

ITEM NO: 6

DECISION-MAKER:	COUNCIL		
SUBJECT:	ANNUAL TREASURY MANAGEMENT STRATEGY AND PRUDENTIAL LIMITS 2008/09-2011/12		
DATE OF DECISION:	18TH FEBRUARY 2009		
REPORT OF:	CABINET MEMBER FOR RESOURCES PORTFOLIO		
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STRATEGY OF CONFIDENTIALITY

NOT APPLICABLE

SUMMARY

Council is requested to approve the Prudential Indicators and the Treasury Management Strategy and to note the main activities undertaken during 2008/09 to date which are summarised below:

- (i) Investment returns have decreased from £4.4M in 2007/08 to an estimated £3.7M in current year as a result of a fall in interest rates. The average rate achieved to date (5.45%) is above the performance indicator of the average 7 day Libid rate (4.42%).
- (ii) The average rate for repayment of overall outstanding debt has reduced from 4.48% in 2007/08 to 4.15% of as a result of restructuring £65M of debt. This has generated £280,000 savings in 2008/09 and savings of £1.2M for 2009/10.
- (iii) £25M of debt has been repaid at an average rate of 4.41% to be funded by either a reduction in internal investments or temporary borrowing at an average rate of 1.25%, which should achieve savings of £130,000 for 2008/09.

The estimates for interest payable and the Prudential Indicators contained within this report assume that the recommendations in the Capital and Revenue budget reports, elsewhere on the agenda, are approved. If there are any changes to the capital programme or the level of borrowing the Prudential Indicators will need to be revised.

RECOMMENDATIONS:

- (i) Approve the Council's Prudential Indicators as detailed in paragraph 9 and within Appendix 1;
- (ii) Approve the Treasury Management Strategy for 2009/10 as outlined in the report; and
- (iii) To note that the indicators as reported, have been set on the assumption that the recommendations in the reports earlier on the agenda have been approved. Should the recommendations change, the Prudential Indicators may have to be recalculated.

- (iv) To note the action taken by the Chief Financial Officer in light of the turmoil in current financial markets.
- (v) To approve the introduction of an Interest Equalisation Reserve that will help to smooth out Treasury Management volatility and its potential impact on budget setting.

REASONS FOR REPORT RECOMMENDATIONS

1. In order to comply with Part 1 of the Local Government Act 2003, and the established treasury management procedures that have been adopted by the Authority, the Council must each year set certain borrowing limits and approve a treasury management strategy.

CONSULTATION

2. The proposed capital and revenue budget on which this report is based have been subject to their own consultation processes outlined in the relevant reports elsewhere on the agenda.

ALTERNATIVE OPTIONS CONSIDERED AND REJECTED

3. Alternative options for borrowing would depend on decisions taken on the setting of the capital programme, which are being taken today.

DETAIL

Background

4. The Local Government Act 2003 introduced a system for borrowing based largely on self-regulation by local authorities themselves. The basic principle of the new system is that local authorities will be free to borrow as long as their capital spending plans are affordable, prudent and sustainable.
5. The system is based around the “Prudential Code for Capital Finance in Local Authorities”, to which authorities must have regard when setting and reviewing their affordable borrowing limits.
6. The Prudential Code requires that local authorities establish guidelines in advance, by which to judge whether their capital spending plans are affordable, prudent and sustainable and these must be monitored in the light of actual out-turns. It should be noted that CIPFA undertook a review of the code in early 2008 to assess whether there are any improvements which could be made. The results are not yet known.
7. CIPFA has defined Treasury Management as:
“the management of the organisation’s cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.”

The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury

management activities will be measured. Treasury management risks are identified in the Council's approved Treasury Management Practices; the main risks to the Council's treasury activities are:

- Liquidity Risk (Inadequate cash resources)
- Market or Interest Rate Risk (Fluctuations in interest rate levels and thereby in the value of investments).
- Inflation Risks (Exposure to inflation)
- Credit and Counterparty Risk (Security of Investments)
- Refinancing Risks (Impact of debt maturing in future years).
- Legal & Regulatory Risk (i.e. non-compliance with statutory and regulatory requirements, risk of fraud).

8. The Council's proposed strategy for 2009-10 also takes into account the outlook for interest rates (see Appendix 3), its current treasury position, its projected treasury management and capital financing activities and its approved Prudential Indicators as detailed in Appendix 1.

9. The prudential indicators relevant to the treasury management strategy are set out below:

	2008-09 Estimate	2009-10 Estimate	2010-11 Estimate	2011-12 Estimate
Authorised Limit for External Debt*	£383M	£383M	£408M	£408M
Operational Boundary for External Debt	£372M	£372M	£395M	£395M
Upper Limit for Fixed Interest Rate Exposure	100 %	100 %	100 %	100 %
Upper Limit for Variable Rate Exposure	50 %	50 %	50 %	50 %
Upper Limit for total principal sums invested over 364 days	£50M	£50M	£50M	£50M

Maturity structure of fixed rate borrowing :	Estimated % 31/03/2009	Lower Limit %	Upper Limit %
under 12 months	22	0	30
12 months and within 24 months	17	0	30
24 months and within 5 years	28	0	50
5 years and within 10 years	0	0	75
10 years and above	33	0	100

* The Authorised Limit is the statutory limit determined under Section 3(1) of the Local Government Act 2003 (referred to in the legislation as the Affordable Limit). The limit has been set not only to include provision for additional borrowing but to provide maximum flexibility for short periods to deliver the agreed Treasury Management strategy.

10. The Treasury Management Strategy Statement also incorporates the Council's Investment Strategy

The Treasury Position

11. The current treasury position as at 31st December and the estimate for 31st March 2009 is :

	Actual		Estimate	
	31 December 2008		31 March 2009	
	Total £'000	Rate %	Total £'000	Rate %
External borrowing :				
Fixed rate - PWLB	125,000	4.25	90,000	2.53
Variable rate - PWLB			10,000	1.15
Fixed rate – Long Term Market	9,000	4.86	9,000	4.86
Fixed rate – Short Term Market	9,500	1.59	20,000	1.25
Variable rate - Market	2,900	4.84	2,900	4.84
Other long-term liabilities	20,800		20,000	
Total external debt	167,200		151,900	
Investments				
Short-Term Market deposits	35,700	2.94	20,000	1.00
Long-Term deposits	27,000	5.84	15,000	6.27
Bonds	6,000	4.98	6,000	4.98
Money Market Funds	6,000	3.19	6,000	2.00
Total Investments	74,700		47,000	

12. The table above reflects that fact that at the end of January, a major debt restructure exercise was undertaken in order to take advantage of current market conditions. A total amount of £65M of long term debt was restructured, part of which was then re-financed through variable rate PWLB loans and fixed rate short term market loans.
13. The restructure means that not only has the Council been able to significantly reduce its interest payments over the short term, it has also been able to reduce its investment exposure in the market by not re-financing the whole amount of the restructured debt.
14. It is anticipated that this restructure will produce revenue savings of £1.2M in 2009/10, however it should be noted that in part, the council has achieved this by exposing itself to short term variable interest rate risk by taking variable rate PWLB and fixed rate but short term market debt.
15. In the current climate of falling interest rates this is obviously a sound strategy, however at some point when the market starts to move the Council will need to act quickly to lock into fixed long term rates which may be at similar levels to the debt it has just restructured. The savings generated in 2009/10 will not therefore be recurring savings and should not be used for budget setting purposes.

16. Furthermore, the current volatility in the financial markets will mean that interest costs and investment income will continue to fluctuate for some time and it is therefore recommended that an Interest Equalisation Reserve be created from the savings arising from the restructure which will also include a one-off premium paid to the Council following the debt restructure. This will help to manage volatility in the future and ensure that there is minimal impact on annual budget decisions.

Borrowing Requirement and Strategy:

17. The Council's underlying need to borrow for capital purposes is measured by reference to its Capital Financing Requirement (CFR) as detailed in Appendix 1. The CFR will determine the council's requirement to make a Minimum Revenue Provision for Debt redemption (MRP) from within its Revenue budget. Actual borrowing may be greater or less than the CFR.
18. In accordance with the Prudential Code, the Council will ensure that net external borrowing does not, except, in the short term, exceed the CFR in the preceding year plus the estimates of any additional CFR for the current and next two financial years.
19. Capital expenditure not financed from internal resources (i.e. Capital Receipts, Capital Grants and contributions Revenue or Reserves) will produce an increased requirement to charge MRP in the Revenue Account.
20. The Council's long-term borrowing as at 31 March 2009 is estimated to be £82M. It is estimated that the Council's long-term borrowing requirement over the next 3 financial years will be:

	31/3/2009 £'000	2009-10 £'000	2010-11 £'000	2011-12 £'000
New borrowing to finance capital expenditure	24,698	24,451	14,114	806
Replacement of maturing debt	0	32,000	17,000	7,000
Less MRP for Debt Redemption	(4,362)	(4,750)	(5,406)	(5,531)
Total	20,336	51,701	25,709	2,275

21. The Council prefers to maintain maximum control over its borrowing activities as well as flexibility on its loans portfolio. The economic backdrop remains uncertain and the forecast for official rates and gilt yields could materially change. Capital expenditure levels, market conditions and interest rate levels will be monitored during the year in order to minimise borrowing costs over the medium to longer term. A prudent and pragmatic approach to borrowing will be maintained to minimise borrowing costs without compromising the longer-term stability of the portfolio, consistent with the Council's Prudential Indicators.
22. Therefore, in conjunction with advice from its treasury advisors, the Council will keep under review the options it has in borrowing from the Public Works

Loan Board (PWLB) and from market and other sources identified in the Treasury Management Practices Schedules up to the available capacity within its Affordable Borrowing Limit (defined by CIPFA as the Authorised Limit).

23. Short-dated gilt yields are forecast to be considerably lower than medium- and long-dated gilt yields during the financial year. Despite additional short-dated gilts issuance to fund the UK government's support to the banking industry, short-dated gilts are expected to benefit from expectations of lower interest rates as the economy struggles through a recession. Yields for these maturities will fall as expectations for lower interest rates mount. Short-dated PWLB rates should consequently provide some attractive fixed rate borrowing opportunities.
24. The shocks in the financial markets in the second half of 2008 leaves the UK in a different era in respect of official interest rates which are forecast to fall below 2%. The Council will evaluate with its financial advisors the relative merits of variable rate funding which is expected to fall to altogether very low levels. Decisions to borrow at low, variable rates of interest will be taken after considering the absolute level of longer term interest rate equivalents and the extent of variable rate earnings on the Council's investment balances. Should longer term rates move below the cost of variable rate borrowing any strategic exposure to variable interest rates will be reviewed and, if appropriate, reduced.
25. Actual borrowing undertaken and the timing will depend on capital expenditure levels, interest rate forecasts and market conditions during the year, in order to minimise borrowing costs. The Council will be advised by its financial advisors of the specific timing of borrowing. This may include borrowing in advance of future years' requirements provided that overall borrowing is maintained within the Council's projected CFR and its approved Affordable Borrowing Limit.
26. The maturity term of new borrowing will be consistent with the Council maintaining a prudent loans maturity profile in accordance with its Prudential Indicators.
27. **The Option for Forward Funding:** The Council does not have to rely on borrowing in discrete financial years to fund its capital financing requirement and the strategy provides flexibility to take forward borrowing decisions when rates are favourable and the need to borrow can be demonstrated. Overall borrowing must still be within the Council's Affordable Borrowing Limit.
28. **'Trigger' rates for borrowing:** The Council's treasury advisor, provides economic and interest rate forecasts as well as formulating views on borrowing and lending opportunities.
29. The Council will maintain a pragmatic approach to borrowing, bearing in mind the Council's debt maturity profile and the need to minimise borrowing costs without compromising longer-term stability of the portfolio. Total borrowing for the year will be reported to Council in July 2009 as part of the Treasury Management Outturn report.

Debt Rescheduling:

30. The Council will continue to maintain a flexible policy for debt rescheduling. Market volatility may provide opportunities for restructuring debt from time to time. The rationale for restructuring would be one or more of the following:
- Savings in interest costs with minimal risk.
 - Balancing the volatility profile (i.e. the ratio of fixed to variable rate debt) of the debt portfolio.
 - Amending the profile of maturing debt to reduce any inherent refinancing risks.
31. The rescheduling of PWLB debt since the introduction of its repayment rates on 1st November 2007 has not ceased, but has become undoubtedly harder and places greater emphasis on the timing and type of new borrowing. Short-term PWLB rates have exhibited a fair degree of volatility in FY 2008-09; this volatility has been much less pronounced for long-dated maturities. Should a similar pattern emerge in FY 2009-10, this could provide the Council with some rescheduling opportunities.
32. The Council's debt portfolio is monitored against equivalent interest rates and available refinancing options on a regular basis. As opportunities arise, they will be identified by the Council's treasury management advisors and discussed with the Council's officers. Any rescheduling activity will be undertaken within the Council's treasury management policy and strategy and will comply with the accounting requirements of the local authority SoRP and regulatory requirements of the Capital Finance and Accounting Regulations (SI 2007 No 573).
33. In 2008/09, up to January 2009, we have restructured debt amounting to £65M which has generated savings of £280,000 in 2008/09 and savings of £1.2M for 2009/10. This has been achieved at no cost to the authority by grouping loans together where premiums and discounts have been offset. This has resulted in the average rate for overall outstanding debt repayment being reduced from 4.48% in 2007/08 to 4.15% in 2008/09. Total debt restructuring activity for the year will be reported to Council as part of the Treasury Management Outturn report in July 2009.
34. As detailed below, due to the fall in interest rates, the risk of holding large investment balances and the increase in the longer term PWLB rates, on the advice of our TM advisors, £25M of long term debt (at an average rate of 4.41%), has been redeemed. This was achieved at no cost to the Council by grouping together premiums and discounts. This will be financed in the short term through the use of internal funds and short term borrowing at an average rate of 1.25%, which should achieve savings of £130,000 in 2008/09. Both PWLB rates and investment rates will be continually monitored to assess the best time to refinance with long term debt.

Annual Investment Strategy:

35. The general policy objective is that the Council should invest its surplus funds prudently. The Council's investment priorities are:
- security of the invested capital.
 - liquidity of the invested capital.
 - an optimum yield which is commensurate with security and liquidity.
- The speculative procedure of borrowing purely in order to invest is unlawful, but treasury strategy will result in surplus investments arising from treasury activity from time to time.
36. Investments are categorised as 'Specified' or 'Non Specified' investments based on the criteria in the DCLG (formally ODPM) Guidance. Potential instruments for the Council's use within its investment strategy are contained in Appendix 2.
37. The Council maintains a counterparty list based on its credit criteria and monitors and updates the credit standing of the institutions on regular basis on the advice of our treasury management consultants. The CFO has delegated powers to determine the counterparty limits to facilitate a prudent and practical diversification of the Council's investments between counterparties. A tiered approach is used to reflect the difference in credit strength between institutions.
38. The global financial market storm in 2008 has forced investors of public money to reappraise the question of risk versus yield. By January 2009 the UK Bank Rate had fallen to 1.5%, it's lowest ever level. It is expected that the Bank Rate will fall to near zero in FY 2009-10, short-term money market rates will continue to fall to very low levels which will have a significant impact on investment income. The Council's strategy must however be geared towards this development whilst adhering to the principal objective of security of invested monies.
39. The Chief Financial Officer, under delegated powers, will undertake the most appropriate form of investments in keeping with the investment objectives, income and risk management requirements and Prudential Indicators. Decisions taken on the core investment portfolio will be reported to Council as part of the Treasury Management Outturn report in July 2009.
40. The Council's shorter term cashflow investments are made with reference to the outlook for the UK Bank Rate and money market rates. For these monies, the Council will mainly invest in
- The Debt Management Agency Deposit Facility (DMADF) which is guaranteed by the UK Government and is therefore a AAA rated investment.
 - AAA-rated Money Market Funds investing predominantly in government securities
 - AAA-rated Money Market Funds (60-day Weighted Average Maturity) investing in instruments issued primarily by financial institutions;
 - Deposits with other local authorities

- Business reserve accounts,
- Term deposits
- Certificates of Deposit

41. The rates of interest from the DMADF are below equivalent money market rates. However, the returns are an acceptable trade-off for the guarantee that the Council's capital is secure. Similarly, the returns on MMFs investing predominantly in government securities and on CDs which are guaranteed by the government will be below those on equivalent securities a risk-return trade-off that the Council acknowledges and accepts in order to safeguard its investments.
42. A proportion of the Council's in-house core balances can be invested with a longer-term strategic focus. With interest rates forecast to fall further in 2009 and remain relatively low in 2010, the Council will evaluate the longer-term investment opportunities available within the limits the Council has set for Non-Specified Investments and will likely include
- **Supranational bonds (bonds issued by multilateral development banks):** Even at the lower yields likely to be in force, the yields could be attractive relative to the increasingly low outlook for official interest rates. The joint and individual pan European government guarantees in place on these bonds provides access to some of the lowest credit risk available.
43. The Council will adhere to the upper limit set under its prudential indicators for 'principal sums invested for over 364 days'.
44. The Council's level of investments at 31st December 2008 was £75M. The Council's investment position is estimated to be:

	31/3/2009	2009-10	2010-11	2011-12
	Estimate	Estimated average	Estimated average	Estimated average
Investments	£47M	£50M	£50M	£50M

45. The Council's shorter term cashflow derived investments are made with reference to the outlook for the repo rate and money market rates. For these monies, the Council will mainly utilise its business reserve accounts and Money Market short term deposits.
46. The Council's core funds, which consist of Schools balances, PFI reserves, and the Housing Revenue and General Fund balances, are invested with a longer-term strategic focus and are currently invested in one year deposits. As agreed in the 2007/08 strategy, longer-term bonds (which provide certainty of investment income over the life of the bond) were explored and resulted in the purchase of a £1M bond in 2007/08 and a further £5M in

2008/09 to date.

47. Based on the forward projections for its investments balances and its budgeted income requirement, the Council will evaluate and consider investment opportunities to earn an optimum return, to build in consistency of return over the medium term to the extent practicable, and to diversify and manage risk.
48. The investment strategy approved at Council in February 2008 set the following investment limits:-
 - Up to £5M can be invested in institutions with a credit rating of A or A+
 - Up to £10M can be invested in institutions with a credit rating of AA- or above.
49. Following market uncertainty earlier in the year, it was decided to try to place all of the Council's investments with AA- institutions or above and only to use lower ratings than that if we had difficulties in placing money. In May 2008, following the downgrading of many banks within the market this was further tightened so that we only lent to institutions of AA- or greater regardless of the amount of money involved. At the end of September 2008 the decision was taken to only place new or maturing deposits with the Debt Management Office (DMO) which is guaranteed by the UK Government and is therefore a AAA rated investment. For investments of less than £250,000 (the minimum amount the DMO will accept) it was decided to use the Council's AAA rated instant-access Money Market Funds.
50. All of these decisions were taken in response to the changing market conditions and following advice from the Council's Treasury advisors. The unprecedented events since then, including the collapse of major financial institutions in the USA and the Icelandic banking collapse highlighted the fact that the council had made the right decisions at the right time.
51. Since then, following advice from the Council's Treasury advisors, it has been decided to reintroduce certain UK banks and building societies who have implicit or explicit expressions of support from the UK government as clients' investment counterparties; this does not include their subsidiary banks. The maximum limit per bank is £5M (including any investments we already have out with them). The maximum maturity period for any of these investment deals is 3 months. All other funds are still invested with the Debt Management Office. This strategy will be kept under constant review until the markets settle down and revert to more normal levels.
52. The following table shows how the Council has increased its investments in higher credit rated institutions (AAA) and reduced its exposure in lower rated institutions (A) in response to the changing environment.

Credit Rating	Investments 31 Mar 08	Investments 31 Dec 08
A	44%	1%
AA	51%	64%
AAA	5%	35%
Total	100%	100%

Our approved investment strategy seeks to maximise our investment return whilst ensuring the security of our deposits.

53. As a result of this the rate of investment returns for 2008/09 is expected to be 5.15% compared to 5.48% in 2007/08 to, which is above the performance indicator of the average 7 day Libid rate, which is currently 4.42%.

Balanced Budget Requirement

54. The Council complies with the provisions of S32 of the Local Government Finance Act 1992 to set a balanced budget.

Annual Minimum Revenue Provision (MRP) Strategy

55. The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 (SI 2008/414) place a duty on local authorities to make a prudent provision for debt redemption. Guidance on Minimum Revenue Provision has been issued by the Secretary of State and local authorities are required to "have regard" to such Guidance under section 21(1A) of the Local Government Act 2003. The four options available are:

Option 1: Regulatory Method

Option 2: CFR Method

Option 3: Asset Life Method

Option 4: Depreciation Method

The Council adopted Option1 in respect of capital expenditure financed by supported borrowing and Option 3 in respect of unsupported capital expenditure. Details of sums included in the revenue budget are set out in the table below:

	Estimate 2008-09 £'000	Estimate 2009-10 £'000	Estimate 2010-11 £'000	Estimate 2011-12 £'000
MRP on supported borrowing	4,175	4,085	3,981	3,965
MRP on unsupported borrowing	187	665	1,425	1,566
Total	4,362	4,750	5,406	5,531

Links to the Capital and Revenue Budgets

56. The Treasury Management estimates contained in this report are included

within the Revenue budget and are based on the level of borrowing outlined in the Capital Programme reports elsewhere on the agenda. If there are any changes to the level of unsupported borrowing this will affect the estimates for MRP and interest payable.

Report on the Annual Treasury Outturn

57. After the completion of the financial year, the Council will report on its treasury activity during 2008-09. This report will include the latest approved Prudential Indicators for the year together with final outturn position.

FINANCIAL/RESOURCE IMPLICATIONS

Capital

The Capital implications are considered as part of the General Fund Capital Programme report and HRA Capital Programme report elsewhere on the agenda.

Revenue

The Revenue implications are considered as part of the General Fund Revenue Budget report and HRA Revenue Budget report elsewhere on the agenda

Property

None

Other

None

LEGAL IMPLICATIONS

Statutory power to undertake proposals in the report:

Local Authority borrowing is regulated by Part 1, of the Local Government Act 2003, which introduced the new Prudential Capital Finance System.

From 1 April 2004, investments are dealt with, not in secondary legislation, but through guidance. Similarly, there is guidance on prudent investment practice, issued by the Secretary of State under Section 15(1)(a) of the 2003 Act. A local authority has the power to invest for "any purpose relevant to its functions under any enactment or for the purposes of the prudent management of its financial affairs". The reference to the "prudent management of its financial affairs" is included to cover investments, which are not directly linked to identifiable statutory functions but are simply made in the course of treasury management. This also allows the temporary investment of funds borrowed for the purpose of expenditure in the reasonably near future; however, the speculative procedure of borrowing purely in order to invest and make a return remains unlawful.

Other Legal Implications:

None

POLICY FRAMEWORK IMPLICATIONS

This report has been prepared in accordance with CIPFA's Code of Practice on Treasury Management

SUPPORTING DOCUMENTATION

Appendices

1.	Prudential Indicators for 2009/10– 2011/12
2.	Specified and Non Specified Investments for use by the Council.
3.	Economic and Interest Outlook

Documents In Members' Rooms

1.	
2.	

Background Documents

Title of Background Paper(s)

Relevant Paragraph of the Access to Information Procedure Rules / Schedule 12A allowing document to be Exempt/Confidential (if applicable)

1.		
2.		

Background documents available for inspection at:

FORWARD PLAN No:

KEY DECISION?

WARDS/COMMUNITIES AFFECTED:	
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