Item No: 7.2	Classification: Open	Date: 28 November 2012	Meeting Name: Council Assembly
Report title:		Treasury Management – Mid-Year Update 2012/13	
Wards or Groups affected:		All	
From:		Strategic Director of Finance and Corporate Services	

RECOMMENDATIONS

1. That council assembly notes this 2012/13 mid-year treasury management update.

2. That council assembly agrees the changes to Prudential Indicators as set out in paragraph 17 of this of this report.

BACKGROUND INFORMATION

3. This report is a half-year update on the council's borrowing, investments and prudential indicators, and is one of a series on treasury management to the council assembly by the Strategic Director of Finance and Corporate Services. In February 2012, the council assembly considered the treasury strategy for 2012/13 and in July 2012 it received a report on treasury performance in 2011/12.

4. Quarterly updates on treasury activity are considered by cabinet, and a report reviewing treasury policy and strategy was presented to audit and governance committee on 13 November 2012.

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). Council assembly is responsible for agreeing treasury strategy and prudential indicators and, under the constitution, all executive and operational decisions are the responsibility of the Strategic Director of Finance and Corporate Services.

KEY ISSUES FOR CONSIDERATION

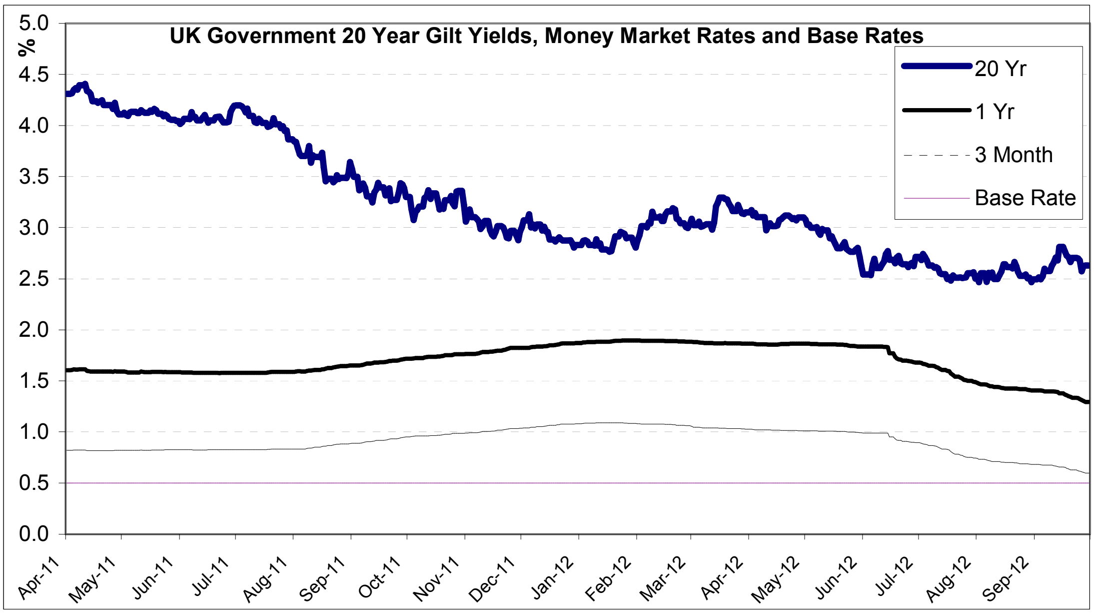
Treasury management borrowing and investments

Financial market backdrop

6. Throughout the first half of 2012/13 investor attention was dominated by expectations of slower growth and concerns about the finances of some euro zone countries. The cost of Spain's borrowing rose significantly when the country sought help to strengthen its banks, and was made worse by slowing growth. Other euro-area sovereigns experienced pressure too and the cost of Italian government borrowing also rose. However financing pressure began easing in July 2012 when the European Central Bank (ECB) indicated that additional measures would be taken to strengthen the euro. Yields on Italian and Spanish

bonds fell and in September 2012 the ECB issued details of its sovereign debt purchase plan to help contain borrowing costs. The ECB was not alone in supporting financial markets. The United States, the Bank of Japan and the Bank of England all maintained loose monetary policy and continued with or raised asset purchase programmes to help counter slower growth.

7. The combination of weak growth, central bank action and the flow of money out of weaker sovereigns helped keep the cost of borrowing by high rated sovereigns low, including the UK. Movements in UK rates are shown in the chart below.



Investment activity and position

8. The cash invested at 30 September 2012 stands at £366m, and a cautious approach to lending remains in place since the credit turmoil began in 2008. Bank exposure favours 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. Call accounts and certificates of deposits are used in the interest of liquidity. There is also exposure to gilts and treasury bills issued by the UK government, and supranational bonds (European Investment Bank (EIB) and the International Bank for Reconstruction and Development (IBRD, the 'World Bank')).

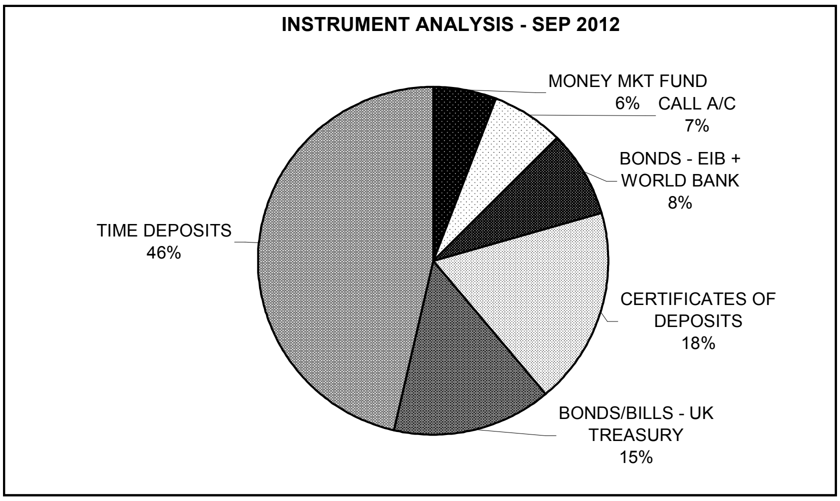
9. The investments are managed by an in-house operation and fund managers. Three fund managers were in place up to May 2012 and following a review of the appointment, which were for an initial period of five years, the contracts with Aberdeen Asset Managers and AllianceBernstein were extended for a further three years. In July 2012, following the appointment of a new custodian, Bank of New York Mellon, London Branch, (BNYM), the sum managed by the two managers was raised back up to a total of £150m (the amount sum previously allocated across three managers). BNYM is a US incorporated global financial institution and one of largest custodians in the world and replaces HSBC in the

provision of safekeeping and settlement services for the cash, certificates of deposits and bonds held by the managers.

10. The counterparties across which the £366m balance at the end of September 2012 was spread, together with the maturity profile and instrument analysis is set out below.

EXPOSURE - Sep 2012 COUNTERPARTY AND RATINGS									
Exposure £m	**FUND**				**Fitch Ratings**				
COUNTERPARTY	Aberdeen	Alliance Bernstein	In-House	**£m**	Long	Short	Sup-port	Sovereign	Sovereign Rating
COMMONW BK AUSTRALIA	-	-	5.0	5.0	AA-	F1+	1	AUSTRALIA	AAA
ANZ BK CORP	-	-	10.0	10.0	AA-	F1+	1	AUSTRALIA	AAA
FORTIS BK	7.7	-	-	7.7	A	F1	1	BELGIUM	AA
BK OF NOVA SCOTIA	5.0	-	-	5.0	AA-	F1+	1	CANADA	AAA
NORDEA BK FINLAND	9.5	1.0	15.0	25.5	AA-	F1+	1	FINLAND	AAA
SOCGEN	-	1.0	10.0	11.0	A+	F1+	1	FRANCE	AAA
BANQUE NATIONAL DE PARIS	-	1.0	15.0	16.0	A+	F1+	1	FRANCE	AAA
DEUTSCHE BK	5.0	1.0	15.0	21.0	A+	F1+	1	GERMANY	AAA
LANDESBK BADEN WERTMBG	-	1.0	-	1.0	A+	F1+	1	GERMANY	AAA
DZ BANK	8.0	-	-	8.0	A+	F1+	1	GERMANY	AAA
GLOBAL TREAS FUNDS-MMF	-	-	20.9	20.9		AAA		GLOBAL	
ABN AMRO BK	5.0	1.0	-	6.0	A+	F1+	1	NETHERLAN	AAA
ING BK	5.2	1.0	15.0	21.2	A+	F1+	1	NETHERLAN	AAA
RABOBANK	-	0.5	-	0.5	AA	F1+	1	NETHERLAN	AAA
EUROPEAN INV BK	13.6	6.0	-	19.6	AAA	F1+		SUPRANATI(	AAA
INT BK RECONST DEVT	3.5	5.8	-	9.3	AAA	F1+		SUPRANATI(	AAA
SVENSKA	-	-	15.0	15.0	AA-	F1+	1	SWEDEN	AAA
UBS	3.3	-	15.0	18.3	A	F1	1	SWITZERLAI	AAA
BARCLAYS BK	-	1.0	15.0	16.0	A	F1	1	UK	AAA
LLOYDS TSB/BK SCOTLAND	5.0	0.3	15.0	20.3	A	F1	1	UK	AAA
NATIONWIDE BSOC	4.0	1.0	15.0	20.0	A+	F1	1	UK	AAA
RBS/NATWEST	-	-	35.3	35.3	A	F1	1	UK	AAA
UK TREASURY	0	53.3	0	53.3	AAA	F1+		UK	AAA
BNYM CASH	0.2	0.1	0	0.3	AA-	F1+	1	US	AAA
Total £m	75.0	75.0	216.2	366.2					

Maturity Profile & Long Term Fitch Rating at Sep 2012							
Yr Band	A	A+	AA	AA-	AAA	Money Fund	Grand Total
0-6 Mths	94.3	99.0	-	60.8	35.2	20.9	310.2
6-12 Mths	3.3	5.2	0.5	-	18.0	-	27.0
1-2 Yrs	-	-	-	-	4.3	-	4.3
2-5 Yrs	-	-	-	-	24.7	-	24.7
Grand Total	97.6	104.2	0.5	60.8	82.2	20.9	366.2



11. The investment strategy demands high ratings in the interest of capital preservation. For investments up to one year the long term rating of a bank or building society must be a minimum of A/A2/A (Fitch/Moody's/S&P) from at least one of the three rating agencies. And the rating must be even higher for exposure between one and three years (AA-/Aa3/AA- Fitch/Moody's/S&P). Any exposure above three years may only be with the more secure UK Government or supranational banks. Further enhancements are being considered to raise flexibility and improve diversification, without unduly raising credit risk. These include widening the range of supranational banks, adding GBP bonds issued by non UK sovereigns (i.e. by the governments of other countries, e.g. Sweden), purchasing collateral backed covered bonds, and investing in short duration cash/bond funds. The changes were considered by audit and governance committee on 13 November, and an update to the investment strategy will be put to the council assembly in February 2013.

Debt activity and position

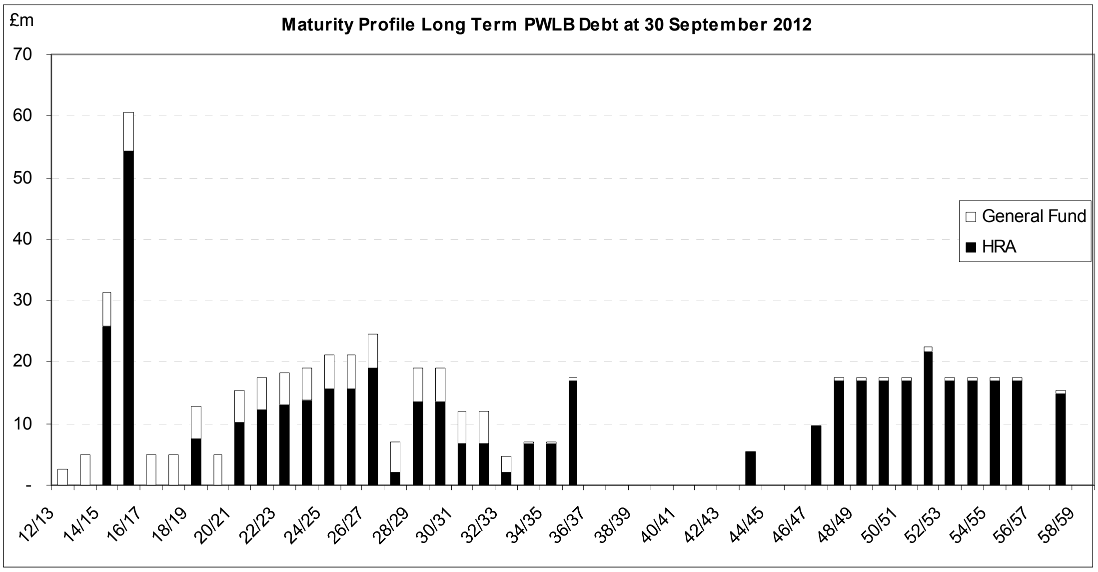
12. The debt outstanding to fund past capital spend stands at £562.5m at 30 September 2012. It is all from the Public Works Loans Board (PWLB, a local authority lending arm of the Government) and at fixed rates. The loans mature at different dates in the future and, on maturity or sooner, it can be replaced with new borrowing, which can either be repayable at the end of the loan term, in equal instalments over loan life, or by way of annuity, depending on the future financing requirement. Rates depend on market conditions prevailing at the time and borrowing may also be deferred, if prudent, by the use of cash balances.

13. Rates on PWLB loans attract a margin of some 1% above gilts, the rates at which the government itself borrows. From November 2012 local authorities will be able to borrow at 0.20% lower than normal PWLB rates, where they have supplied information about borrowing plans in advance. Southwark has submitted information about potential refinancing of up to £105m should it be prudent and affordable in view of market volatility. There is no commitment or requirement for the council to draw down these funds, but access to lower cost borrowing protects the council interests in any future financing which can involve premiums that vary over time and affect affordability.

14. Previously, interest on debt was shared on an averaging basis between the HRA and the General Fund. From 1 April 2012, under the HRA self-financing (which involved a reduction in HRA debt of £199.3m on 28 March 2012 and the ending

of Housing Subsidy from 2012/13), the debt has been disaggregated between the HRA and the General Fund, and each fund will be responsible for paying interest on its own pool, as detailed in the council assembly report of 4 July 2012. Each fund now manages its debt in a way that best suits its own financing requirements. The average rate on the two funds is currently running at 6.56% HRA and 3.57% General Fund. The HRA rate will fall in the future as maturing debt is replaced or refinanced with new low coupon loans. The difference between the two rates reflects the debt financing carried out between March 2012 and April 2012 using £100m in General Fund cash, which involved replacing high rate loans (at 9.0% or more) with lower rate loans at 3.2% repayable in equal instalments over 20 years. The new loans are structured to match the General Fund's debt repayment requirements in the form of Minimum Revenue Provision, and will lead to the debt being written off over the 20 year period. A premium arising from the restructuring, of £20.6m, was paid in March, and will be spread over 20 years.

15. The maturity profile of the £562.5m debt outstanding with the PWLB at 30 September 2012 (HRA £451m and GF £111.5m) is set out in the chart below.



Prudential indicators

16. 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 latest projection for 2012/13 indicators are set out in Appendix A.

Authorised limit for debt

17. One of the Prudential Indicators is the authorised limit on debt (Appendix A, Indicator 7). This consists of a limit on borrowing and a limit on long term liabilities (like certain PFI and leases). The borrowing element of the limit was reduced from £890m in 2011/12 to £655m in 2012/13, partly in response to actual debt reduction under the HRA reform. However, it is now considered the borrowing component of the authorised limit should be set at a higher level of £770m instead of £655m:

- The authorised limit is an upper limit within which the operational limit moves, and should not alter year-on-year other than for major circumstances. The limit of £770m is considered sufficient headroom to accommodate all future needs in the points below without requiring annual amendments
- Debt restructuring could require borrowing in advance of the repayment of old loans, should timing prove advantageous. This would lead to a temporary peak in borrowing, to be contained within the authorised limit
- Borrowing rates with the PWLB are at an all-time low. Borrowing in advance of capital expenditure need may prove advantageous, to reduce exposure to interest rate risk as rates rise at some point in the future
- Borrowing in advance or at the time of need may become necessary if changes in the investment strategy, or in the level of balances held, means that cashflow could not support capital expenditure financing decisions in lieu of drawing down debt
- Major capital expenditure needs can be accommodated within normal approval processes without frequent changes to the authorised limit by council assembly. For example, the Housing Commission report identifies significant spending pressures which are not yet factored into the authorised capital programme.

SUPPLEMENTAL ADVICE FROM OTHER OFFICERS

Director of Legal Services

18. 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 Strategic Director of Finance and Corporate Services.

19. 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.

20. 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 2010 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.

21. 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
None		

APPENDICES

No.	Title
Appendix A	Prudential Indicators 2012/13 Update

AUDIT TRAIL

Lead Officer	Jennifer Seeley, Deputy Finance Director	
Report Author	Dennis Callaghan, Chief Accountant	
Version	Final	
Version Date	14 November 2012	
Key Decision	Yes	
CONSULTATION WITH OTHER OFFICERS / DIRECTORATES / CABINET MEMBER		
Officer Title	**Comments Sought**	**Comments Included**
Director of Legal Services	Yes	Yes
Strategic Director of Finance and Corporate Services	N/a	N/a
Cabinet Member	Yes	Yes
Final Report Sent to Constitutional Team		15 November 2012