Item No: 3.2	Classification: Open	Date: 27 February 2013	Meeting Name: Council Assembly
Report title:		Treasury Management Strategy 2013/14 Including Annual Investment Strategy, Prudential Indicators, and Annual Minimum Revenue Provision Statement	
Wards or groups affected:		All	
From:		Strategic Director of Finance and Corporate Services	

RECOMMENDATIONS

1. That the council assembly:

   a) Notes the treasury management strategy 2013/14 to be managed by the strategic director of finance and corporate services under financial delegation.

   b) Agrees the annual investment strategy 2013/14 set out in Appendix A, with capital preservation a key objective, in line with government guidance on investments.

   c) Agrees prudential indicators covering capital finance, borrowing and cash management for the years 2013/14 to 2015/16 set out in Appendix B.

   d) Agrees the annual minimum revenue provision statement which sets aside prudent sums from revenue to reduce debt, set out in paragraph 31 and Appendix C

   e) Notes the proposed changes to capital allowances as set out in paragraph 34, and agrees the level of capital allowances for 2013/14 in paragraph 30 should the changes not be implemented.

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 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 and Guidance plus the Prudential Code for Capital Finance in Local Authorities, issued by the Chartered Institute of Public Finance and Accountancy (CIPFA).

3. Whilst the strategic director of finance and corporate services is, under financial delegation, responsible for all executive and operational decisions on borrowings and investments, the council assembly remains responsible for approving a debt and investment management strategy and the prudential indicators, which include limits on investments and borrowing. The indicators

give a general picture of 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 approval each year.

4. 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 reviews and scrutinises treasury policies and strategy.

KEY ISSUES FOR CONSIDERATION

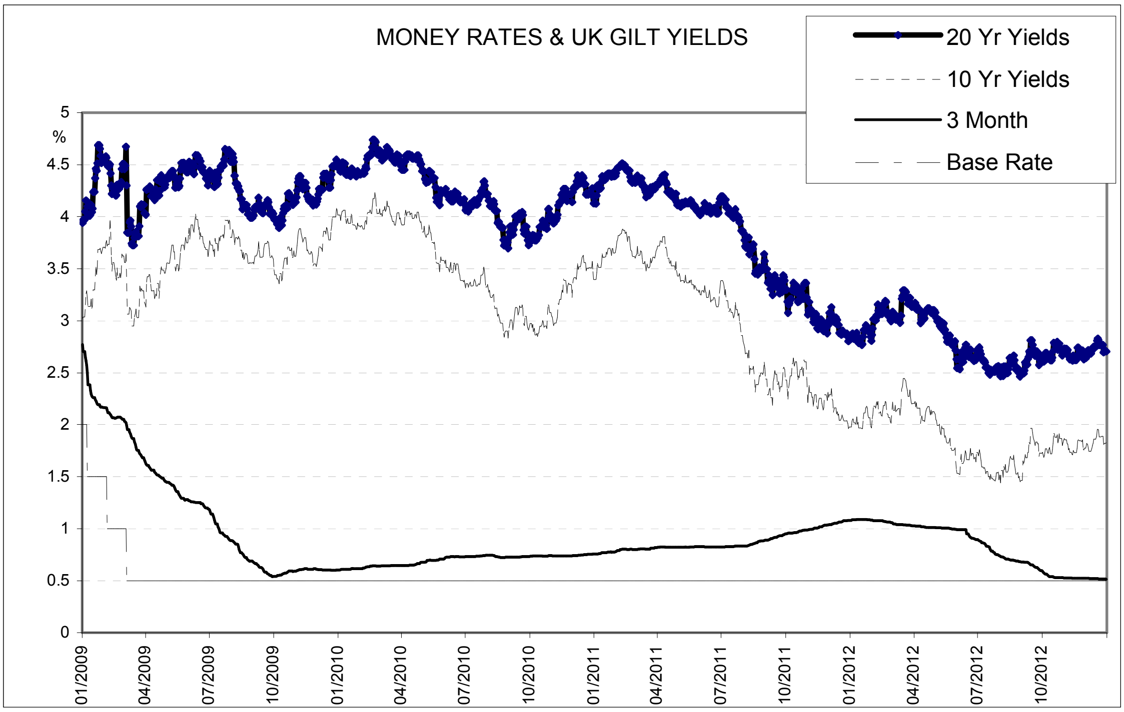
Developments in financial markets

5. 2012 was another turbulent year for financial markets. Following considerable concern in the first half of the year about the sustainability of the debt of some euro area governments amid slowing growth, substantial monetary policy action was taken in the second half of 2012 to support financial markets. The European Central Bank (ECB) cut its interest rates and signalled measures to purchase euro area government bonds. Almost immediately following the announcement the cost of Italian and Spanish government bond market borrowing fell.

6. Other central banks also continued with monetary easing. The US Federal Reserve increased purchase of financial assets and indicated that it would continue until the employment outlook improved substantially. It expected rates to remain low until 2015. In the UK, the Bank of England expanded its asset purchase programme and commenced a scheme to rise lending in the economy.

7. The central bank action combined with investor preference for high rated sovereigns such as the UK helped keep the cost of borrowing in those countries low. Lately however yields have risen slightly as investors have become more comfortable with holding more risky volatile assets, for example equities and lower rated bonds to secure higher returns. The rates on UK government borrowing (gilt yields) are set out in the chart below. It also shows that the cost of short term bank borrowing (3 month rates) began falling in the second half of 2012 on account of central bank liquidity and lower euro area sovereign risks.

8. Despite widespread monetary support, global economic prospects remain weak. Sovereigns remain challenged by fiscal targets, the financial sector continues to cut back operations and lending, and future profitability remains uncertain. The UK economy is not immune, and faces a prolonged period of austerity and slow growth. And in spite of the attraction of its debt to investors, rating agencies have indicated the UK's AAA rating is at risk. A cut would also see further downgrading in the UK financial sector, on top of any cuts from concerns about the sector's future profitability.



Investment position and strategy

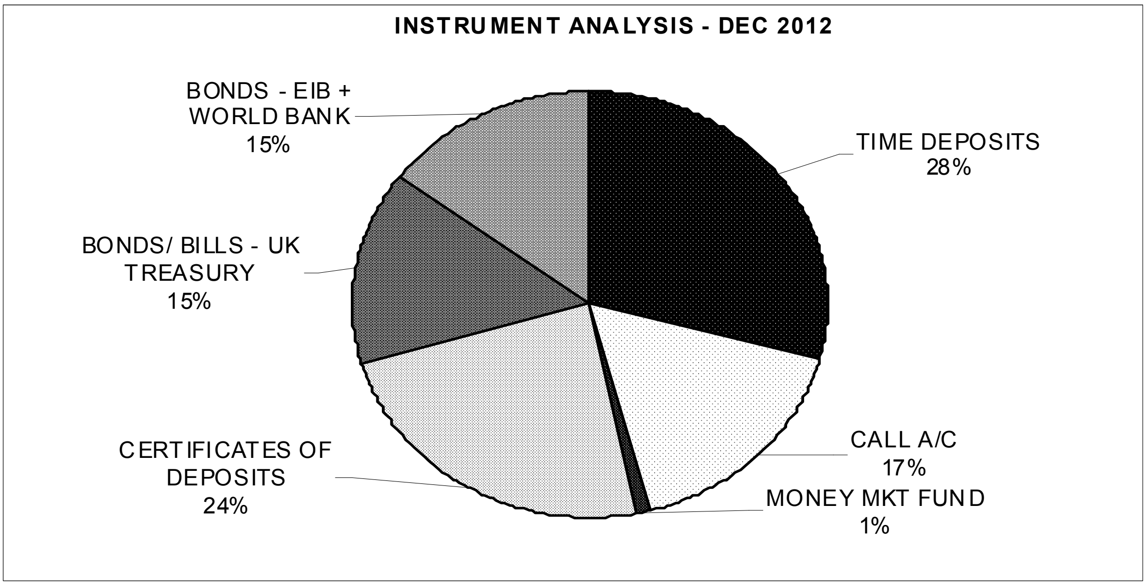
9. Given market volatility, a cautious approach to lending was maintained throughout 2012. This will continue into 2013/14. Investment exposure to banks shall be biased in favour of large institutions in stronger sovereigns where the likelihood of support, in the event it were needed, is high. And any exposure to investments above one year shall be in UK gilts, supranational bonds or other high rated investments discussed below, paragraphs 20 to 22.

10. As at 31 December 2012 the balance in investments stood at £188.6m. The sums held vary daily, depending on cash flow and debt and capital financing activity. Balances fell in December when cash was used to fund the acquisition of the freehold interest in the council's headquarters at 160 Tooley Street, discussed further in paragraph 18 below. Balances were also used to pay-off £100m in expensive borrowing in March 2012 ahead of its replacement with new cheaper borrowing in the following April, discussed further in paragraph 25 below.

11. Investments are managed by an in-house operation along with two fund managers (AllianceBernstein Ltd and Aberdeen Asset Managers Ltd) who each manage £50m in UK gilts, supranational bonds and certificates of deposit. The sums managed externally were reduced from £75m each in December to release cash for the Tooley Street acquisition.

12. The counterparties, instruments and maturities across which the cash is invested is set out in the tables and chart below.

EXPOSURE - Dec 2012 COUNTERPARTY AND RATINGS									
Exposure £m	**FUND**				**Fitch Ratings**				
COUNTERPARTY	Aberdeen	Alliance Bernstein	In-House	**£m**	Long	Short	Sup-port	Sovereign	Sovereign Rating
CREDIT INDUSTRIAL ET COMMERCIA	3.5	-	-	3.5	A+	F1+	1	FRANCE	AAA
SOCIETE GENERALE	-	1.0	-	1.0	A+	F1+	1	FRANCE	AAA
BANQUE NATIONALE DE PARIS	3.5	1.0	-	4.5	A+	F1+	1	FRANCE	AAA
DEUTSCHE BANK	3.5	1.0	-	4.5	A+	F1+	1	GERMANY	AAA
LANDESBANK BADEN WERTMBURG	-	1.0	-	1.0	A+	F1+	1	GERMANY	AAA
DZ BANK (DEUTSCHE ZENTRAL)	3.5	-	-	3.5	A+	F1+	1	GERMANY	AAA
GLOBAL TREAS FUNDS-MONEY FND	-	-	2.1	2.1		AAA		GLOBAL	Money Fund
ABN AMRO BANK	3.5	1.0	-	4.5	A+	F1+	1	NETHERLANDS	AAA
ING BANK	3.4	1.0	-	4.4	A+	F1+	1	NETHERLANDS	AAA
RABOBANK	-	0.5	-	0.5	AA	F1+	1	NETHERLANDS	AAA
EUROPEAN INVESTMENT BANK	10.4	7.1	-	17.5	AAA	F1+		SUPRANATIONAL	AAA
INTERNATIONAL BK RECONST DVT	3.5	6.9	-	10.4	AAA	F1+		SUPRANATIONAL	AAA
UBS	3.5	-	-	3.5	A	F1	1	SWITZERLAND	AAA
BARCLAYS BANK	5.0	1.0	15.0	21.0	A	F1	1	UK	AAA
LLOYDS TSB	3.5	-	15.1	18.6	A	F1	1	UK	AAA
NATIONWIDE BUILDING SOC	3.0	1.0	15.0	19.0	A+	F1	1	UK	AAA
RBS/NATWEST	-	-	41.0	41.0	A	F1	1	UK	AAA
UK TREASURY	-	27.6	-	27.6	AAA	F1+		UK	AAA
BANK OF NEW YORK MELLON	0.4	0.1	-	0.5	AA-	F1+	1	US	AAA
Total £m	50.2	50.2	88.2	188.6					



Investments at 31 December 2012 – Maturity Profile and Long Term Ratings

Rating	AAA	AA+ to AA-	A+ to A	Money Funds	**Total**
	£m	£m	£m	£m	**£m**
0-6 months	17.6	1.0	118.0	2.1	**138.7**
6-12 months	9.3		12.0		**21.3**
1-2 years	8.5				**8.5**
2-5 years	20.1				**20.1**
Total	**55.5**	**1.0**	**130.0**	**2.1**	**188.6**

13. Investment returns remain low, reflecting low base rates and money market rates. The return for the 9 months to December 2012 was 0.6% and is expected to be around 0.8% for the financial year. Next year, returns are

expected to be around base rates, 0.50%, on account of a prolonged period of low base rates and supportive central bank action.

14. In December 2012 the council acquired the freehold interest in its headquarters at 160 Tooley Street, which it previously leased. The acquisition was paid for by reducing sums held in investments (including sums managed externally) as it was more efficient than borrowing at current rates. Further details on the acquisition may be found on the cabinet agenda of 12 December 2012. To ensure that the transaction could settle efficiently, the £75m limit on exposure to RBS/NatWest was temporarily raised between December 2012 and January 2013. Cash balances remaining after paying for the purchase are sufficient to meet working capital and spending plans and should further sums be needed in the future they may be accessed through wholesale markets at rates which are close to prevailing investment rates.

15. The existing investment strategy covering 2012/13, approved by council assembly in February 2012, remains sound. It underlines the requirement for capital preservation and prudent risk management. However some changes are needed to ensure that the council can invest efficiently and access more high rated investments. The changes, which were considered by the audit and governance committee on 13 November 2012, involve the use of additional supranational banks and holding GBP debt issued by high rated foreign sovereigns.

Supranational banks

16. The council currently places funds with two supranational banks: the European Investment Bank (EIB) and the International Bank for Reconstruction and Development (IBRD, the "World Bank"). The two are the largest supranational entities and have the highest possible ratings of AAA/Aaa/AAA (Fitch/Moody's/S&P). Other similarly rated supranationals that issue in sterling include:

- Asian Development Bank,
- African Development Bank
- Council for Europe Development Bank
- Inter-American Development Bank, and
- The Nordic Investment Bank.

17. Use of these banks would raise access to high rated investments. An upper limited of £5m would be placed per issuer and the maximum term would be 5 years in the interest of liquidity.

Additional sovereigns

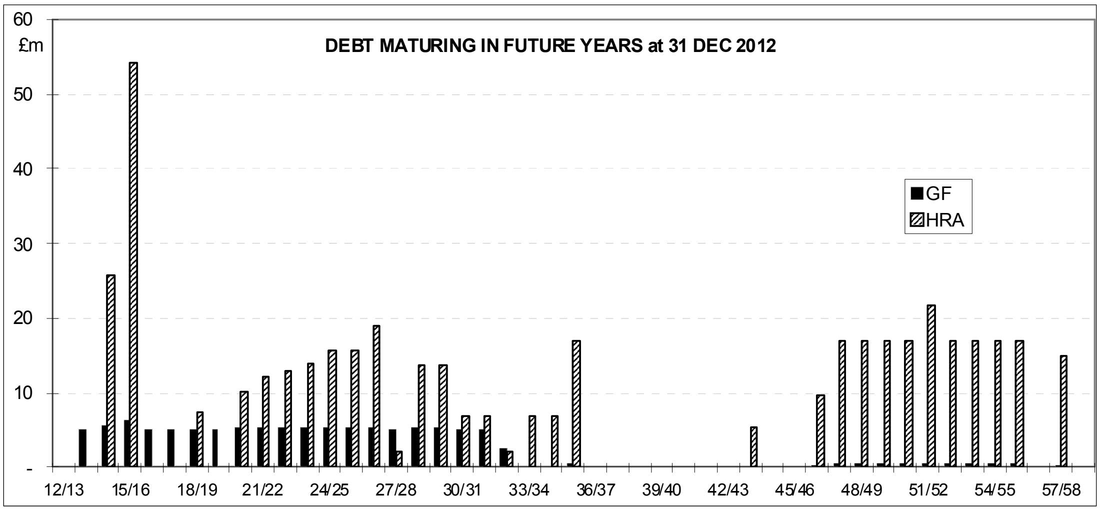
18. At the moment the strategy does not recognise GBP bonds issued by major high rated foreign states (referred to as sovereigns), e.g. Sweden. Adding flexibility to purchase these bonds would help diversify the portfolio. Exposure to such countries would have to be rated AAA/Aaa/AAA (Fitch/Moody's/S&P) and would be limited to £5m per sovereign with a maximum maturity of 5 years on account of liquidity.

19. The 2013/14 investment strategy updated for these additions is set out at Appendix A for council assembly approval. Exposure to the additional supranationals and high rated foreign government GBP issues would be managed by the fund managers within a risk controlled framework, placing priority on capital preservation. As before, should there be further rating

downgrades, the strategic director of finance and corporate services shall have discretion to vary minimum ratings where prudent to protect the council's interests.

Debt management position and strategy

20. The debt outstanding at the end of December 2012 to fund capital spend was £560m. All the debt is from the Public Works Loans Board (PWLB) at fixed rates. From April 2012, following HRA self-financing reforms and loss of support for HRA debt interest, the loans are disaggregated between the HRA and the General Fund. The self-financing cancelled £199m in debt attributable to the HRA in March 2012, lowering the HRA share to £451m, so that it can be serviced out of HRA income without subsidy. The remainder of the £109m debt falls on the General Fund. The years in which the loans for each fund fall for repayment is set out in the chart below.



21. The maturity profile reflects the debt financing activity carried out between March 2012 and April 2012. As previously reported, £100m in high rate debt (at rates of 9.0% or more) maturing between 2014 and 2015 was paid off in March from General Fund cash and replaced in April 2012 with cheaper longer loans at 3.2%. The average rate of interest on all General Fund debt currently stands at 3.57%. The HRA average rate is 6.56% and will fall when £80m in high rate loans maturing between 2015 and 2016 are refinanced with new lower rate loans.

22. The council will have some £5m in General Fund debt maturing in 2013/14, which will not need to be refinanced as the sum can be meet from existing cash balances which includes sums set aside as the minimum revenue provision. The council is also in a strong position to refinance debt maturing in the future. It has access to PWLB lending facilities and borrowing from it has become more competitive with the introduction in November 2012 of a new lower tier rate, the certainty rate. Under it the council may borrow up to £105m at a discount of 0.20% below normal PWLB rates. The facility may be used to fund capital spend, replace cash used in place of borrowing (such as in the acquisition of 160 Tooley Street, referred to above) or to refinance debt ahead of maturity where prudent to protect the council from significant rate increases.

23. PWLB rates closely follow the cost of the government's own borrowing in gilts. Normal rates are some 1% above gilts and the certainty rate is some 0.20% below that. In 2012 gilts yields have benefited from central bank support and flight-to-safety trades. The unwinding of these forces together with risk from

adverse economic or rating developments could raise yields sharply, and it may become attractive to refinance debt to protect the council from significant rate increases. Options on refinancing will therefore be kept under review in 2013/14, and any activity carried out will take place within existing delegation and be managed within a prudent risk controlled framework.

Prudential indicators

24. 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 in Local Authorities and the Treasury Management Code of Practice and Guidance, which were updated for HRA self-financing under the Localism Act 2011.

25. The prudential indicators are set out in detail in Appendix B, and the Codes require council assembly, as the appropriate body for this council, to approve these for 2013/14 to 2015/16. The indicators do not affect existing budgets and approval will enable the strategic director of finance and corporate services to carry out his financial responsibilities. The indicators will be updated over the course of 2013/14 to reflect activity. 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 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. Council assembly 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

26. 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 set aside funds from revenue to pay some of the principal of the sums borrowed. A policy on MRP is required under statutory guidance to be approved annually.

27. The MRP policy for 2013/14 recommended for approval is set out at Appendix C. 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. As now, application of the policy is the responsibility of the strategic director of finance and corporate resources. The policy includes a provision for the strategic director of finance and corporate resources to make additional MRP contributions or set aside capital receipts to reduce debt liabilities should it be prudent for the proper management of financial affairs of the council. This provision will also apply for the remainder of 2012/13 to assist, for example, in any residual issues that may arise from financing of the Tooley Street acquisition, on which MRP will commence in 2013/14.

Capital allowances

28. Currently, 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. 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, which is subject to separate rules.

29. The amount of non-RTB housing disposals that may be retained is known as the capital allowance. It increases as spend on affordable housing or regeneration is programmed, and falls as receipts are drawn against it. The capital allowance agreed by council assembly in February 2012 was £192m and since then £33m in receipts have been drawn against it, which leaves a balance of £159m, against which future receipts may be drawn down from.

30. The government is considering proposals to abolish capital allowances from April 2013 and allow non-RTB receipts to be retained for housing use. However, under these proposals, if the receipts are used for non-housing purposes, debt attributable to the HRA will have to be adjusted down. On the basis that the regulations will proceed, no statement of capital allowances is required in this report. If the changes do not proceed as anticipated, then the balance of capital allowances, £159m, as set out in the paragraph above, which would be adequate for 2013/14 purposes, will apply. Future reports will confirm the application of the regulations or not.

SUPPLEMENTARY ADVICE FROM OTHER OFFICERS

Director of Legal Services

31. 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.

32. Financial standing orders require the strategic director of finance and corporate services 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 strategic director of finance and corporate services.

33. 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.

34. 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 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.

35. 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, subject to the outcome of the changes referred to in paragraph 30 of the report.

36. Members are advised to give approval to the recommendations contained in paragraphs one to five of this report, ensuring continuing compliance with Government guidance and CIPFA's codes.

BACKGROUND DOCUMENTS

Background Papers	Held at	Contact
None		

APPENDICES

No.	Title
Appendix A	Annual Investment Strategy 2013/14
Appendix B	Prudential Indicators – Recommended for Approval
Appendix C	Annual Minimum Revenue Provision Statement 2013/14

AUDIT TRAIL

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<tr><th>Version</th><td colspan="2">Final</td></tr>
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<tr><th colspan="3">CONSULTATION WITH OTHER OFFICERS/DIRECTORATES/CABINET MEMBER</th></tr>
<tr><th>Officer Title</th><th>Comments sought</th><th>Comments included</th></tr>
<tr><td>Director of Legal Services</td><td>Yes</td><td>Yes</td></tr>
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<tr><th>Cabinet Member</th><th>Yes</th><th>Yes</th></tr>
<tr><th colspan="2">Final report sent to Constitutional Team</th><td>14 February 2013</td></tr>
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