Item No: 7.1	Classification: Open	Date: 30 November 2016	Meeting Name: Council Assembly
Report title:		Treasury Management – Mid-year Update 2016-17	
Wards or Groups affected:		All	
From:		Strategic Director of Finance and Governance	

RECOMMENDATIONS

1. That council assembly note this 2016-17 mid-year treasury management update report on treasury management and that:

   a) all treasury management activity in the period was undertaken in compliance with the approved treasury management strategy and with the council's prudential indicators.

   b) the balance on all loans at 31 March 2016 was £463m (371m HRA and £92m General Fund). Loans totalling £2.5m were repaid during the period. No new borrowing or debt rescheduling were undertaken during the period.

   c) in the six months to 30 September 2016 the sum invested averaged £186m (£253m in the corresponding period last year) and the balance of investments at 30 September stood at £206m. The average return on investments was 0.52% (0.77% in 2015-16).

   d) following the result of the European Union referendum no changes to the overall treasury management strategy were necessary.

2. That council assembly:

   a) approve the council's acceptance of the UK Municipal Bonds Agency Framework Agreement and its accompanying schedules including the joint and several guarantee.

   b) note that signing the Framework Agreement does not make the council subject to the joint and several guarantee or provisions of the Framework Agreement until such time as it chooses to borrow from the Agency.

   c) delegate authority to the Strategic Director of Finance and Governance to agree amendments to the Framework Agreement as appropriate.

BACKGROUND INFORMATION

3. In compliance with the Local Government Act 2003, the council has adopted the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management Code of Practice. The Code requires local authorities to determine an annual Treasury Management Strategy and, as a minimum,

formally report on their treasury activities and arrangements to Council Assembly mid-year and after the year-end.

4. The CIPFA Code provides the following objective with regard to treasury management:

   "It is important that treasury management policies adequately reflect risk and in particular security, liquidity and yield risk, in that order of importance. No treasury management transaction is without risk and management of risks is the key purpose of the treasury management strategy."

5. The 2016-17 Treasury Management Strategy was approved by council assembly in February 2016. Under financial delegation all executive, managerial and operational decisions are the responsibility of the strategic director of finance and governance.

6. The council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The key issues covered in this report are:

   i. treasury activity during the first six months of 2016-17 and treasury position at 30 September 2016
   ii. confirmation of continuing compliance with treasury and prudential indicators
   iii. update on the treasury management strategy following the outcome of the European Union referendum result.

Municipal Bonds Agency Framework Agreeement

7. This report seeks approval for the council to enter into the borrowing documents prepared by the UK Municipal Bonds Agency (the Agency). The Agency requires that local authorities borrowing from it enter into its Framework Agreement.

KEY ISSUES FOR CONSIDERATION

Borrowing strategy and debt management activity/position

8. At 30 September 2016 the council held £460m of loans (£371m HRA and £89m General Fund), a decrease of £2.5m on 31 March 2016. The council does not expect to take additional borrowing in 2016-17.

9. The majority of current loans were taken out many years ago to pay for investment in housing and general fund capital spend when rates were high. The loans are all with from the Public Works Loans Board (PWLB) at fixed rates. In 2016-17 £2.5m PWLB loans have matured and been repaid. No new borrowing was undertaken in the period.

10. Affordability and the "cost of carry" remained important influences on the borrowing strategy alongside the consideration that for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short term interest rates have remained and are likely to remain, at least over the forthcoming two years, lower than long-term rates, it has been more cost effective in the short-term to use internal resources. However should cash supporting internal borrowing be needed in the future for spend, external borrowing would be necessary.

11. As well as PWLB loans, the council also has internal borrowing to support previous years' capital expenditure. The sum outstanding in internal borrowing at 30 September 2016 was £198m (£181m General Fund, £17m HRA). Internal borrowing is temporary drawing on internal balances pending replacement with loans.

12. Each year, the General Fund sets aside sums known as the minimum revenue provision (MRP) to reduce its borrowing liabilities. In February 2016 council assembly approved an updated MRP strategy. The revised approach continues to make a prudent provision for the repayment of debt but now takes account of other factors, most notably affordability. The HRA also sets aside sums to reduce its own borrowing liabilities.

13. The PWLB continues to operate a spread of approximately 1% between "premature repayment rates" and "new loan" rates so the premium charge for early repayment of PWLB debt remained expensive for the council's portfolio and therefore unattractive for debt rescheduling activity. No debt rescheduling was undertaken in the period.

14. The council's capital programme is expanding and the financing strategy is to maximise the application of capital grants and contributions, capital receipts and revenue contributions before considering borrowing. This year, the Housing Investment Programme (HIP) is expecting to draw on the £98m debt finance that was made available during 2015-16 to secure investment in new housing, make existing properties warm dry and safe, and provide quality kitchens and bathrooms. This would not involve the council taking any new loans, but instead be advanced to the HRA by drawing on existing PWLB debt held by the General Fund at an average rate of 3.5%, close to historical lows and well below the 6.0% rate on existing HRA loans. This ensures the council, as a whole, does not suffer a significant financial loss by borrowing money before it is actually needed.

Investment strategy and investment activity and position

15. The council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. Cash flow forecasts indicate that during 2016-17 investment balances would range between £230m and £90m at the year end. Investments held at 30 September 2016 were £206m (£252m at 30 September 2015).

16. Cash that is not immediately used in spend is invested in money market instruments in accordance with the DCLG Guidance on Local Authority Investments and the approved Investment Strategy. The guidance gives priority to security and liquidity and the council's aim is to achieve a yield commensurate with these principles.

17. The half year return was around 0.6%. The UK bank rate had been maintained at 0.5% since March 2009 until August 2016, when it was cut to 0.25%. It is expected that the bank rate will be cut further towards zero in the coming months, which will in turn lower short-dated money market investments with banks and building societies. This, together with lower cash balances, is likely to result in fall in investment income over the year.

18. The investment strategy demands that no investment may be longer than five years and holdings beyond one year can only be in: government bonds,

supranational bonds, quasi-sovereign bonds or covered bonds issued by major banks.

19. The investments are managed by an in-house operation and two fund managers, AllianceBernstein and Aberdeen Asset Managers. The fund managers invest more stable cash over a longer term within a risk controlled framework in UK government gilts, supranational bank bonds, and certificates of deposits issued by major banks/building societies. The use of fund managers has the advantages of diversification of investment risk, coupled with the services of professional fund managers which, over the longer-term, provides enhanced returns within the council's risk appetite. Their performance and suitability in meeting the council's investment objectives are regularly monitored.

20. In-house, the focus is on liquidity and meeting variable day to day cash requirements, principally using money market funds.

21. The distribution of investments across counterparties, maturities and instruments at 30 September 2016 is set out in the table below:

INVESTMENT COUNTERPARTY AND RATING AT 30 SEPTEMBER 2016								
		CREDIT RATING			FUND			
Couterparty	Country Of Origin	Sovereign Rating	Long-term	Short term	Aberdeen £m	Alliance £m	In house £m	Grand Total £m
AUSTRALIA & NEW ZEALAND BANKIN	AUSTRALIA	AAA	AA-	F1+	-	1.4	-	1.4
ABN AMRO BANK	NETHERLANDS	AAA	A	F1	1.5	1.1	-	2.6
BANK NEDERLANDSE GEMEENTEN N	NETHERLANDS	AAA	AAA		-	0.7	-	0.7
BANK OF AMERICA	UNITED STATES	AAA	A+	F1+	5.0	-	-	5.0
BANK OF MONTREAL	CANADA	AAA	AA-	F1+	4.0	2.2	-	6.2
BANK OF NOVA SCOTIA	CANADA	AAA	AA-	F1+	2.0	2.2	-	4.2
BARCLAYS BANK PLC	GREAT BRITAIN	AA+	A	F1	1.5	2.2	-	3.7
BNP PARIBAS	FRANCE	AA	A	F1	5.0	-	-	5.0
CAISSE D'AMORTISSEMENT DE LA D	FRANCE	AA	A		-	1.4	-	1.4
CANADIAN IMPERIAL BANK	CANADA	AAA	AA-	F1+	2.0	2.2	-	4.2
COMMONWEALTH BANK OF AUSTRA	AUSTRALIA	AAA	AA-	F1+	3.0	2.2	-	5.2
CREDIT AGRICOLE CORP & INVST BA	FRANCE	AA	A	F1	-	2.3	-	2.3
CREDIT SUISSE AG/LONDON	SWITZERLAND	AAA	A	F1	4.2	-	-	4.2
DANSKE BANK A/S	DENMARK	AAA	A	F1	0.9	2.2	-	3.1
EUROPEAN INVESTMENT BANK	SUPRANATIONAL	AAA	AAA	F1+	4.8	-	-	4.8
EXPORT DEVELOPMENT CANADA	CANADA	AAA	AAA		-	1.4	-	1.4
FMS WERTMANAGEMENT AOER	GERMANY	AAA	AAA	F1+	-	2.9	-	2.9
GLOBAL TREAS FUNDS - MMF	GLOBAL	AAA	AAA		-	-	31.8	31.8
ING BANK NV	NETHERLANDS	AAA	A+	F1	1.3	2.1	-	3.4
INTERNATIONAL BANK FOR RECON &	SUPRANATIONAL	AAA	AAA	F1+	-	2.9	-	2.9
INTERNATIONAL SECURITY FUND - M	GLOBAL	AAA	AAA		-	-	30.4	30.4
JPMORGAN CHASE & CO	UNITED STATES	AAA	AA-	F1+	-	2.1	-	2.1
KFW	GERMANY	AAA	AA+	F1+	-	0.3	-	0.3
LLOYDS TSB BANK PLC	GREAT BRITAIN	AA	A+	F1	4.0	2.1	-	6.1
NATIONAL AUSTRALIA BANK LTD	AUSTRALIA	AAA	AA-	F1+	1.0	-	-	1.0
NATIONWIDE BUILDING SOCIETY	GREAT BRITAIN	AA	A	F1	-	2.2	-	2.2
NORDEA EIENDOMSKREDITT AS	NORWAY	AAA	AA-	F1+	-	2.2	-	2.2
RABOBANK LONDON	GREAT BRITAIN	AA	AAA		-	1.9	-	1.9
ROYAL BANK OF CANADA	CANADA	AAA	AA	F1+	5.0	2.2	-	7.2
SANTANDER UK PLC	GREAT BRITAIN	AA	A	F1	0.7	2.1	-	2.8
SKANDINAVISKA ENSKILDA BANKEN	SWEDEN	AAA	AAA		2.4	2.2	-	4.6
SOCIETE GENERALE	FRANCE	AA	A	F1	4.5	2.3	-	6.8
STANDARD CHARTERED BANK	GREAT BRITAIN	AA	A+	F1	5.0	-	-	5.0
SWEDBANK HYPOTEK AB	SWEDEN	AAA	AAA		-	2.1	-	2.1
SVENSKA HANDELSBANKEN	SWEDEN	AAA	AA	F1+	5.0	-	-	5.0
TORONTO-DOMINION BANK	CANADA	AAA	AA-	F1+	-	2.2	-	2.2
UBS LONDON	SWITZERLAND	AAA	A	F1	3.5	-	-	3.5
UNITED KINGDOM I/L	GREAT BRITAIN	AA	AA+	F1+	-	0.3	-	0.3
UNITED KINGDOM TBILLS	GREAT BRITAIN	AA	AA+	F1+	2.4	18.5	-	20.9
WELLS FARGO BANK	UNITED STATES	AAA	AA	F1+	2.0	-	-	2.0
WESTPAC BANKING CORP	AUSTRALIA	AAA	AA-	F1+	1.0	-	-	1.0
Grand Total					**71.7**	**72.1**	**62.2**	**206.0**

INVESTMENT MATURITY PROFILE AND RATING - 30 SEPTEMBER 2016				
Yr Band	**A**	**AA**	**AAA**	**Total**
Up to 1 Year	51.70	53.00	76.30	**181.00**
1 - 2 years	4.70	10.60	5.00	**20.30**
2 - 5 years	0.70	1.80	2.20	**4.70**
Total £m	**57.10**	**65.40**	**83.50**	**206.00**

INVESTMENT MATURITY PROFILE AND RATING - 30 SEPTEMBER 2016				
Yr Band	**A**	**AA**	**AAA**	**Total**
Up to 1 Year	25%	26%	37%	**88%**
1 - 2 years	2%	5%	2%	**10%**
2 - 5 years	0%	1%	1%	**2%**
Total	**28%**	**32%**	**41%**	**100%**

Rating	**Definition**
AAA	Highest credit quality
AA	Very high credit quality
A	High credit quality
Ratings issued by Fitch or equivalent (The UK government and its treasury bonds are rated AA by Fitch, Aa1 by Moody's and AA by Standard & Poor's) Money market funds have a AAA rating based on liquidity and diversification	

22. Various indicators of credit risk reacted negatively to the result of the referendum on the UKs membership of the European Union. Fitch downgraded the UKs sovereign rating by one notch to AA from AA+, and Standard & Poor's downgraded its corresponding rating by two notches to AA from AAA. Fitch, S&P and Moody's have a negative outlook on the UK.

Prudential Indicators

23. The CIPFA codes set out a series of prudential indicators to support local authority capital financing, borrowing and investment activities. The indicators were last approved by council assembly in February 2016. The 2015-16 outturn indicators were reported to council assembly in July 2016 and an update to 2016-17 indicators is set out at appendix A.

24. The indicators include a self imposed authorised limit on debt, determined under the Local Government Act 2003. As well as loans, the limit accommodates long term liabilities (e.g. from the three PFI funded schools and the integrated waste reprocessing facility), capacity to replace internal borrowing with loans and borrow for very short periods if needed for re-finance within a risk controlled framework. The 2016-17 authorised limit is £900m and the council has remained within it. Over the six months to 30 September 2016 the actual debt and PFI liabilities totalled £572m. The draw against the limit will increase where the council has to raise loans to prudently manage interest rate exposure or raise cash to meet spend.

Impact of the European Union membership referendum

25. The council's treasury management strategy follows the CIPFA principles of preservation of capital and liquidity over yield and this approach protects the council's cash position. In the run up to the EU referendum we reviewed the council's investments in consultation with our advisors, Arlingclose, and with

both our fund managers in the context of potential scenarios arising from both possible outcomes.

26. Whilst the fund managers undertook some positive actions in the run up to the referendum in order to hedge risk and position portfolios appropriately (for example shorter durations, diversified counterparties and sovereigns, increased holdings of index linked securities), no specific changes to the implementation of the approved strategy were considered necessary.

27. Following the vote to leave the European Union, there was turbulence in UK and European markets. Initial post-referendum economic data showed that the feared collapse in business and consumer confidence had not immediately led to lower GDP growth. However, the prospect of a leaving the single market has dented business confidence and resulted in a delay in new business investment and, unless counteracted by higher public spending or retail sales, will weaken economic growth in 2017-18.

28. Negotiations are expected to start once the UK formally triggers exit in early 2017 and last for at least two years. Uncertainty over future economic prospects will therefore remain throughout this year and next.

29. The fall and continuing weakness in sterling and the near doubling in the price of oil in 2016 have combined to drive inflation expectations higher. The Bank of England is forecasting that Consumer Price Inflation will breach its 2% target in 2017, the first time since late 2013, but the Bank is expected to look through inflation overshoots over the course of the next few years when setting interest rates so as to avoid derailing the economy.

30. Whilst the negotiations for a smooth exit from the European Union will be a major external influence on the Authority's treasury management strategy for 2017-18, the current treasury investment strategy remains prudent and continues to protect our overall cash position. No changes are recommended at this stage.

UK Municipal Bonds Agency Framework Agreement

31. The purpose of the Agency is to deliver cheaper capital finance to local authorities. It will do so via periodic bond issues, as an aggregator for financing from institutions such as the European Investment Bank ("EIB") and by facilitating greater inter-authority lending. The Agency is wholly owned by 56 local authorities and the Local Government Association ("LGA"). The council is a shareholder in the Agency with a total investment of £200,000.

32. The Agency requires that local authorities borrowing from it enter into its Framework Agreement. The Agreement sets out the arrangements for borrowing from the Agency and incorporates a joint and several guarantee that requires all local authorities borrowing from the Agency to guarantee the money owed by the Agency to those who have lent it money to fund its loans. The Agreement incorporates a mechanism to prevent a call under the guarantee by requiring borrowers to lend the Agency money to cover a default by another local authority, referred to as "contributions". Entering into the Framework Agreement enables the council to access funding from the Agency if and when required.

33. Acting on behalf of prospective borrowers, Southwark Council, Birmingham Council and Reading Council, appointed lawyers, Allen and Overy, to review and advise on the documentation. Allen & Overy instructed counsel to obtain

senior opinion on vires and reasonableness. The advice and opinion resulted in a small number of changes to the Agency's documentation.

34. The Framework Agreement comprises:

- The Framework Agreement itself, which is primarily designed to prevent a call on the joint and several guarantee and lays out how the Agency will interact with local authorities:
  - Schedule 1: Form of Authority Accession Deed, which local authorities sign to commit themselves to the Framework Agreement.
  - Schedule 2: Form of Guarantee, which is the joint and several guarantee.
  - Schedule 3: Loan Standard Terms, which is the loan agreement that covers any borrowing by an authority.
  - Schedule 4: Form of Loan Confirmation, which supplements the Loan Standard Terms and confirms details of a loan such as principal, maturity, interest rate and etc. It is signed by the Agency and a borrower.

35. The joint and several guarantee is a schedule to the Framework Agreement and is direct, unconditional, irrevocable and not separately administered. In practice this means that all borrowers are collectively and individually guaranteeing the lenders to the Agency against a default by a local authority.

36. Signing the Framework Agreement does not make the council subject to the joint and several guarantee or provisions of the Framework Agreement until such time that it chooses to borrow from the Agency.

37. The council can withdraw from the joint and several guarantee by giving notice and repaying its loans to the Agency. However, the irrevocable nature of the guarantee means that the council will continue to guarantee the Agency's borrowings at the date of withdrawal until those borrowings mature. This prevents moral hazard i.e. a local authority borrowing from the Agency to achieve a cheaper borrowing rate, but walking away from the obligations. Withdrawal does mean that the council will not be guaranteeing future borrowing by the Agency.

38. The risk to the council is the requirement to make contributions in the event of a default by another borrower and this exposure is proportional because it is calculated by reference to the amount borrowed by the Council as a proportion of all non-defaulting loans made by the Agency. In return for accepting this risk, the Council will receive access to more diverse and cheaper sources of capital finance via the Agency.

39. The risk of a default by a local authority is deemed to be very low: no principal local authority has ever defaulted on a loan. The National Audit Office in its Financial Sustainability of Local Authorities report of November 2014 observed:

    "A legal framework at the core of the local government accountability system effectively prevents local authorities becoming insolvent. Local authorities cannot borrow to finance revenue expenditure or run deficits."

40. The council has a forecast need to borrow over the next three years comprising of borrowing to fund capital expenditure and refinancing of maturing loans and internal borrowing. If the council signs the Framework

agreement, then the Agency will provide a potential alternative source of borrowing, and the council will be able to compare the rates offered by the Agency against rates from alternative sources primarily finance available from the Public Works Loan Board (PWLB). The Agency's intent is to make funding available at favourable rates compared to the PWLB, and borrowing from the Agency may therefore offer savings in interest payments. However, the council would review all potential sources of borrowing to ensure VFM in any borrowing decision, and would also weigh up any potential savings which could be achieved from borrowing via the Agency against the potential risks.

SUPPLEMENTAL ADVICE FROM OTHER OFFICERS

Director of Law and Democracy

Treasury Management

41. 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, governance and standards committee.

42. Financial standing orders require the strategic director of finance and governance to set out the treasury management strategy for consideration and decision by council assembly, and report on activity on a regular 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 governance.

43. The Local Government Act 2003 ("the 2003 Act") 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.

44. 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) made under section 21(1A) of the 2003 Act.

45. 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.

Municipal Bonds Agency Framework Agreement

46. With regard to approval for the Council to enter into the borrowing documents prepared by the UK Municipal Bonds Agency my view is that the council can rely on the general power of competence in section 1 of the Localism Act 2011, together with the power to borrow in section 1 of the 2003 Act.

BACKGROUND DOCUMENTS

Background Papers	Held At	Contact
Municipal Bonds Agency Framework Agreement	Finance & Government Department, Southwark Council, 160 Tooley Street SE1 2QH	Fay Hammond 020 75250614

APPENDICES

No.	Title
Appendix A	Prudential Indicators 2016-17 Mid Year Update

AUDIT TRAIL

Lead Officer	Duncan Whitfield, Strategic Director of Finance and Governance	
Report Author	Fay Hammond, Department Finance Manager Corporate Finance	
Version	Final	
Version Date	18 November 2016	
Key Decision	Yes	
CONSULTATION WITH OTHER OFFICERS / DIRECTORATES / CABINET MEMBER		
Officer Title	**Comments Sought**	**Comments Included**
Director of Law and Democracy	Yes	Yes
Strategic Director of Finance and Governance	Not applicable	Not applicable
Cabinet Member	Yes	Yes
Final Report Sent to Constitutional Team		18 November 2016