ITEM NO: 19 (v)

DECISION-MAKER:		COUNCIL		
SUBJECT:		REVIEW OF PRUDENTIAL LIMITS AND TREASURY MANAGEMENT OUTTURN 2007/08		
DATE OF DECISION:		16 JULY 2008		
REPORT OF:		CABINET MEMBER FOR RESOURCES AND WORKFORCE PLANNING PORTFOLIO		
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STATEMENT OF CONFIDENTIALITY
NOT APPLICABLE

SUMMARY

Council is requested to note the Treasury Management activities and performance for 2007/08 against the approved Prudential Indicators for External Debt and Treasury Management.

This report highlights that:-

i. Borrowing activities have been undertaken within the borrowing limits approved by Council on 20th February 2008.

ii. Long term loans of £12M were raised in 2007/08.

iii. £29M of long term debt was restructured in the year achieving £150,000 savings in year and on-going savings of £170,000 per year.

iv. The Council now has a significant investment portfolio, which amounted to £75M at 31st March 2008, earning an average interest rate of 6.0%. £31M of this balance is invested in a rolling programme of 12 month investments implemented to utilise the Council's core balances.

v. A £1M Bond was purchased (5.486%), as part of the Council's longer investment strategy, which matures in 13 years time.

Net loan debt decreased during 2007/08 from £98M to £68M as shown in Appendix 2.

RECOMMENDATIONS:

(i) To note the Treasury Management activities for 2007/08 and the outturn on the Prudential Indicators; and

(ii) To note that the continued proactive approach to Treasury Management has led to significant savings in borrowing costs and additional investment income during the year.

REASONS FOR REPORT RECOMMENDATIONS

1. The reporting of the outturn position for 2007/08 forms part of the approval of the statutory accounts. The Treasury Management Strategy and Prudential Indicators are approved by Council in February each year in accordance with legislation and CIPFA's Code of Practice

2. CIPFA's code states that the activities and results should be reported on a formal basis to the responsible committee on a regular basis. The current practice in Southampton is three times a year.

CONSULTATION

3. Not Applicable.

ALTERNATIVE OPTIONS CONSIDERED AND REJECTED

4. No alternative options are relevant to this report.

DETAIL

5. ***BORROWING LIMITS***

A comparison between the revised borrowing limits approved by Council on 20th February 2008 and the highest borrowing position incurred during the course of the financial year is provided below.

		Approved Operation Limit 2007/08	Highest Level of Borrowing in 2007/08
(i)	Overall Borrowing Limit	£349M	£146M
(ii)	Proportion of Variable Debt	50%	10.29%

6. The table shows that the Council's borrowing activities have been undertaken within the Approved Limits. The variations arise from the need to set limits which will be sufficient to provide a degree of flexibility in the management of the Council's debt.

7. ***LONG TERM BORROWING***

The need to borrow arises from the requirement to finance new capital expenditure and to meet the repayment of existing long term loans, and is also dependant on any increase or decrease in internal funds.

8. The borrowing may either be long term (i.e. one year or longer) or short term (i.e. under one year). In general, long term loans are raised to fund capital expenditure and short term sources are used for the replacement of internal funds arising through movements in cash-flows.

9. The Council's borrowing requirement for financial year 2007-08 and that of two succeeding financial years was estimated at £49M. PWLB borrowing is no longer subject to quotas. Forward funding can be undertaken provided it is affordable, prudent and sustainable. All borrowing is aggregated and there is no requirement to separately identify loans that relate to unsupported borrowing.

10. The central forecast for long-dated PWLB rates (i.e. 20 – 50 years, the

period which has been the mainstay for much of the Council's borrowing) was that they would trend around 4.9% early in the financial year before falling in second half of the financial year. The Council's strategy was to fund its borrowing requirement at optimum rates and with a spread of maturities. The Council sought the advice of its treasury consultants who monitor the markets and advise the Council on all aspects of borrowing.

11. The following loans, totalling £11.7M, were raised during the year including the refinancing of £3M of debt maturing in 2007-08 :

Date	Loan Source	Principal £'000	Rate %	Maturity
29/08/07	PWLB	1,700	4.65%	30/09/37
24/01/08	PWLB	5,000	4.40%	31/03/13
13/03/08	PWLB	5,000	4.08%	30/09/12

12. The table below shows the average PWLB rate for the year at quarterly intervals and the average for the year. All of the loans raised were below the average for the year for their respective groupings.

PWLB rates %

	1yr	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
Minimum	3.76	4.05	4.44	4.51	4.41	4.40	4.38
Average	**5.19**	**5.11**	**5.07**	**4.95**	**4.73**	**4.65**	**4.59**
Maximum	6.00	5.95	5.75	5.50	5.15	5.00	4.90
spread	2.24	1.90	1.31	0.99	0.74	0.60	0.52

DEBT RESTRUCTURING

13. The main objective of debt restructuring is to reduce the Council's overall exposure to the risk of interest rate movements, to lower the long-term interest charges paid on its debt, to smooth the maturity profile without compromising the overall longer-term stability, or to alter its volatility profile (i.e. exposure to variable rate debt).

14. The Council undertook the following restructuring activity during the year :

Loans repaid/restructured:

Date	Lender	Principal £'000	Rate %	Average Period outstanding	Premium/ (Discount) £'000
April 2007	PWLB	21,100	4.95	20 years	(104)
June 2007	PWLB	5,000	5.63	24 years	20
Aug 2007	PWLB	3,200	7.18	20 years	55

Replacement Borrowing:

Date	Lender	Principal £'000	Rate %	Period of loan
April 2007	PWLB	5,000	4.65	31 Years
April 2007	PWLB	6,000	4.65	30.5 Years
July 2007	PWLB	5,000	5.05	25 .5 Years
Aug 2007	PWLB	5,000	4.70	31.5 years
Aug 2007	PWLB	3,300	4.65	30.5 years
Aug 2007	PWLB	5,000	4.60	36 years

15. The above restructuring achieved £150,000 savings in 2007/08 with ongoing saving of £170,000 per year. The Council's portfolio will continue to be reviewed for debt rescheduling opportunities but on 1st November 2007 the PWLB retrospectively issued Circular 141 dated 31st October 2007 which introduced a separate set of discount rates alongside the borrowing rates, the former set at a margin below the reference gilt yield and the latter at a margin above. The effect of this has been to remove much of the flexibility of the PWLB, to dramatically increase the cost of loan repayment, and to reduce opportunities for debt rescheduling The new arrangements are the least equitable for more than a decade with the creation of a 0.40%-0.45% margin between the old and new discount rates for longer-dated loans.

16. As a result of new borrowing, maturities during the year and debt restructuring activity, the average rate on the Council's debt changed from 4.66% at 1st April 2007 to 4.41% at 31st March 2008. The portfolio average life increased from 31 years to 36 years.

SHORT TERM BORROWING

17. During 2007/08, the Council raised loans through the London Money Market from financial institutions and other Local Authorities on a short term basis.

18. The following table illustrates the level of short term borrowing activity which has taken place during 2007/08 and shows the average rate for 2007/08.

Number of Transactions	59
Total Transaction Value	£130,650,000
Average Interest Rate	5.73%
Interest Paid/Earned	£198,600

OUTSTANDING DEBT

19. Appendix 2 shows that the Council's net external borrowing has decreased by £30M from £98M to £68M and that the average interest rate on loans outstanding at 31st March 2008 was 4.41% compared to 4.66% on 31st March 2007. Appendix 2 also compares the source of outstanding loan debt on 31st March 2007 and 2008 respectively.

20. Appendix 2 also shows that the average period to maturity for outstanding loans has increased from 31 years to 36 years. This has been achieved by borrowing for longer periods to take advantage of lower interest rates, which also has the effect of placing the Council in a more favourable position in respect of the risk of future increases in interest rates.

21. Appendix 3 illustrates the Long Term debt maturity profile at 31st March 2008.

SHORT TERM INVESTMENTS

22. During 2007/08 short term investments have been arranged with approved institutions to match cashflows between receipts and payments.

23. Following the escalation of the credit crisis in the financial markets, on advice from the Council's treasury advisor, the Council applied a higher minimum long-term credit rating criteria (the long-term rating in the 'double-A' category) wherever practicable. By seeking to place investments with higher rated institutions the Council accepted the consequence of a small diminution in investment return. The amount which could be lent to the various institutions was also reviewed; the limit for higher rated institutions was increased from £5M to £10M from 18th January 2008. In March 2008 the £10M limit was 'breached', a deal was made with Bank of Ireland for £1.4M which took us over the limit by £1.1M, this was due to there being two accounts for the Bank, one where we dealt direct and the other through the broker system, information for these has now been merged, £4.7M has since been returned bringing the account below the £10M limit. In April 08 there was a further breach; two deals were agreed with First Active, (which is an AA- rated bank) on consecutive days totalling £12.8M. Both these deals mature on the 23rd July 2008 and there is no reason to believe that there will be any problem with the return of this money. Procedures have been reviewed and amended to prevent this happening in the future.

24. The following table illustrates the level of investment activity which has taken place during 2007/08 and shows the average rates for 2007/08. It also shows those funds which have been invested for a year as part of the Council's rolling programme of investment of Core balances to generate higher interest . The investment figures exclude the Business Reserve accounts, where interest is earned on the daily balance and not on individual deals; these generated an additional £0.385M in interest and achieved an average return of 5.6%.

25.

	Short Term Investments	One yearly Investments
Number of Transactions	95	17
Total Transaction Value	£199,625,000	£31,000,000
Average Interest Rate	5.97%	5.80%
Interest Paid/Earned	£2,601,300	£1,811,000

26. In line with the Council's Investment strategy and strong eurosterling bond yields, a £1M bond, detailed below, was purchased during 2007/08 to ensure

a longer-term investment against the outlook that concerns of a prolonged economic downturn would compel the Bank of England to cut interest rates and reduce the rates available on the money markets.

Bonds

Date of investment	Issuer	Nominal value £	Yield to maturity %	Maturity Date
31/7/2007	Royal Bank of Canada	1,000,000	5.486	07/06/2021

MINIMUM REVENUE PROVISION (MRP)

27. SI 2008 No.414 replaces the requirement that local authorities undertake detailed formula based calculations in relation to the minimum amount charged to Revenue for the redemption of debt related to the financing of capital expenditure (MRP). Instead, there is a statutory requirement to make a "prudent provision". Statutory Guidance issued by the DCLG in March 2008 makes recommendations to local authorities on the interpretation of the term "prudent provision". Local authorities are to have regard to this Guidance which provides four options:

    Option 1: Regulatory Method

    Option 2: CFR Method

    Option 3: Asset Life Method

    Option 4: Depreciation Method

    The operative date of the change was 31 March 2008; it therefore applies to 2007/08 and to subsequent years.

28. Options 1 and 2 can be used on all capital expenditure incurred before 1st April 2008 and on Supported Capital Expenditure on or after that date. Options 3 and 4 are considered prudent options for Unsupported Capital Expenditure on or after 1st April 2008 and can also be used for Supported Capital Expenditure whenever incurred.

29. The Statutory Guidance requires local authorities to prepare an MRP Statement setting out its policy on MRP prior to the commencement of the financial year. The MRP Statement must be approved by Full Council. As the Guidance was issued in March 2008, the MRP Statement for 2007/08 must be approved by Full Council at the earliest opportunity. Southampton City council approved its policy at its meeting of 20th February 2008 and determined that for 2007/08 Option 2 would be adopted for Supported Borrowing and Option 3 for Unsupported Borrowing.

COMPLIANCE WITH TREASURY LIMITS

30. The Council implemented its treasury strategy within the limits and parameters set in its treasury policy statement and Prudential Indicators against the prevailing market opportunities as follows:

    (a) Obtaining long-term funding for the Council's supported and unsupported borrowing requirement from the PWLB.

    (b) Restructuring existing long-term loans to lower debt financing costs without compromising longer-term stability.

(c) Adhering to the paramount requirement of safeguarding the council's invested balances during a period of unprecedented money market dislocation; tightening the minimum credit criteria for lending in response to the credit crisis and maintaining adequate diversification between institutions; optimising investment returns subject to the overriding requirement of security and liquidity.

(d) Forecasting and managing cash flow and undertaking short-term borrowing and lending to preserve the necessary degree of liquidity.

TREASURY RELATED PRUDENTIAL INDICATORS

31. The Prudential Code requires the Prudential Indicators for External Debt and Treasury Management to be reported against approved indicators previously reported. Appendix 4 compares actual performance against approved indicators, all of which were within agreed limits.

BALANCED BUDGET

32. The Council complied with the Balanced Budget requirement.

2007 SORP

33. The 2007 SORP Exposure Draft includes significant revisions to the accounting treatment of financial instruments based on the requirements of Financial Reporting Standard (FRS) 25 (Presentation), FRS 26 (Recognition and Measurement) and FRS 29 (Disclosures). Financial instruments have been categorised into Financial Liabilities (i.e. Borrowing instruments) and Financial Assets (i.e. Investment instruments).

34. Financial liabilities will be measured at amortised cost, using the effective interest rate. This will have an impact in the case of stepped Lender's Option Borrower's Option's (LOBOs) and will result in the smoothing of interest charges to revenue over the life of the loan. The Council has no stepped interest rate LOBO's.

35. The SORP will also result in a change to the accounting treatment for premiums and discounts arising from debt rescheduling. The Department of Communities and Local Government has produced regulations (The Local Authorities (Capital Finance and Accounting) (Amendment) (England) Regulations 2007 SI 2007 No 573) that will permit amortisation of premiums and discounts to continue in a way that will mitigate the impact of the accounting requirements under the SORP.

36. Investments : (a) Term deposits will fall into the category of Loans and Receivables and will be measured at amortised cost. (b) Gilts and Bonds will fall into the Available for Sale category and be measured at Fair Value. Interest and dividends income will be credited to Revenue; gains and losses arising from changes in Fair Value will be recorded in the Balance Sheet and will only be taken to revenue when the investments are realised. (c) For investments treated as capital expenditure, gains or losses on realisation will be transferred from Revenue to Capital via the Movement on General Fund Balances section of the Revenue accounts

FINANCIAL/RESOURCE IMPLICATIONS

<u>Capital</u>

37. None.

Revenue

38 The report is a requirement of the Treasury Management Strategy, which was approved at Council on 20th February 2008.

39. The interest cost of financing the Authority's long term and short term loan debt is charged corporately to the Income and Expenditure account, the interest cost of financing the Authority's loan debt amounted to £8.7M in 2007/08 compared with an estimate of £9.3M, a reduction of £0.6M, which was mainly due to savings as a result on restructuring as detailed in paragraphs 13 and 14 above and new borrowing taken out below the estimated interest rate.

40. In addition interest earned on temporary balances invested externally is credited to the Income and Expenditure account. In 2007/08 £4.4 M was earned against a budget of £1.5M, an increase of £2.9M, this was a result of higher than expected interest rates primarily due to the credit crunch which benefited new term deposits made in the year, a more proactive approach to investing longer term and increased funds, mainly capital balances earmarked to be spent in later years. Appendix 1 gives further details surrounding the Economic climate for 2007/08.

41. The expenses of managing the Authority's loan debt consist of brokerage, printing costs and internal administration charges. These are pooled and borne by the HRA and General Fund proportionately to the related loan debt. Debt management expenses amounted to £107,350 in 2007/08 compared to an estimate of £91,900. The increase in expenditure was mainly due to additional commission payable to the Public Works Loans Board as a result of restructuring debt and a payment to our Treasury Management advisers to look into the possibility of transferring the £21M debt we inherited as part of Local Government restructure, which we currently pay interest and principal repayments to Hampshire County Council. Our average rate of interest for long term borrowing (4.41%) is currently below what we pay HCC for this debt (5.21%) and it is hoped that if we are able to transfer ownership there will be future opportunities to restructure and achieve on-going revenue savings.

Property

42. None.

Other

43. None.

LEGAL IMPLICATIONS

Statutory power to undertake proposals in the report:

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

45. 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:

46. None.

POLICY FRAMEWORK IMPLICATIONS

47. This report has been prepared in accordance with CIPFA's Code of Practice on Treasury Management and the Treasury Management Strategy approved by Council on 20th February 2008

SUPPORTING DOCUMENTATION

Appendices

1.	Summary of Economic Outturn 2007/08
2.	Summary of debt by type of loan
3.	Long Term maturity profile as at 31st March 2008
4.	Prudential Indicators 2007/08 and Outturn

Documents In Members' Rooms

1.	None

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.	None	

Background documents available for inspection at:

E-mail:
