Item No: 8.1	Classification: Open	Date: 4 July 2012	Meeting Name: Council Assembly
Report title:		Treasury Management Performance - 2011/12 Annual Report, and update on HRA self-financing settlement	
Wards or groups affected:		All	
From:		Finance Director	

RECOMMENDATIONS

1. That council assembly notes this 2011/12 outturn report on debt, investments and prudential indicators.

2. That council assembly notes the £100m debt refinancing carried out between March and April 2012 and the disaggregation of the long term debt outstanding at 1 April 2012 between the HRA and the General Fund, as set out in paragraph 18.

BACKGROUND INFORMATION

3. This item reports the outturn on the council's debt and investment activities in 2011/12, as part of the annual cycle of reports on treasury matters. Council assembly also receives a treasury strategy report before the start of a year, in February, and a half year update after September. The cabinet receives quarterly updates, and a review and scrutiny of the treasury strategy is carried out by the audit and governance committee before the council assembly meets in February.

4. The borrowing and investment activity is supported by a series of prudential indicators (estimates and limits on capital finance, debt and investments), which are agreed by council assembly each year. Under financial delegation all executive, managerial and operational decisions are the responsibility of the finance director. This area of finance falls under the Local Government Act 2003 and is supplemented by investment guidance issued by the government and codes of practice issued by the Chartered Institute of Public Finance and Accountancy (CIPFA). The CIPFA codes have statutory force under the 2003 Act and supporting regulations.

KEY ISSUES FOR CONSIDERATION

Treasury Management Borrowing and Investments

Financial Market Backdrop

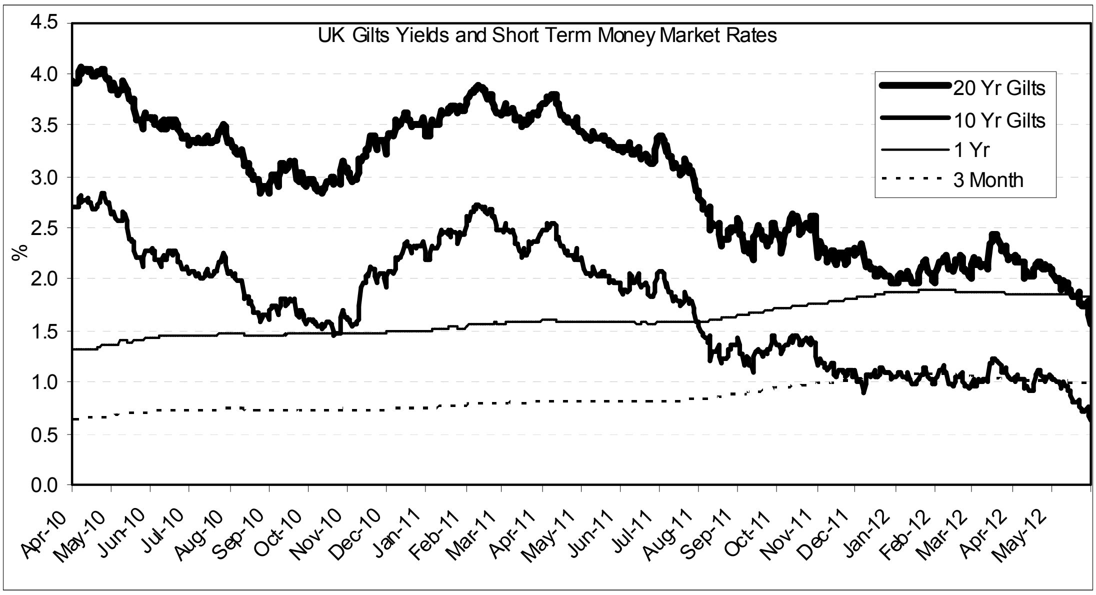
5. Throughout 2011 concerns about the financial stability of some euro zone countries dominated investor attention. The cost of borrowing from the financial markets soared for peripheral sovereign governments as declining expectations of economic growth raised uncertainty over the fiscal path of those economies. Banks in those sovereigns also faced increased funding pressure, and bank shares underperformed.

6. However, towards the end of 2011 and into the first quarter of 2012, conditions in European markets improved markedly as central banks across the globe took co-ordinated action to improve short-term funding conditions, and the European Central Bank (ECB) provided unlimited three-year liquidity to banks in December 2011 and February 2012. The cost of sovereign borrowing fell in many euro zone countries, and lessened banking sector tension. Agreement was also reached on further International Monetary Fund and European Union assistance for the Greek government, and several countries in the euro zone agreed reforms to reduce fiscal deficits and improve competitiveness.

7. Since March 2012 the cost of borrowing in euro zone periphery countries and the larger Spanish and Italian sovereigns have risen, reflecting continuing concern about the indebtedness and competitiveness of these economies. As before, the ECB stands ready to take further action to support the financial system and continues to make unlimited liquidity available to banks.

8. In the meantime safe-haven flows kept the cost of sovereign borrowing in Germany, the US and the UK low (see UK rates on chart 1 below).

CHART 1



Investment Activity and Position

9. Throughout the market turmoil, the council has maintained a cautious approach to lending. Exposure to banks is biased in favour of large institutions 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, and the uses of liquid call accounts and certificates of deposits. There is also exposure to gilts issued by the UK government, 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 limited to gilts or EIB and IBRD bonds.

10. Ratings agencies responded to developments in financial markets by lowering the rating of many previously high rated sovereigns and systemically important banks in Europe, including in the UK. To ensure that the council can continue to have flexibility to lend to major high rated banks, including UK banks where the likelihood of support is high, the minimum long term rating recommended to the council assembly in February 2012 within the annual investment strategy was lowered by one notch. The minimum rating still represents high credit quality, with a strong capacity for timely repayments. The short term rating was unchanged at F1/P-1/A-1 (Fitch, Moody's and S&P respectively) and is the highest it can be. The support rating issued by Fitch also remained unchanged at 1 and 2 (1=extremely high likelihood of support, 2=high likelihood of support).

11. The cash held in investments averaged £299m over the course of 2011/12 (£238m in 2010/11). Investments at the end of March 2012 were £187m (£236m at March 2011), affected by the £100m debt repayment and refinancing carried out on 22 March 2012, set out in paragraph 15 below. The counterparty, type of investment, rating and maturity analysis of the investments at 31 March 2012 is set out in chart 2 and tables 1 and 2, below. The average return for 2011/12 was 1.03% (1.08% in 2010/11), reflecting the prolonged period of very low money market rates, as expressed by the Bank of England's base rate of 0.5% throughout the year.

Chart 2

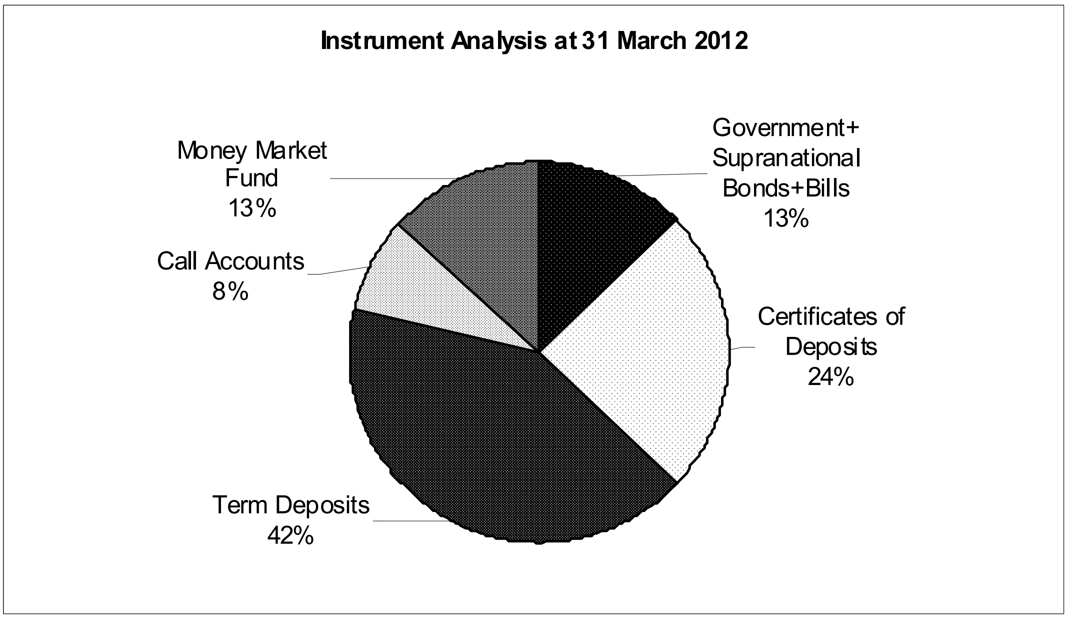


Table1

COUNTERPARTY EXPOSURE AND RATING at 31 March 2012										
	FUND					FITCH RATING				
COUNTERPARTY	ABER DEEN	ALLIANCE BERN STEIN	INVESCO	IN HOUSE	Total £m	Long	Short	Sup port	Country	Country Rating
BARCLAYS BK		1.0	6.5	12.8	20.3	A	F1	1	UK	AAA
CREDIT INDST COMRCL	1.0				1.0	A+	F1+	1	FRANCE	AAA
DEUTSCHE BK				15.0	15.0	A+	F1+	1	GERMANY	AAA
EUROPEAN INVST BK	6.2	5.9			12.1	AAA	F1+	1	SUPRANATION	AAA
GLOBAL TREAS FNDS PLC MMF				25.0	25.0	0	AAA	1	GLOBAL	0
HSBC	0.4		0.7		1.1	AA	F1+	1	UK	AAA
ING BK	5.0	1.0	3.5		9.5	A+	F1+		NETHERLANDS	AAA
INTL BK RECON & DEV	3.5	5.8			9.3	AAA	F1+		SUPRANATION	AAA
LLOYDS/BK SCOTLAND		1.0			1.0	A	F1	1	UK	AAA
NATIONWIDE B/SOC	4.0	1.5		10.0	15.5	A+	F1	1	UK	AAA
NORDEA BK				15.0	15.0	AA-	F1+		FINLAND	AAA
RBS/NATWEST					-	A	F1	1	UK	AAA
SANTANDER UK	4.5			15.0	19.5	A+	F1	1	UK	AAA
SVENSKA HANDELSBKN	2.7	1.0			3.7	AA-	F1+	1	SWEDEN	AAA
UBS	3.1			15.0	18.1	A+	F1	1	SWITZERLAND	AAA
UK TREASURY	2.1	1.1			3.2	AAA	F1+	1	UK	AAA
COMMONWLTH BK AUSTRALIA				10.0	10.0	AA-	F1+	1	AUSTRALIA	AAA
NATIONAL AUSTRALIA		0.5			0.5	AA-	F1+	1	AUSTRALIA	AAA
BK NOVA SCOTIA	3.5				3.5	AA-	F1+	1	CANADA	AAA
ABN AMRO	5.0				5.0	A+	F1+	1	NETHERLANDS	AAA
Total £m	**41.0**	**18.8**	**10.7**	**117.8**	**188.3**					

(Includes £1.5m held on behalf of trust funds)

Table 2

Rating and Investment Maturity Profile				
Fitch Rating	AAA	AA+ to AA-	A+ to A	Total
2-5 Years	9%			9%
1-2 Years	4%			4%
Up to 1 Year	14%	18%	56%	88%
Total	27%	18%	56%	100%

12. Investments are managed by a combination of an in-house operation and external investment management firms. During 2011/12 three firms were used: Invesco Asset Management Ltd, AllianceBernstein Ltd and Aberdeen Investment Managers Ltd. The external managers hold portfolios totalling £150m plus accrued interest, although these portfolios were reduced in March 2012 in order to finance the cashflow on debt refinancing carried out, see paragraphs 14 and 15 below, with the external portfolios planned to be restored to £150m following the debt refinancing.

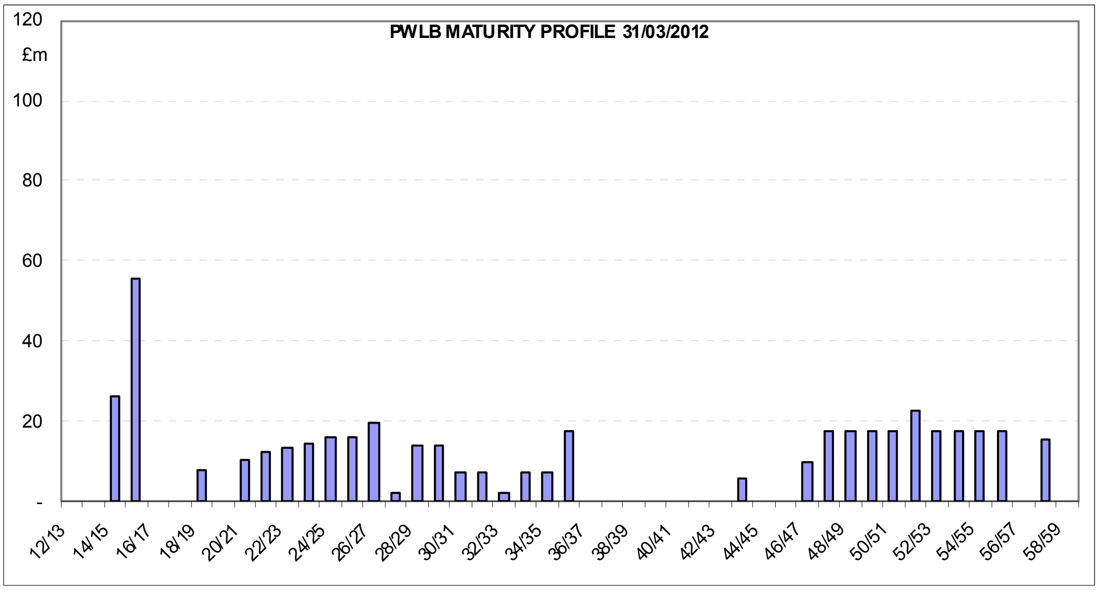
13. The use of external fund managers, and the types of investments they use, requires the use of custodian bank accounts. The current custodian, HSBC Bank plc, gave short notice that it wished to stop providing this service from the end of June 2012, due to a change in its business requirement. A replacement custodian is being sought, and terms are being discussed with a major global custodian bank. There is a risk that the HSBC service may come to an end before a replacement is in place, in which case the investments held by the managers may need to be sold and the proceeds transferred in-house pending the start of the new appointment.

Debt Activity and Position

14. The council took on no new debt to finance capital spend in 2011/12. At 31 March 2012 the debt outstanding stood at £462m (£761m at 31 March 2011). All debt is from the Public Works Loans Board (PWLB), the local authority lending arm of HM Treasury. On 28 March the government paid off £199m under HRA self-financing. In conjunction with the government's action, on 22

March 2012 £100m was redeemed and refinanced with new loans on 26 April 2012, the new loans being for a period of 20 years. This brought the level of debt down to £462m at 31 March 2012, the maturity profile of which is shown in chart 3 below

Chart 3



15. The £100m refinancing was carried out using cash supported by General Fund balances and reserves. It involved repaying high interest loans at 9.00% or more, maturing between 2014 and 2015 and replacing them with loans at 3.20% repayable over twenty years in equal instalments to match the General Fund's statutory minimum revenue provision requirements. A premium of £20.6m was also incurred and will be spread out over twenty years - £17.2m will fall on the HRA and £3.4m on the General Fund. As discussed further below the refinancing enables the General Fund, after the debt is disaggregated between the General Fund and the HRA, to reduce the average rate of interest (from 6.78% in 2011/12 to 3.56% in 2012/13), whilst ensuring HRA's substantial unsupported debt remains affordable. The HRA also benefited from the interest reduction, offsetting the premiums cost, so that there was no net effect on the HRA from this action.

16. 2011/12 was the final year that the HRA and the General Fund debt needed to be managed in a single pool. From 01 April 2012 it has been disaggregated and each fund can manage its debt in a way that best suits its financing requirement.

17. CIPFA have issued guidance on disaggregating debt and it envisages allocating the long term debt outstanding on 1 April 2012 between the HRA and the General Fund by allotting the HRA in full with loans up to its capital financing requirement (excluding long term liabilities like PFI and leases), with the residual allotted to the General Fund. Where the residual is lower than General Fund's own capital financing requirement (excluding long term liabilities), CIPFA treats it as internal borrowing funded with cash represented by General Fund reserves and balances.

18. At Southwark, the HRA capital financing requirement (excluding long term liabilities) is £451m and the General Fund requirement is £127m at 01 April

2012. After the HRA self-financing payment and the £100m refinancing on 22 March, using General Fund cash, the long term debt outstanding at 01 April 2012 was £462m. This means the HRA can be allotted £451m, with the remainder, £11m, taken up by the General Fund. The General Fund also takes on a further £100m in low interest long term debt on 26 April 2012, which replaces the 22 March repayment. This allotment properly recognises the use of General Fund cash in the refinancing and ensures that the resulting allocation is both affordable and sustainable by each fund. It also lowers the average rate of interest on General Fund loans to 3.56% and improves its resilience and capacity to manage debt flexibly and, as far as possible, independently of the HRA. The average rate on HRA loans would be 6.56% and from 2015 will fall as maturing debt is refinanced at lower rates. It is attractive for the council as a whole to disaggregate debt between the HRA and General Fund and the council assembly is asked to note the allotment between the two funds as set out above.

Prudential Indicators

19. Prudential indicators bring together elements of capital finance, borrowing and investment in a series of estimates and limits to give a general picture of the affordability, prudence and sustainability of financing activities. The outturn for each indicator based on the 2011/12 draft accounts is set out in Appendix A and includes the authorised debt limit, which is a self imposed cap on borrowing and other long term liabilities (like leases and PFI schemes) outstanding on any one day. The limit for 2011/12 was £997m and included operational flexibility for temporary borrowing and prudent refinancing in a risk controlled framework. The opening debt was £761m. No new borrowing was taken in 2011/12 and £299m was paid off to leave a closing debt of £462m. The value of long term liabilities at 31 March 2012 was £107m. Taken together, actual borrowing and other long term liabilities remained below the £997m limit throughout the year.

SUPPLEMENTAL ADVICE FROM OTHER OFFICERS

Strategic Director of Communities, Law & Governance

20. The constitution determines that agreeing the treasury management strategy is a function of council assembly. All executive and operational decisions are the responsibility of the finance director.

21. The Local Government Act 2003 and supporting regulations require local authorities to determine annual borrowing limits and have regard to the Prudential Code for Capital Finance, and the Treasury Management in the Public Services Code of Practice, both published by the Chartered Institute of Public Finance and Accountancy, when considering borrowing and investment strategies, determining or changing borrowing limits or prudential indicators.

22. Section 15(1) of the 2003 Act requires a local authority “to have regard (a) to such guidance as the Secretary of State may issue”. This guidance is found in the Department of Communities and Local Government Guidance on Local Authority Investments updated March 2011 and statutory guidance on the Minimum Revenue Provision (MRP) produced under amendments made to section 21(1A) of the Local Government Act 2003 by section 238(2) of the Local Government and Public Involvement in Health Act to 2007.

23. Members are advised to give approval to the recommendations contained in this report ensuring compliance with CIPFA's codes.

BACKGROUND DOCUMENTS

Background Papers	Held at	Contact
DCLG Guidance on Local Authority Investments.	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 Outturn

AUDIT TRAIL

Lead Officer	Duncan Whitfield, Finance Director		
Report Author	Dennis Callaghan, Chief Accountant		
Version	Final		
Version Date	21 June 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
Cabinet Member		Yes	Yes
Final report sent to Constitutional Team			21 June 2012