Item No: 6.2	Classification: Open	Date: 28 November 2018	Meeting Name: Council Assembly
Report title:		Treasury Management – Mid-year Update 2018/19	
Wards or Groups affected:		All	
From:		Strategic Director of Finance and Governance	

RECOMMENDATION

1. That council assembly note the 2018-19 mid-year treasury management update report and that:

   - all treasury management activity was undertaken in compliance with the approved treasury management strategy and with the council's prudential indicators, as Appendix A.
   - the balance remaining on all external debt as at 30 September 2018 was £588m.
   - in the six months to 30 September 2018 the average investment balance was £116m and the balance of investments at 30 September 2018 stood at £147m.
   - the debt cap for HRA was removed with immediate effect from 29 October 2018.

BACKGROUND INFORMATION

2. 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). 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.

3. The 2018-19 treasury management strategy was approved by council assembly in February 2018. Under financial delegation, all executive, managerial and operational decisions are the responsibility of the strategic director of finance and governance.

4. The council is exposed to financial risks from short term investments, existing external debt, as well as future borrowing requirements arising from the council's capital programme. The risks include potential losses from investments and increased borrowing costs from changing interest rates.

5. The key issues covered in this report are:

   - Local authority regulatory changes
   - The council's borrowing strategy and debt management position
   - Investment activity
   - Prudential indicators for 2018-19.

KEY ISSUES FOR CONSIDERATION

Local Authority Regulatory Changes

Revised CIPFA Codes

6. In December 2017, following a consultation exercise in September 2017, CIPFA published revised editions of the Treasury Management and Prudential Code. The additional requirements of the revised Treasury Management and Prudential Code, as outlined below, are being incorporated into treasury management strategies and monitoring reports.

7. In the 2017 Treasury Management Code the definition of 'investments' has been widened to include additional financial assets as well as non-financial assets held primarily for financial returns, such as investment property. These, along with other investments made for non-treasury management purposes such as loans supporting service outcomes and investments in subsidiaries, must be presented in the Capital Strategy or Investment Strategy. Additional risks of such investments are to be set out clearly and the impact on financial sustainability is be identified and reported.

8. The objective of the Prudential Code is to provide a framework such that individual local authority capital investment plans are affordable, prudent and sustainable.

9. The 2017 Prudential Code introduces the requirement for an authority to produce a Capital Strategy to provide a high-level overview of the long-term context of capital expenditure and investment decisions and their associated risks and rewards along with an overview of how risk is managed for future financial sustainability.

10. The Code recommends that the Capital Strategy should include sufficient information about the council's long term capital expenditure expectations, council assets and liabilities in such detail to allow elected members to understand how value for money, prudence, sustainability and affordability will be secured. The Code also expands on process and governance issues associated with capital expenditure and investment decisions.

11. The requirement to produce a capital strategy as per the 2017 Prudential Code is effective from April 2019. However the council elected to produce an early version of the capital strategy, which was agreed by Council Assembly in July 2018 in advance of this deadline, in order to ensure early consideration of the strategy and the context in which capital and investment decisions are made.

MHCLG Investment Guidance and Minimum Revenue Provision

12. In February 2018 the Ministry of Housing, Communities and Local Government (MHCLG) published revised Guidance on Local Government and Investments and Statutory Guidance on Minimum Revenue Provision (MRP). Local authorities are required to have regard to the revised guidance in consideration of capital, debt and investment decisions.

13. Changes to the Investment Guidance include a wider definition of investments to include non-financial assets held primarily for generating income return, typically investment property. This also extends coverage to a new category called

"loans" (e.g. temporary transfer of cash to a third party, joint venture, subsidiary or associate).

14. The investment guidance specifies additional reporting and disclosure requirements as part of the Capital and Treasury Management Strategy. The Investment Guidance is effective from 1 April 2018 with the additional disclosure requirements necessary as part of the capital and investment strategy for 2019-20.

15. The Guidance introduces the concept of proportionality and additional disclosure for borrowing solely to invest. Investment strategies must detail the extent to which service delivery objectives are reliant on investment income and a contingency plan should yields on investments fall.

16. During the financial year 2017-18 the council acquired a number of strategic property assets including four properties in London Bridge and property within Old Kent Road opportunity area. These were funded from prudential borrowing and part financed from rental income. It is expected that these assets will provide a long term, sustainable source of income for the council.

17. The new Statutory Guidance on the MRP issued by MHCLG in February 2018 will be applicable for accounting periods from 1 April 2019 for which Southwark must have regard to when setting and applying MRP policy.

18. The guidance has sought to clarify what the government considered as prudent provision for the repayment of debt. This has included updated specification of individual asset lifetime over which provision is to be made for repayment, including an upper limit of 50 years in all but exceptional cases.

19. The definition of prudent MRP has been changed to "put aside revenue over time to cover the Capital Financing Requirement (CFR)" and any change in MRP policy cannot create an overpayment; the new policy must be applied to the outstanding CFR going forward only.

20. The council's existing MRP policy and proposed MRP Policy for 2019-20 is compliant with the new guidance.

UK Budget 2018 and HRA Debt Cap

21. As part of the 2018 UK National Budget on 29 October 2018 the debt cap for the HRA has been lifted with immediate effect. As at 31 March 2018 the HRA had £147m headroom within the debt cap.

22. The capital programme for the HRA will continue to comply with the requirements of the CIPFA prudential code; such that capital expenditure and any associated financing implications must be affordable, prudent and sustainable.

23. The setting of internal prudential borrowing limits for the HRA will be required to ensure that the annual cost of debt interest remains affordable. Any prudential limit is expected to be significantly greater than the national debt cap. Initial estimates indicate that a prudential borrowing cap for affordability for the HRA borrowing could be up to £1,300m, increasing the headroom for new borrowing by around £900m, over the long term.

24. The potential to increase prudential borrowing within the HRA will allow the council to consider opportunities for ambitious housebuilding schemes that would otherwise have been excluded due to the limitations enforced by the debt cap.

MiFID II

25. As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3 January 2018 local authorities were automatically treated as retail clients but could “opt up” to professional client status, providing certain criteria was met which includes having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority have at least a year’s relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that that person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

26. The Authority met the conditions to opt up to professional status and has done so in order to maintain its former MiFID II status prior to January 2018.

Prudential Indicators - Actuals

27. Local authority borrowing, investment and capital finance activity is supported by the Prudential Code for Capital Finance, the Treasury Management in the Public Services Code of Practice and related guidance published by CIPFA. The codes require councils to set a series of indicators and limits each year. The 2018-19 indicators were agreed in February 2018, before the start of the financial year and enabled the strategic director of finance and governance to carry out his responsibilities in this area. The prudential indicator estimates for 2018-19 are included at Appendix A.

28. The council has complied with its Prudential Indicators throughout 2018-19.

Borrowing strategy and debt management activity and position

29. The council’s debt management strategy since 2011-12 has been to pursue a policy of internal borrowing, which is the use of existing reserves and balances to temporarily fund capital expenditure rather than the use of external borrowing.

30. The use of internal borrowing allows the council to minimise unnecessary external borrowing costs by only borrowing when needed for liquidity, or to benefit from advantageous borrowing rates. Borrowing in advance of need from a cashflow perspective creates a ‘cost of carry’ which is the difference between the short term investment income earned through holding cash balances compared against longer term external debt financing costs

31. Efficient use of existing council resources to fund capital expenditure through internal borrowing also reduces the council’s counterparty risk inherent in the investment of cash balances

32. During 2017-18, it became necessary to undertake new borrowing in order to finance prior internal borrowing from the capital programme and to maintain target cash balances. During the course of the financial year 2017-18 the council elected to borrow £110m in short term loans from other local authorities.

33. This approach to short term borrowing has continued into the first half of 2018-19 with the balance of short term borrowing from local authorities at £145m as at 30 September 2018. The weighted average rate of interest on short term borrowing is 0.90%, significantly less than long term rates of borrowing.

34. Officers regularly monitor current and forecast interest rates to determine the appropriateness of the internal and short term borrowing approach, so that the reduction in current borrowing costs from use of internal balances is not offset by higher borrowing costs in the future.

35. Future borrowing requirements arising from the approved capital programme, the extent of internal borrowing and the need to refinance scheduled debt repayments, together with potential for interest rate rises, indicate the need for long-term borrowing during the second half of 2018-19, with further borrowing required during 2019-20.

36. Projections for approved capital expenditure and cashflows indicate an additional borrowing requirement of up to £250m by March 2019.

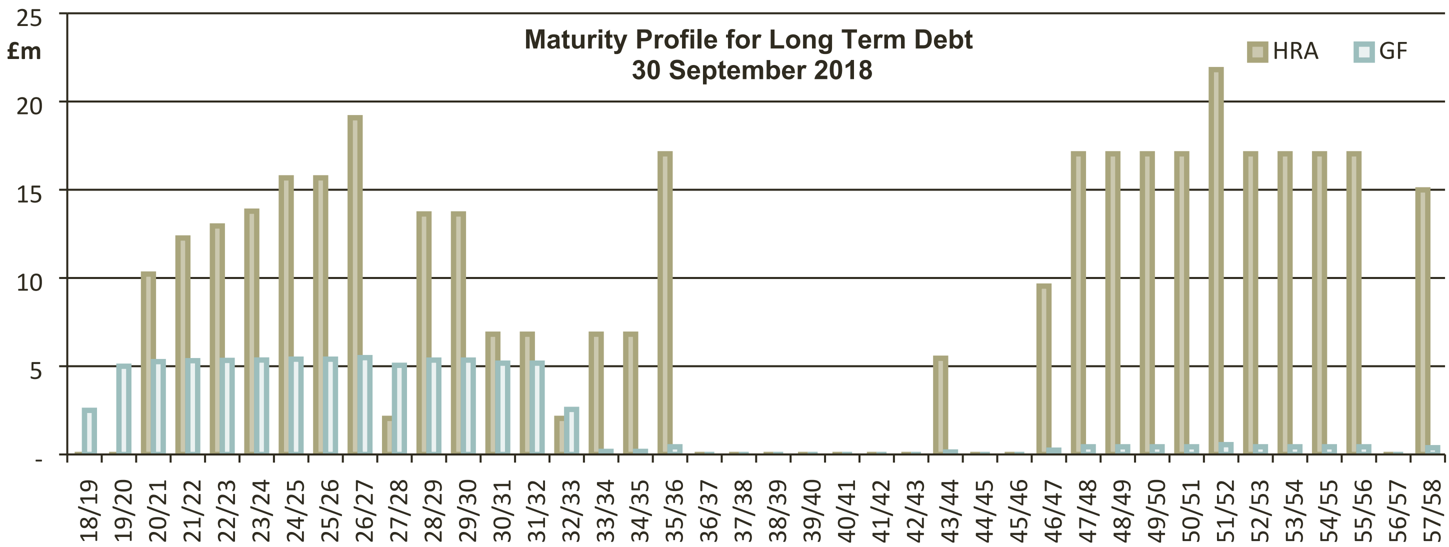
37. All historical long term debt for the council has been drawn from the PWLB; however future borrowing could come from a variety of different sources. The council could borrow through other financial institutions and banks, the Municipal Bond Agency, or directly from other local authorities. All short term borrowing during 2018-19 was via other local authorities. Borrowing from other local authorities is typically at lower rates than from other sources for short duration debt.

38. The council's outstanding debt portfolio, used to fund historical capital expenditure, stood at £588m as at 30 September 2018.

39. All long term outstanding debt was borrowed from the Public Works Loans Board (PWLB), part of HM Treasury, at fixed rates of interest. During the first half of 2018-19, £10m of long debt principal matured and was repaid to PWLB. All long term debt was drawn prior to 2011-12.

40. The weighted average rate of interest for the council's debt portfolio is 4.6% as at 30 September 2018 a reduction from 5.5% as at 31 March 2017. This reflects the largely historical nature of the debt, the majority of which was drawn prior to 2008.

41. The maturity profile of outstanding long term borrowing as at 30 September 2018 is shown in the chart below:



Provisions for repayment of debt

42. Each year, the general fund sets aside sums, known as the minimum revenue provision (MRP), to reduce its borrowing liabilities. The HRA can also set aside sums to reduce borrowing liabilities. During 2017-18 no additional balances were set aside for repayment of debt.

43. The PWLB operates a spread of approximately 1% between “premature repayment rates” and “new loan” rates so the premium charge incurred for early repayment of PWLB debt remained expensive for the council’s portfolio and therefore unattractive for debt rescheduling activity.

Investment strategy and investment activity and position

44. The council holds sizable investment balances, representing income received in advance of expenditure plus balances and reserves held. Investments as at 30 September 2018 were £147m (£116m at 30 September 2017).

45. Council resources that are not immediately required for current expenditure are invested in money market instruments in accordance with the MHCLG Guidance on Local Authority Investments and the approved investment strategy. The MHCLG guidance gives priority to security and liquidity and the council’s aim is to achieve a yield commensurate with these principles.

46. Council investments are managed both in-house and delegated to two fund managers: Alliance Bernstein and Aberdeen Standard (formerly Aberdeen Asset Management). The focus for in-house investment is to meet variable near term cash liquidity requirements, principally using money market funds and other highly secure, liquid financial instruments

47. Any surplus cash resources not required in the short term to fund council activities is placed with the council’s two external fund managers. The fund managers invest for a longer term in UK government gilts, supranational bank bonds, certificates of deposits issued by major banks/ building societies and other financial instruments.

48. The use of fund managers has the advantage 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. Although investments can be redeemed from the fund managers at short notice, the intention is to hold them for the medium term. Their performance and suitability in meeting the council's investment objectives are regularly monitored.

49. The distribution of council investments across counterparties by rating and maturity as at 30 September 2018 is set out in the table below:

	A		AA		AAA		Total
Investment Maturity	**£m**	**%**	**£m**	**%**	**£m**	**%**	**£m**
Up to 1 Year	10.7	7%	25.2	17%	85.2	59%	121.1
1 - 2 Years	-	0%	3.2	2%	14.6	10%	17.8
2 - 5 Years	-	0%	-	0%	7.7	5%	7.7
Total	10.7	7%	28.4	19%	107.5	74%	146.6

50. The annualised rate return for council treasury management assets for the first six months of the financial year was 0.74%. Market expectations of a further increase in UK base rate, agreed unanimously by the UK Monetary Policy Committee in August, led to increased yields in short duration gilts. The increase in short duration interest rates has had a limited, negative impact on existing asset valuations.

51. The council's portfolio was well placed for an increase in rates with a low duration exposure, and therefore will likely benefit from an increased rate of return during the second half of 2018-19.

52. To assess the treasury management investment performance, the council measures the return against a composite investment benchmark of three month LIBID and one to three year gilt index. For the first half of the financial year the benchmark index annualised return was 0.54% indicating an outperformance versus the benchmark of 0.20%.

53. The rate of investment return generated by the treasury management portfolio is a consequence of the council's prudent, low risk approach to treasury management investing. This is in line with the requirements of the statutory guidance for local government treasury investment issued by MHCLG.

54. The priorities for treasury management investment are, in order of priority, security, liquidity, and yield. The objective therefore is to ensure that funds are available to meet council liabilities as they fall due.

SUPPLEMENTAL ADVICE FROM OTHER OFFICERS

Director of Law and Democracy

55. 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.

56. 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.

57. 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.

58. 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 Ministry of Housing, Communities and Local Government Guidance on Local Authority Investments updated February 2018 and there is statutory guidance on the Minimum Revenue Provision (MRP) made under section 21(1A) of the 2003 Act.

59. 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
None		

APPENDICES

No.	Title
Appendix A	Prudential Indicators – 2018-19 Actuals & Estimates

AUDIT TRAIL

Lead Officer	Duncan Whitfield, Strategic Director of Finance and Governance	
Report Author	Rob Woollatt, Interim Departmental Finance Manager	
Version	Final	
Version Date	15 November 2018	
Key Decision	No	
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		15 November 2018

APPENDIX A

PRUDENTIAL INDICATORS: 2018-19 ACTUALS AND ESTIMATES

BACKGROUND

1. Capital finance, borrowing and investment arrangements are supported by a series of prudential indicators, drawn from the Prudential Code on Capital Finance for Local Authorities and the Treasury Management in the Public Services Code of Practice plus Guidance, published by CIPFA. The Local Government Act 2003 requires that councils have regard to these codes. The indicators were approved by council assembly in February 2018, and the outturn positon was reported in July 2018. This appendix updates 2018-19 indicators.

2. The indicators are grouped into three broad areas: affordability and prudence, capital finance and treasury management. The indicators are of a technical nature and existing budgets take account of capital finance and treasury activities. The indicators themselves have no effect on those budgets.

INDICATORS ON AFFORDABILITY AND PRUDENCE

3. The indicators below are for affordability and prudence.

2017-18 Outurn	2018-19 Estimate	
		Ratio of Financing Cost to Net Revenue Stream A measure of the cost of borrowing and long term liabilities (e.g. PFI) net of interest income and set-asides, as a percentage of revenue.
9%	9%	HRA
4%	4%	General fund

		Capital Financing Requirements (CFR) and Gross Debt The CFR is the balance remaining on past capital expenditure financed through debt and long term liabilities (e.g. PFI). The level of gross debt should not exceed the CFR unless prudent over the short term. Actual gross debt remained below the CFR throughout 2017-18 on account of cash balances, internal borrowing and PFI transactions.
£956m	£1,117m	CFR
£563m	£588m	Maximum Gross Debt in the Year

INDICATORS ON CAPITAL FINANCE

4. The indicators below are for capital finance.

2017-18 Outurn	2018-19 Estimate	
		Capital Expenditure Capital expenditure includes PFI funded spend.
£168m	£120m	HRA
£233m	£193m	General fund
£401m	**£313m**	**Total**

		Capital Financing Requirement (CFR) The CFR is the balance on past capital expenditure financed through borrowing and long term liabilities (e.g. PFI).
£430m	£436m	HRA
£526m	£681m	General fund
£956m	**£1,117m**	**Total**

		HRA Indebtedness Limit A limit determined by the government below which the HRA CFR must remain. The HRA CFR has remained within the indebtedness limit.
£577m	£577m	HRA indebtedness limit determined by the government
£430m	£436m	Actual HRA CFR
£147m	**£141m**	**HRA Headroom**

INDICATORS ON TREASURY MANAGEMENT

5. The indicators below are for treasury management.

2017-18 Outturn	2018-19 Limit	2018-19 Estimate	
			Operational Boundary on Debt and Authorised Limits for External Debt These are limits the council determines to accommodate 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, enabling additional borrowing to be taken for very short periods, in the interest of prudence, within a risk controlled framework.
			Operational Boundary
£563m	£791m	£588m	Borrowing (maximum outstanding in year)
£101m	£110m	£96m	Other Long Term Liabilities
£664m	**£901m**	**£684m**	**Total**

			Authorised Limit
£563m	£1,207m	£588m	Borrowing (maximum outstanding in year)
£101m	£130m	£96m	Other Long Term Liabilities
£664m	**£1,337m**	**£684m**	**Total**

2017-18 Outturn	2018-19 Limit	2018-19 Estimate	
78%	100%	75%	**Gross and Net Debt** An upper limit on net debt as a percentage of gross debt. The net debt has remained below gross on account of investments held to meet spend.
			Fixed and Variable Rate Upper Limits Limits recognising existing positions with flexibility to vary exposure within a risk controlled framework should it be prudent.
100%	100%	100%	Fixed rate debt
0%	20%	0%	Variable rate debt

			Maturity Structure of Borrowing Limits accommodating existing positions with flexibility to vary exposure within a risk controlled framework.
22%	25%	23%	Under 1 year
1%	25%	2%	1 year and within 2 years
9%	50%	10%	2 years and within 5 years
17%	75%	17%	5 years and within 10 years
52%	100%	48%	10 years and over
			Limits on Investments Greater than One Year Caps on the maximum exposure to longer investments, while recognising benefits from prudent exposure within a risk controlled framework.
23%	50%	17%	Percentage longer than one year
7 months	2 years	6 months	Overall maximum average maturity