND INFORMATION

2. Treasury management is about borrowing and investments. Borrowing is carried out to meet new capital funding, refinance maturing obligations or restructure debt. Any cash not immediately used in spending is held in deposits and money market investments with large high rated banks or in government bonds to earn interest. (This report does not cover investments held by the pension fund, which operates under a different framework).

3. Borrowing and investments are managed according to arrangements set out in the Code of Practice on Treasury Management in the Public Services, issued by the Chartered Institute of Public Finance and Accounting (CIPFA) first published 1992 and updated subsequently. Investment management is also subject to guidelines issued by the government and under it, the council assembly is responsible for agreeing an annual investment strategy, in which cash is managed prudently with security and liquidity being high priorities.

4. The council assembly is also responsible for agreeing a series of prudential indicators on capital finance, borrowing and investments. The indicators help assess the affordability, prudence and sustainability of activities and are part of a self-regulating regime brought in by the Local Government Act 2003, supporting regulations and the Prudential Code for Capital Finance in Local Authorities issued by CIPFA.

5. The annual minimum revenue provision statement is an additional requirement that came into effect from April 2008. It replaces complex

detailed statutory regulations about sums that must be set aside from revenue to reduce debt arising from capital expenditure with simpler flexible guidance having statutory force. The council already makes provisions each year in accordance with existing regulations, but the guidance calls for an annual statement to be prepared each year about prudent provisions to be made from revenue accounts to ensure that debt, particularly self financed debt, used to finance capital expenditure, is repaid over a period reasonably commensurate with that over which the capital expenditure provides benefits.

6. 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.

7. Under financial delegation previously agreed by council assembly, the finance director is responsible for all executive and operational decisions on borrowings and investments. The recommendations in this report will enable the director to carry out his responsibilities in this area.

KEY ISSUES FOR CONSIDERATION

Treasury Management Strategy: Borrowing and Investments

Background - Developments in Financial Markets

8. Since the Summer of 2007, financial markets have been under considerable strain. What started then as losses from rising rates of mortgage delinquencies (particularly US sub-prime mortgages and related products), in September 2008 turned into a general loss of confidence in the global banking system after the failure of the US government to secure Lehman Brothers (the large US based investment bank). The US and major governments across the world stepped in to reassure investors by providing massive liquidity to all banks and begin to deal with problem loans.

9. The roots of the global turmoil are thought to lay on large imbalances in international trade and capital flows built up over many years. The rapid growth in Asia and the Gulf built up substantial savings, which flowed back to developed countries and the US in particular. That kept interest rates low and allowed a rapid growth in credit. The low rates helped expand bank balance sheets in the developed world and led to an increasingly risky search for high returns and became the source of excesses of lending to the sub-prime housing market in the US and sharp rise in house prices.

10. The flow of funds into the US was re-exported back to other advanced countries through complex credit vehicles, which helped finance the rapid increases in house prices in the UK and many other countries. Banks raised their holding of these vehicles and when losses emerged in sub-prime markets they not only hit US banks but spread through the international banking system.

11. Central banks had responded to the first signs of the crisis in 2007 by supplying extensive liquidity to banks, and supporting institutions on a case by case basis (e.g. the nationalisation of Northern Rock in the UK, the rescue of IKB in Germany and the take over of Countrywide and Bear Stearns in the US). The assurance of support seemed to calm the markets, which right up to Summer 2008 were focused on risks to inflation from rising oil and food prices on still resilient emerging market demand.

12. But when in September 2008, the US government rescued its large mortgage finance companies (Fannie Mae and Freddie Mac), but then failed to stop

Lehman Brothers filing for bankruptcy, investors picked up this inconsistency, panicked, deserted the capital markets and headed for the relative safety of government bonds. Governments across the world then had to step in by supplying unprecedented sums in liquidity to all banks, helping major banks re-capitalise, deal with problem loans and provide deposit guarantees.

13. Major names that attracted state or sovereign fund help or had had to be absorbed with another entity included: in the UK - HBOS, RBS, Lloyds, Barclays and Bradford & Bingley; in Europe - Hypo Real Estate, Dexia, Fortis, ING, KBC, Commerzbank, Dresdner, UBS, Credit Suisse, Anglo Irish, Allied Irish and Bank of Ireland; and in the US - Merrill Lynch, AIG, Morgan Stanley, Goldman Sachs, Washington Mutual, Wachovia, Bank of America and Citibank. Many other major UK and international banks have had state funding guarantees and several more have had to be absorbed into larger entities, but many smaller banks, notably in the US, have also filed for bankruptcy, and three Icelandic banks, in which more than 100 UK local authorities had deposits, went into administration - Southwark was not one of those.

14. The loss of confidence in the financial markets was also threatening a tight squeeze on credit to household and businesses. As oil and commodity prices fell, inflation expectations turned downwards and opened the way to globally coordinated interest rates cuts in October 2008. In the UK this was followed up with a 1.5% cut in November, a 1% cut in December and a 0.5% cut in both January and February 2009 bringing the base rate down to just 1.0% from 5.0% in September 2008. Euro rates came down to 2.0%. Other central banks have had to go further. Rates in US, Japan and Switzerland have been brought down to between zero and 0.25% and further cuts in Euro and UK are still possible.

15. Fiscal stimulus packages have also been announced or are being planned by both advanced and developing countries, the largest being from the US. The US is also expected to supply unlimited support to credit markets and the UK may well have to do the same. Further support to relieve banks of impaired assets and direct interventions in credit markets are also planned.

16. Together these measures should boost confidence in the financial system, but they will take time to work though the economy. Until then, the squeeze on credit and loss in wealth thus far is expected to lead to a marked downturn in economic activity in the UK, US and Euro, and a slowdown in growth elsewhere. It is uncertain when economic prospects will improve and it may well take years rather than months before growth returns. But when that happens and commodity prices rise once again, markets could once again become worried about inflation risks and inevitable interest rate increases.

17. The council is not immune from this crisis. Resources, both revenue and capital will come under strain - spending demands will rise just when income and receipts slow. In relation to treasury management, the reductions in UK base rates will result in interest returns being much lower. The implications of this are set out in the budget report which is on the same council assembly agenda as this report.

Investment Management and Annual Investment Strategy

18. The basic approach to lending in the financial crisis has been, as it was before the crisis, to concentrate lending to large high rated banks in major economies where the likelihood of support, in the event it were needed, was high. The support provided has confirmed the critical role these banks play in both the domestic and international financial markets and has ensured that no losses occurred in deposits held by the council. The approach always avoided lending to banks in smaller economies, and has meant the council had no exposure to Icelandic banks which went into administration.

19. While governments have recognised the severity of the turmoil by co-ordinating liquidity and monetary intervention and ensuring that major financial institutions that are of systemic importance to the functioning of their economy can survive, it is clear that bank balance sheets across the globe still remain under pressure and that further intervention will be needed to improve confidence, restore inter-bank lending and in turn lending to consumers and business. It therefore remains in the interest of governments to ensure that major banks continue to be supported.

20. Given support arrangements already put in place and the likelihood of further support for critical elements of the banking sector, risk of loss from exposure to a major bank may be regarded as low. With continued active monitoring of developments in credit markets, the council may still cautiously lend to major banks which have a high likelihood of support in major developed sovereign states.

21. Further practical steps taken to reduce credit risk have included placing sums in high rated short term money market funds. These funds reduce exposure to any one entity. Amendments have been included in the Annual Investment Strategy to permit exposure to UK nationalised entities (currently Northern Rock and Bradford & Bingley) and reduce credit exposure further. Published ratings continue to inform credit quality and the range of indicators that will now be drawn on has been expanded to include sovereign rating and support rating which were implicit in existing lending practice.

22. The council has also avoided long term exposure to banks as investment holdings beyond one year have been in bonds issued or guaranteed by the UK government and supranational entities (such as the European Investment Bank and the International Bank for Reconstruction and Development - the "World Bank"). As well as helping reduce long term credit exposure, the bonds helped improve returns in a falling interest rate market.

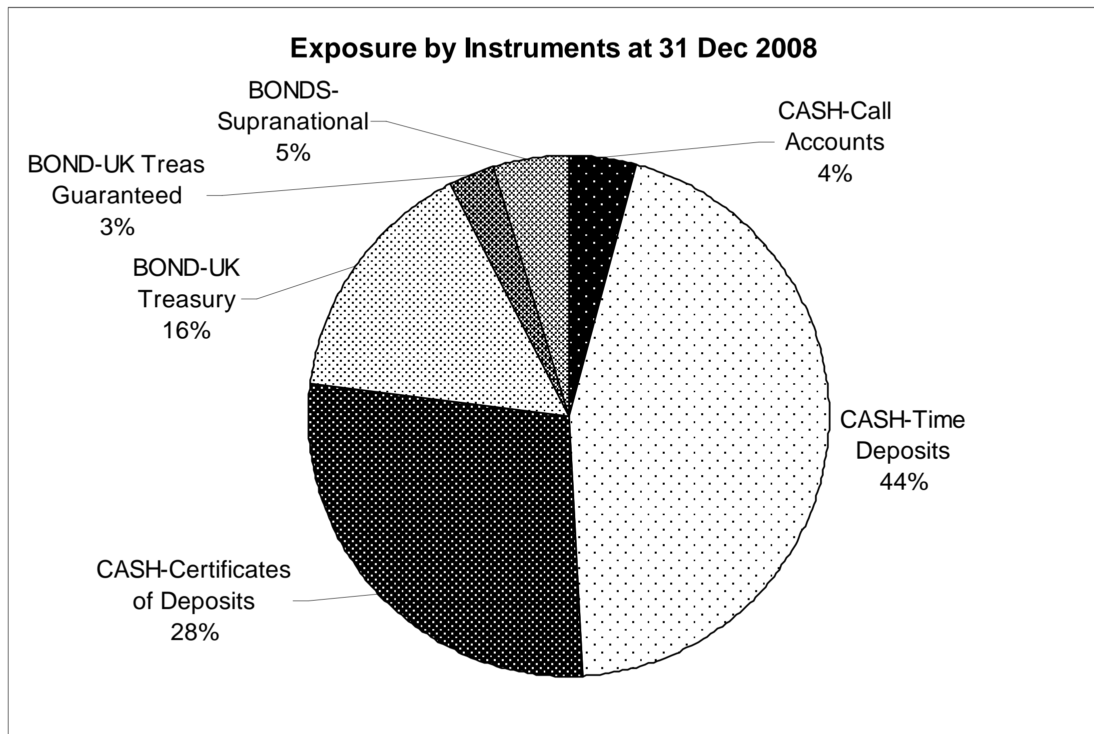
23. The annual investment strategy for 2009/10, drawn up according to investment guidelines issued by the government in 2004 (which places priority on security and liquidity), requiring council assembly approval is set out in Appendix A. As now the likelihood of support from a major sovereign, in the event it were needed, remains a strong feature in any deposit with banks, and to underline this, a sovereign rating filter has been added to the strategy. Also, given the willingness and capacity of strong sovereigns to continue supporting major banks, exposure to major banks has been raised to £40m each. This will help avoid undue concentration in any one region and help diversify deposit exposure amongst those large banks likely to be supported should it become necessary and as now the finance director will remain responsible for this strategy and its management. External specialists and fund managers shall assist in advising or executing elements of the strategy and in the interest of operational effectiveness the finance director will have flexibility, given market turbulence, to vary minimum rating and limits where prudent to protect the council's interests.

Investment Management – Update to December 2008

24. Cash balances averaged £298m over the course of 2007/08 and in the nine months to December 2008 have averaged £293m. Day to day investment management is carried out by an in-house operation and three investment management firms: Invesco Asset Management Ltd, AllianceBernstein Ltd and Credit Suisse Asset Management Ltd.

25. 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. In-house funds focus on meeting day to day cash volatility using a number of call accounts and short term deposits.

26. Investments are spread over many major high rated institutions and concentrated where the likelihood of support in the event it were needed is high. The actual instrument, counterparty exposure and rating at the end of December 2008 is set out in the table below.



COUNTERPARTY EXPOSURE at 31 December 2008						
Counterparty	Rating	Alliance Bernstein	Credit Suisse	Invesco	In-house	Grand Total
AUSTRALIA						
Nat Australia Bk	AA	0.5	-	-	-	0.5
Westpac Bkng Crp	AA-	-	-	5.0	-	5.0
BELGIUM						
KBC	A+	1.0	-	-	-	1.0
FINLAND						
Nordea Bk	AA-	0.5	3.9	-	10.3	14.7
FRANCE						
Calyon	AA-	-	-	5.1	-	5.1
Societie Generale	AA-	-	-	5.0	-	5.0
GERMANY						
DZ Bank	A+	-	3.5	-	-	3.5
IRELAND						
Allied Irish Bk	AA-	-	-	-	10.2	10.2
Anglo Irish Bk	A+	-	3.5	-	-	3.5
Bk of Ireland	AA-	-	-	5.1	-	5.1
ITALY						
Intesa Sanpalo	AA-	-	4.9	-	-	4.9
Unicredito	A+	0.5	3.5	-	-	4.0
NETHERLANDS						
ABN AMRO Bk	AA-	0.5	-	-	-	0.5
ING Bk	AA	1.0	-	6.6	-	7.6
NORWAY						
DNB NOR Bk	A+	-	5.0	-	-	5.0
SPAIN						
Banco Bilbao	AA-	-	-	5.0	10.0	15.0
SWEDEN						
Svenska Handelsbk	AA-	-	5.0	-	-	5.0
SWITZERLAND						
Credit Suisse	AA-	0.6	-	5.2	-	5.8
UBS	A+	-	4.3	5.0	10.2	19.5
UK						
Abbey National	AA-	0.5	-	-	15.6	16.1
Barclays Bk	AA	3.7	-	5.2	15.2	24.1
Bk of Scotland	AA	-	-	-	-	-
GTD Exp Finance	AAA	4.9	-	-	-	4.9
HSBC	AA	0.7	0.1	-	-	0.8
LCR Finance	AAA	3.5	-	-	-	3.5
Lloyds TSB	AA+	-	-	-	15.0	15.0
Nationwide Bsoc	AA-	1.1	5.0	-	5.0	11.1
NatWest Bk	AA-	-	-	-	41.3	41.3
UK Treasury	AAA	29.8	9.0	7.7	-	46.5
SUPRANATIONAL						
Int Bk Recons Dvt	AAA	2.8	-	-	-	2.8
European Inv Bk	AAA	3.9	7.9	-	-	11.8
Grand Total		55.5	55.6	54.9	132.8	298.8

In the table, the counterparty ratings refer to long term ratings issued by Fitch Ratings. Bonds guaranteed by the UK government have been given the same rating as bonds issued by the government itself.

27. The average return for the 9 months to December 2008 was 4.82% against average base rates of 4.45%. These returns reflect past investments and as these mature and are reinvested, future returns will be considerably weaker - reflecting the steep fall in base rates, which fell from 5% in September 2008 to just 1.0% in February 2009. The budget report which is on the same council assembly agenda as this report discusses the implications of this further.

28. In December 2008 Credit Suisse advised the council of its plans to sell a stake in its global asset management business to Aberdeen Asset Management Plc, a UK listed fund management firm. The stake includes the business that manages the council's funds. Aberdeen's London operation already manages cash under capital preservation mandates that are similar to the one the council has with Credit Suisse. The transfer is due to take effect in the second quarter of 2009 and transition arrangements will become clearer in the coming months when the finance director will be in a position to assess the merits of the transfer.

Debt Management Strategy

29. Borrowing is undertaken to meet that element of capital spend that is not met from locally available resources (receipts from asset sales, grants and revenue funding). Borrowing for capital takes two forms: supported borrowing (which is associated with support for interest and sums set aside to repay debt) or self-financed prudential borrowing (the cost of which attracts no revenue support from the government). There are currently no plans for any prudential borrowing in 2009/10, although there may be some need in the future to deal with any short term timing mismatch that arises from pre-funding capital spend ahead of income from asset sales and grants.

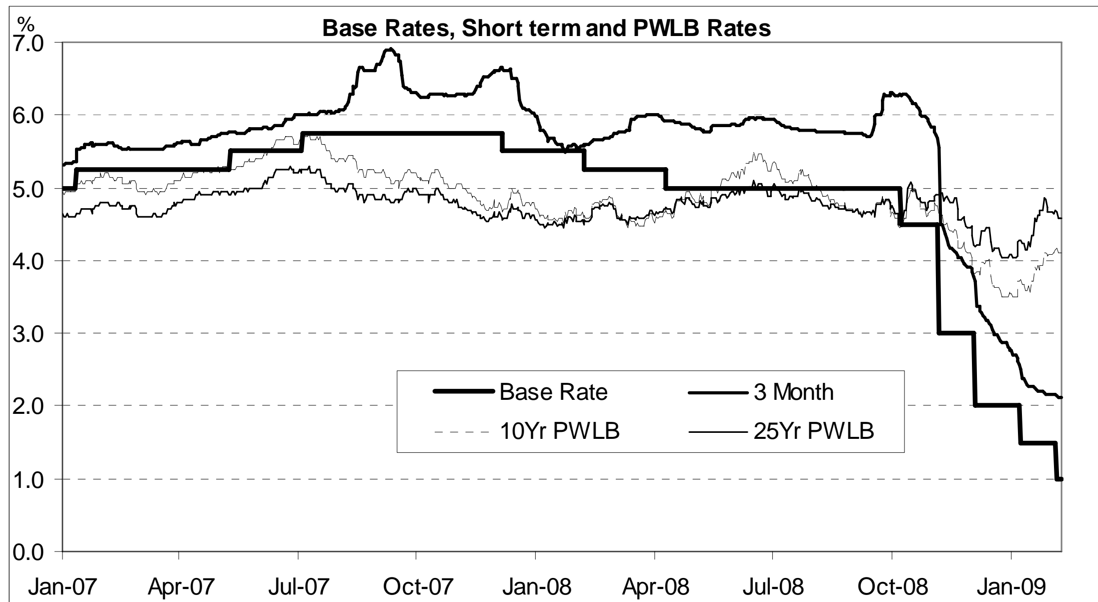
30. The £32m new loans taken in December 2008 (see debt management update below) will meet government supported capital expenditure. Further borrowing to fund future years' supported spend or maturing obligation may remain an option. Any such borrowing is likely to be of long term debt, given that rates are still low. This not only reduces refinancing risk, but also protects against future rate rises. Short term or variable rate debt is only likely to have a subsidiary role, and only likely for cash flow requirements or funding pending replacement with longer term debt. Refinancing by paying off high rate loans and replacing with lower rate ones reduces the long term average rate of interest in debt, and will remain an option where prudent and where loan breakage and financing costs are affordable for the council.

31. The principal source of borrowing for local authorities is the Public Works Loans Board (PWLB, a division of HM Treasury). The PWLB provide funding for capital spend and debt refinance at both fixed and variable rates. Rates are close to the cost of borrowing by the government itself and therefore lower than comparable borrowing from the commercial sector. However, long term commercial sector loans may also be attractive in limited cases e.g. it can, unlike the PWLB, be organised to start at a future date and call-options built into commercial loans can offer rates that may be lower than the PWLB in the short run. Both sources will remain open in future borrowing or refinance, but the PWLB will continue to represent the bulk of debts held.

32. 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 arrangement under financial standing orders and prudential indicators and limits set out in Appendix B.

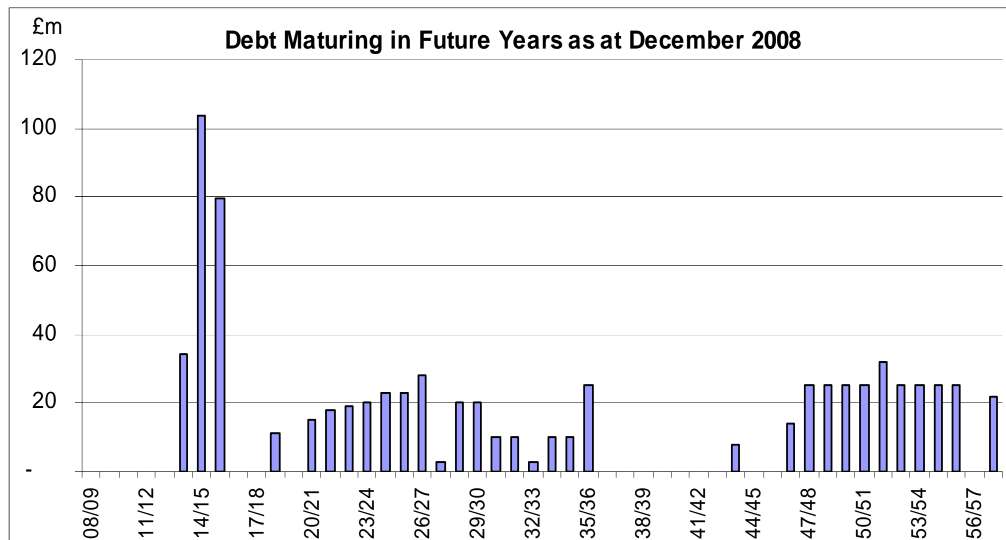
Debt Management – Update to December 2008

33. In December 2008, £32m new loans were taken up to meet supported capital spend. The loans were for a term of 43 years at a rate of 3.99%, near historical lows for long loans (see the interest rate chart below) and below the 7.6% average rate on debt interest in 2007/08. As well as providing funding certainty, the loans help reduce the risk of rate rises in the long term.



34. The average rate of interest of 7.6% on long term debt remains high relative to current rates and that of many other local authorities. The average 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, as around 83% of the debt is attributable to the HRA and reimbursed in subsidy pound-for-pound, and an allowance for the remainder is included in Formulae Grant, the impact on Council finances of the high average rate is minimal.

35. The level of debt as at 31 December 2008 stands at £762m, an increase of £32m since April 2008. All loans are at fixed rates, from the PWLB and the average life of loans is 24 years. The amount falling out for refinance in futures years is shown in the chart below – the Council has no loans maturing before 2014.



Prudential Indicators

36. Prudential indicators draw out elements of borrowing and investment activities and combine them with capital finance. The indicators include the authorised borrowing limit, which is a self imposed cap on borrowing outstanding on any one day. Council assembly approval is sought for these indicators, set out in Appendix B. The indicators will enable the finance director to carry out his responsibilities in this area.

Annual Minimum Revenue Provision Statement

37. 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 to pay off some of the borrowing each year. 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 have been replaced by statutory guidance. The policy for 2008/09 was produced in February 2008 and the one for 2009/10 is set out as Appendix C.

38. Under the statutory guidance, a prudent provision should be made to reduce debt used to fund capital expenditure. 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 through revenue grant.

39. The guidance proposes four options which it regards as prudent:

a) Regulatory method

b) CFR (Capital Finance Requirement) method

c) Asset life method

d) Depreciation method

40. The regulatory and CFR methods are similar to existing arrangements and are only available for capital borrowing supported by the government. The CFR method is simpler but more expensive than the regulatory method.

41. The asset life method makes equal annual instalments over the estimated life of the asset for which the borrowing was undertaken. This method is also recommended where the borrowing relates to expenditure that is capitalised by direction or regulation.

42. Under the fourth option, the depreciation method, MRP is calculated under rules for depreciation accounting and refers directly to asset valuations rather than the financing underlying the asset. It is much less straight forward than the other three methods.

43. The government recommends the asset life and depreciation methods for self financed prudential borrowing. Although the council currently has no plans to undertake any such borrowing in 2009/10, the MRP statement would still need to refer to it.

44. The annual MRP statement for 2009/10 drawing on these principals and recommended for approval by council assembly is set out in Appendix C. As capital borrowing in 2009/10 is of a supported nature there is no practical change to the way that MRP is calculated. However, the statement as a whole has been clarified in relation to determining asset life involving mixed types of expenditure or mixed sources of funding. No MRP is required where expenditure involves repayable loans or grants as these liabilities are settled in full when the loan or grant is repaid.

Capital Allowances

45. 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.

46. 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.

47. The capital allowance agreed by council assembly in February 2008 was £152m. This now requires updating to reflect the planned expenditure on affordable housing or regeneration programmes. After taking account of the receipts that have already been drawn against the existing allowance, an additional £25m needs to be added to reflected planned expenditure, which brings the total allowance requiring approval to £177m.

48. The council assembly is recommended to agree a capital allowance of £177m to enable the council to carry on retaining capital receipts for affordable housing and regeneration that would otherwise pass to the government under pooling arrangements. The level of allowance needed in the future will be kept under review as the capital programme develops.

SUPPLEMENTAL ADVICE FROM OTHER OFFICERS

Strategic Director of Legal and Democratic Services

49. 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.

50. Reference should also be made to the Department of Communities and Local Government (DCLG, previously the ODPM) Guidance on Local Authority Investments issued in 2004. 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.

51. 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.

52. Statutory guidance on the MRP (Minimum Revenue Provision) SI No. 2008/414 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.

53. Members are advised to give approval to the recommendations contained in paragraph one of this report.

BACKGROUND DOCUMENTS

Background Papers	Held at	Contact
Prudential Code for Capital Finance in Local Authorities. Code of Practice on Treasury Management in the Public Services ODPM Investment Guidelines. 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	Annual Investment Strategy 2009/10 – Recommended for Approval
Appendix B	Prudential Indicators 2009/10 to 2011/12– Recommended for Approval
Appendix C	Annual Minimum Revenue Provision Statement 2009/10 – Recommended for Approval

AUDIT TRAIL

Lead Officer	Simon Hughes, Assistant Finance Director	
Report Author	Simon Hughes, Assistant Finance Director	
Version	Final	
Version Date	10 Feb 2009	
Key Decision	Yes	
CONSULTATION WITH OTHER OFFICERS / DIRECTORATES / EXECUTIVE MEMBER		
Officer Title	**Comments Sought**	**Comments Included**
Strategic Director of Legal and Democratic Services	Yes	Yes
Final Report Sent to Constitutional Support Services		10/02/09