Item No: 8.	Classification: Open	Date: 26 November 2014	Meeting Name: Council Assembly
Report title:		Treasury Management - Mid-year Update 2014/15	
Wards or Groups affected:		All	
From:		Strategic Director of Finance and Corporate Services	

RECOMMENDATION

1. That council assembly notes this 2014/15 mid-year treasury management update.

BACKGROUND INFORMATION

2. This item is one of an annual cycle of reports on the council's debt and investments. Other reports to council assembly on treasury include a strategy report at the start of each financial year and an out-turn report following the end of the year. The cabinet also receives quarterly updates and the audit and governance committee reviews treasury strategy annually.

3. Treasury 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 and under financial delegation all executive, managerial and operational decisions are the responsibility of the strategic director of finance and corporate services. 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).

KEY ISSUES FOR CONSIDERATION

Investment management activity and position

4. The council's cash is invested in accordance with its investment strategy, which is agreed annually by council assembly. The investment objectives are to preserve capital, ensure liquidity and secure a reasonable return.

5. Over the first half of 2014/15 the balance in investments averaged £224 million and at 30 September 2014 stood at £213 million (£157 million at 31 March 2014). The movement over the six months to September 2014 reflects cash flows from day to day flows of receipts and payments. Investments were diversified across major high rated banks/building societies and placed in the UK government or supranational bodies (such as the European Investment Bank and the International Bank for Reconstruction and Development, both backed by governments across the world).

6. Bank exposure was in the form of money market funds, call accounts, time deposits or certificates of deposits (CD), maturing within 12 months. The UK government exposure was in bonds or treasury bills, and the supranational was in bonds alone. The CD, treasury bill and bond portfolios are managed by two fund managers (AllianceBernstein and Aberdeen Investment Managers). Each

manager holds circa £50 million and sums are placed in bonds longer than one year where prudent within a risk controlled framework, prioritising security and liquidity. The remainder of the funds are managed in-house, and the focus is on investing cash safely to meet day to day spending.

7. The half-year return to 30 September 2014 was 0.32%, reflecting the prolonged period of very low UK base rates (0.50%, equivalent to 0.25% over the half-year) and the stimulatory monetary policies which central banks here and abroad still have in place. Here expectations of a rise in base rates have been pushed back to the second half of 2015.

8. The sum held across investment counterparties as at 30 September 2014, together with rating and maturity profiles is set out in the tables and chart below.

INVESTMENT COUNTERPARTY AND RATINGS - 30 SEP 2014

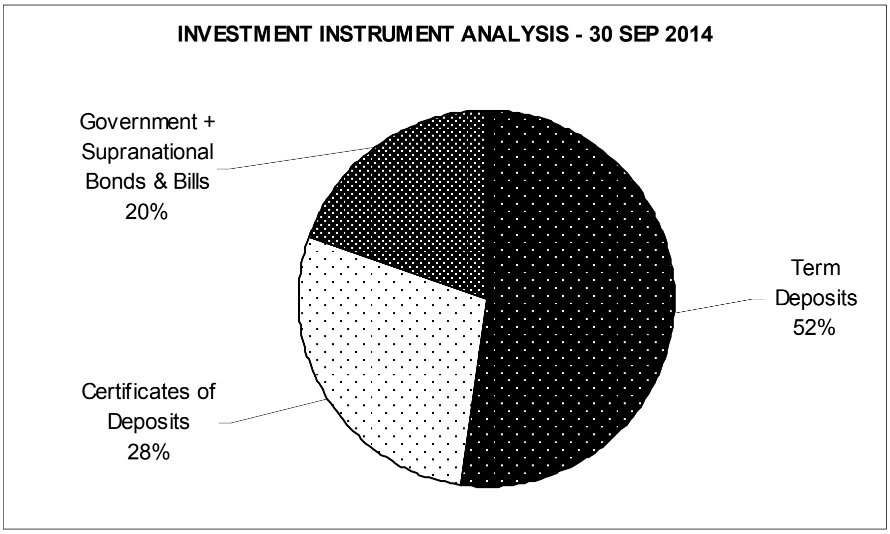
EXPOSURE £m	FUND				Ratings				
COUNTERPARTY	Aberdeen	Alliance Bernstein	In-House	£m	Long	Short	Sup-port	Sovereign	Sovereign Rating
NORDEA BANK FINLAND	6.50	-	-	6.50	AA-	F1+	1	FINLAND	AAA
CREDIT INDUST ET COMRCL	3.50	-	-	3.50	A+	F1	1	FRANCE	AA+
SOCGEN	-	1.20	6.30	7.50	A	F1	1	FRANCE	AA+
BANQUE NATIONAL DE PARIS	3.50	2.00	15.00	20.50	A+	F1	1	FRANCE	AA+
DEUTSCHE BANK	-	2.00	-	2.00	A+	F1+	1	GERMANY	AAA
RABOBANK	1.10	2.00	-	3.10	AA-	F1+	1	NETHERLANDS	AAA
ING BANK	3.40	2.00	15.00	20.40	A+	F1+	1	NETHERLANDS	AAA
ABN AMRO BANK	3.50	2.00	-	5.50	A+	F1+	1	NETHERLANDS	AAA
EUROPEAN INV BANK	7.00	6.50	-	13.50	AAA	F1+	0	SUPRANATIONAL	AAA
INT BANK RECONST DEVT	3.50	6.80	-	10.30	AAA	F1+	0	SUPRANATIONAL	AAA
SVENSKA	-	-	15.00	15.00	AA-	F1+	1	SWEDEN	AAA
SKANDINAVISKA	3.30	2.00	-	5.30	A+	F1	1	SWEDEN	AAA
CREDIT SUISSE	3.50	2.00	-	5.50	A	F1	1	SWITZERLAND	AAA
UBS	3.50	2.00	15.00	20.50	A	F1	1	SWITZERLAND	AAA
NATIONWIDE BSOC	3.30	2.00	5.00	10.30	A	F1	1	UK	AA+
RBS/NATWEST	-	-	10.00	10.00	A	F1	1	UK	AA+
SANTANDER UK	1.50	-	-	1.50	A	F1	1	UK	AA+
UK TREASURY	-	18.10	-	18.10	AA+	F1+	0	UK	AA+
BARCLAYS BANK	-	-	15.00	15.00	A	F1	1	UK	AA+
LLOYDS BANK	-	-	15.10	15.10	A	F1	1	UK	AA+
BNY MELLON	0.10	-	-	0.10	AA-	F1+	1	US	AAA
BANK OF AMERICA	3.50	-	-	3.50	A	F1	1	US	AAA
TOTAL	50.7	50.6	111.4	212.7	A	F1			

* Refers to Fitch Ratings or equivalent

INVESTMENT MATURITY PROFILE AND LONG TERM RATING - 30 SEP 2014

Yr Band	A	AA	AAA	Grand Total
Up to 1 Yr	70%	13%	4%	87%
1-2 Yrs		1%	4%	5%
2-5 Yrs		5%	3%	8%
Grand Total £m	70%	19%	11%	100%

Fitch Ratings	Definition
AAA	Highest credit quality
AA+,AA, AA-	Very high credit quality
A+, A, A-	High credit quality
F1	Highest short term credit quality; strongest capacity for timely payment (+donates exceptionally strong credit feature)
1 or 2	Extremely high or high probability of support



9. To ensure that the investment strategy remains up to date under current financial conditions, KPMG's investment advisory unit were asked to carry out an independent review. Their review is at draft report stage, and is being considered by officers. Their findings confirm that the council's current investment strategy remains prudent and fit for purpose. They have also suggested a number of updates the council might consider. Broadly these are to:

- Improve diversification by increased use of pooled funds and relaxing minimum ratings.

- Improve liquidity by increasing access to marketable money market instruments that are available through the external fund managers.

10. In light of this, officers are considering reducing ratings for banks by one notch (long term rating from A/A2/A to A-/A3/A- and short term from F1/P-1/A-1 to F2/P-2/A-2 (Fitch/Moody's/S&P), to help reduce exposure to any single counterparty. Officers are also considering reducing the minimum ratings for foreign government sterling bonds, supranational banks and quasi-sovereigns from AAA/Aaa/AAA to AA-/Aa3/AA-.

11. These suggestions were included in the 11 November 2014 audit and governance committee agenda and will help inform the update to the council's investment strategy, which will be reported to council assembly in February 2015.

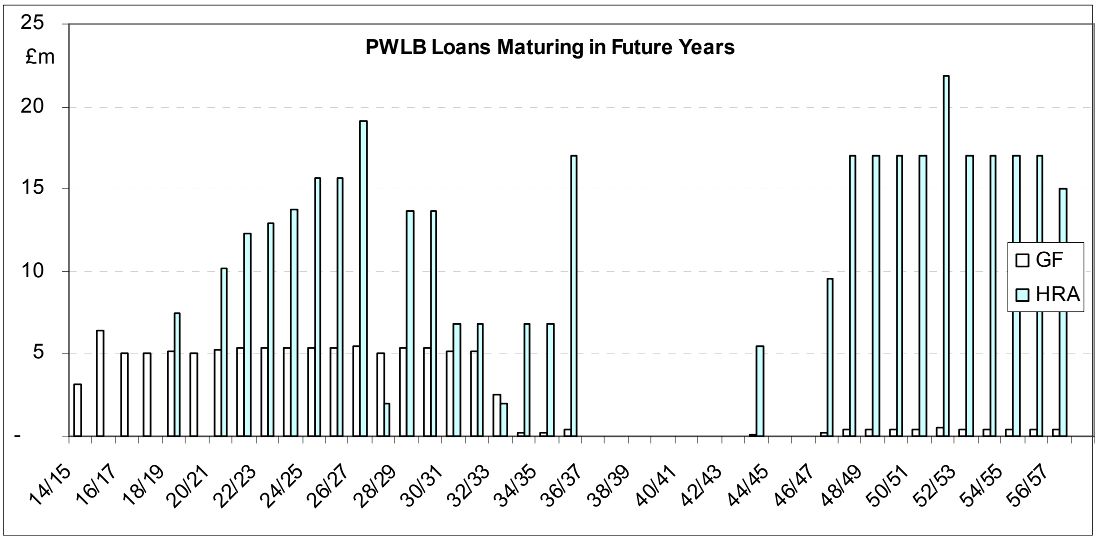
Debt management activity and position

12. The council holds debt to fund past capital spend and the balance outstanding on the debt at 31 March 2014 was £475 million (£560 million at 31 March 2013), divided between the HRA (£371 million) and the general fund (GF) (£104 million). Each year the general fund is required to set aside sums to repay its borrowing by way of the minimum revenue provision. For 2014/15 this is £9.1 million. The HRA is also reducing its debts and raising the borrowing headroom for new investment.

13. In 2013/14 £80 million HRA loans running at an average rate of 9.31% and an annual interest of £7.5 million were paid off out of cash balances. Of the £80 million, £35.8 million was financed in 2013/14 and increased the headroom by

that amount. From 2014/15 the interest no longer payable on these loans is being used to finance the remainder, raising the headroom further.

14. All borrowing is from the Public Works Loans Board (PWLB, a local authority lending arm of the government) at fixed rates and matures at different dates in the future (the chart below shows maturities at 30 September 2014). In 2014/15 £5.2 million general fund debt matures, of which £2.5 million fell due in April 2014. No HRA debt falls due until 2018/19.



15. On maturity the loans can be replaced with new borrowings. The new loans from the PWLB may be repayable at the end of the loan term, in equal instalments over loan life, or by way of annuity, depending on future financing requirements. Rates on new loans depend on prevailing market conditions and are currently low on account of global economic weakness. But as it is still cheaper to use council cash than loans, borrowing is being deferred for the time being. However new borrowing will be taken if it is needed for spend or where prudent. The level of cash used in place of loans, known as internal borrowing, stood at £232 million at 31 March 2014, £44 million HRA and £188 million general fund. The HRA element follows the debt repayment carried out in 2013/14 and the general fund share follows the acquisition of the freehold interest in the council's Tooley Street headquarters.

16. The average rate of interest is currently running at 5.97% on HRA debt and 3.58% on general fund debt. The total debt and the overall average rate have been falling over the last few years; see table below.

Year	Closing debt	Annual interest payable	Average interest rate
	£ million	£ million	%
2006/07	693.7	60.9	8.8%
2007/08	738.3	54.6	7.6%
2008/09	770.7	52.0	7.0%
2009/10	761.7	52.8	6.9%
2010/11	761.7	52.8	6.9%
2011/12*	462.5	55.6	6.9%
2012/13	560.0	33.2	6.0%
2013/14	555.0	33.4	6.0%

* Under HRA self-financing reforms, the debt was reduced by £199.2 million in March 2012 and from 2012/13, councils became responsible for servicing the remaining debt out of rents and other HRA income.

Municipal bond agency

17. The Local Government Association (LGA) has begun raising funds to develop a municipal bond agency as an alternative to the PWLB. To date, 37 local authorities have expressed an interest in providing around £4 million capital to help launch the agency's first bond issue in March or April 2015. The LGA itself is contributing £500,000. The council's own contribution is £200,000 and of this £60,000 has so far been drawn. The agency is going to carry out further fund raising ahead of its bond issues, but the council's contribution will remain capped at £200,000.

18. The contribution will help ensure that the council can participate in the agency and have a positive influence in its development. The agency hopes to undercut the PWLB and if successful, the investment would earn a return after five or so years. Any return would be on top of savings from potentially cheaper agency borrowing. Furthermore, if the government decides to lower the PWLB margin, that too would also result in cheaper borrowing and would easily make up for any loss there may be on the initial investment. . However any borrowing Southwark itself needed in the future would be from whichever source was the cheapest.

Prudential indicators

19. Local authority borrowing, investment and capital finance activity is supported by 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 and backed by the Local Government Act 2003. The codes recommend councils agree a series of prudential indicators and limits on the affordability, prudence and sustainability of capital finance and treasury management. The 2014/15 indicators were agreed in February 2014, before the start of the year and a mid-year update is set out below.

20. The indicators recognise that capital expenditure not otherwise funded through capital receipts, grants or revenue resources, creates liabilities, and raises interest and loan repayment costs, which draw on future income. Capital financing costs are reflected in existing budgets and the indicators themselves have no effect on them. The indicators also include an authorised debt limit, which is a self imposed cap on borrowing and other long term liabilities (like PFI schemes) outstanding on any one day, limits on the mix between fixed and variable rate loans, and limits on sums falling for refinance in future periods. The authorised debt limit for 2014/15 is £935 million. It accommodates existing loans and liabilities and includes operational flexibility for temporary borrowing, prudent refinancing and raising cash with external loans, within a risk controlled framework. The council is within its cap; actual debt and long term liabilities have not exceeded £588m at any time in the six months to September 2014.

PRUDENTIAL INDICATORS – 2014/15 MID-YEAR UPDATE

(A) INDICATORS ON AFFORDABILITY AND PRUDENCE		
2013/14 Actual	2014/15 Estimate	**Ratio of Financing Cost to Net Revenue Stream** A measure of the cost of debt and PFI liability, net of interest income, as a percentage of revenue. The HRA ratio reflects financing for the £80 million debt repayments. £35.8 million was financed in 2013/14 and further sums are to be applied out of interest savings from 2014/15 onwards, discussed further in the report. The GF ratio also reflects debt payments by way of the minimum revenue provision.
34%	17%	HRA
7%	8%	General Fund
2013/14 Actual	2014/15 Estimate	**Incremental Impact of Capital Spend** A measure of the effect of capital spend proposals on council tax and rents. Actual council tax and rents are determined by the council assembly/cabinet taking account of all the resources of the council.
nil	Nil	Weekly rents
nil	Nil	Council tax – band D
2013/14 Actual	2014/15 Estimate	**Capital Financing Requirements (CFR) and Gross Debt** The CFR is a measure of past capital expenditure financed through borrowing and long term liabilities (e.g. PFI). The level of gross debt should normally not exceed the CFR except over a short period. Actual gross debt remained below the CFR throughout the first half of 2014/15, on account of cash balances, internal borrowing and PFI transactions.
£804m	£807m	CFR
£560m	£475m	Maximum Gross Debt, first half of 2014/15

(B) INDICATORS ON CAPITAL FINANCE		
2013/14 Actual	2014/15 Estimate	**Capital Expenditure Estimate** The estimated spend reflects latest spend plans and will be updated over the course of the year. The 2014/15 GF spend includes the PFI funded Sacred Heart Catholic School.
£123m	£189m	HRA
£67m	£107m	General Fund

(B) INDICATORS ON CAPITAL FINANCE		
£190m	**£296m**	**Total**
2013/14 Actual	2014/15 Estimate	**Estimated Capital Financing Requirement (CFR)** Past capital expenditure financed through borrowing and long term liabilities. The GF CFR includes the PFI funded Sacred Heart Catholic School coming into operation this year. Both the HRA and GF include provisions to reduce future CFR liabilities.
£419m	£413m	HRA
£385m	£391m	GF
£804m	**£804m**	**Total**
2013/14 Actual	2014/15 Estimate	**HRA Indebtedness Limit** A limit on capital financed debt and long term liabilities determined by the government.
£577m	£577m	Limit
£419m	£413m	HRA CFR

(C) INDICATORS ON TREASURY MANAGEMENT			
2013/14 Actual Maximum	2014/15 Limit	2014/15 Max. to Sept. 2014	**Operational Boundary on Debt and Authorised Limits for External Debt** Limits the council determine to accommodate debt, internal borrowing and long term liabilities. The lower limit is the operational boundary and takes account of existing positions and ordinary activity and the higher limit is the authorised limit and enables additional debt to be taken for very short periods, in the interest of prudence, within a risk controlled framework.
			Operational Boundary
£560m	£765m	£475m	Borrowing
£98m	£125m	£113m	Other Long Term Liabilities
£658m	**£890m**	**£588m**	**Total**

			Authorised Limit
£560m	£805m	£475m	Borrowing
£98m	£130m	£113m	Other Long Term Liabilities
£658m	**£935m**	**£588m**	**Total**
2013/14	2014/15	2014/15 Max. to	**Gross and Net Debt** An upper limit on net debt as a percentage of gross debt. The net has remained below gross on account of investments held to meet spend.

(C) INDICATORS ON TREASURY MANAGEMENT			
Actual	Limit	Sept. 2014	
68%	100%	57%	Upper Limit
2013/14 Actual	2014/15 Limit	2014/15 Max. to Sept. 2014	**Fixed and Variable Rate Upper Limits** Limits recognising existing positions, with flexibility to vary exposure within a risk controlled framework should it be prudent.
£560m	£805m	£475m	Upper limit on fixed rate debt
£0m	£200m	£0m	Upper limit on variable rate debt
2014/15 Lower Limit	2014/15 Upper Limit	2014/15 Position at start of year	**Maturity Structure of Fixed Rate Debt** Limits accommodating existing positions, with flexibility to vary exposure within a risk controlled framework should it be prudent.
0%	20%	1%	Under 1 year
0%	20%	1%	1 year and within 2 years
0%	30%	5%	2 years and within 5 years
0%	40%	16%	5 years and within 10 years
0%	40%	31%	10 years and within 20 years
0%	40%	6%	20 years and within 30 years
0%	40%	29%	30 years and within 40 years
0%	40%	11%	40 years and within 50 years
2013/14 Actual	2014/15 Limit	2014/15 Max. to Sept. 2014	**Limit on Investments of one year or more** Caps maximum exposure to longer investments, while recognising that it can help secure additional yield within a risk controlled framework. Exposure over the last six months has remained cautious in view of market volatility.
15%	50%	15%	Percentage in one year or longer
8 Mnths	3 Yrs	8 Mnths	Overall maximum average maturity
5 Yrs	10 Yrs	5 Yrs	Longest investment
Adoption of the CIPFA code of Practice on Treasury Management The code and its principles were adopted by the council assembly in 2010.			

SUPPLEMENTAL ADVICE FROM OTHER OFFICERS

Director of Legal Services

21. 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.

22. 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.

23. 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.

24. 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.

25. Section 12 of the 2003 Act grants local authorities the powers to invest for any purpose relevant to its functions or for the purposes of the prudent management of its financial affairs.

BACKGROUND DOCUMENTS

Background Papers	Held at	Contact
Report to Council Assembly 28 February 2014: Treasury management strategy 2014/15 including annual investment strategy, prudential indicators and annual minimum revenue provision statement	160 Tooley Street	Chris O’Brien Tel: 020 7525 7468

APPENDICES

No.	Title
None	

AUDIT TRAIL

Lead Officer	Duncan Whitfield, Strategic Director of Finance and Corporate Services	
Report Author	Jennifer Seeley, Deputy Finance Director	
Version	Final	
Version Date	3 November 2014	
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		13 November 2014