ITEM NO: 9(v)

DECISION-MAKER:	COUNCIL			
SUBJECT:	REVIEW OF PRUDENTIAL LIMITS AND TREASURY MANAGEMENT OUTTURN 2008/09			
DATE OF DECISION:	15 JULY 2009			
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 2008/09 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 18th February 2009.
ii. The average rate for repayment of overall outstanding debt has reduced from 4.41% in 2007/08 to 2.86% as a result of restructuring £65M of debt. This generated £280,000 savings in 2008/09 and a further savings of £1.2M for 2009/10.
iii. £25M of debt was repaid at an average rate of 4.41% and was funded by a reduction in internal investments and temporary borrowing at an average rate of 0.81%, which achieved savings of £152,000 for 2008/09.
iv. As a result of falling interest rates and the risk of holding large investment balances, the investment portfolio was reduced from £75M at 31st March 2008 to £24M at 31st March 2009.
v. A further £5M of EIB Bonds were purchased as part of the Council's longer investment strategy.

Net loan debt increased during 2008/09 from £68M to £97M as shown in Appendix 2.

RECOMMENDATIONS:

(i) To note the Treasury Management activities for 2008/09 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 safeguarded investment income during the year.

REASONS FOR REPORT RECOMMENDATIONS

1. The reporting of the outturn position for 2008/09 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

Background :

5. Treasury Management in Local Government is governed by the CIPFA Code of Practice on Treasury Management in the Public Services and in this context is the "management of the Council's cash flows, its banking and its capital market transactions; the effective control of the risks associated with those activities and the pursuit of optimum performance consistent with those risks". This Council has adopted the Code and complies with its requirements.

6. The Prudential Capital Finance System came into force on 1st April 2004. The Council determines at a local level its capital expenditure and can borrow or use alternative financing methods to finance capital spending provided that capital plans are demonstrably affordable, prudent and sustainable, and options appraisal supports asset management planning. The Prudential Code for Capital Finance in Local Authorities requires indicators to be set – some of which are limits – for a minimum of three forthcoming financial years.

7. The DCLG's (then ODPM) Guidance on Local Government Investments in England came into effect on 1st April 2004. The emphasis of the Guidance is on security and liquidity of invested monies. The Council is required to establish an annual investment strategy and to determine 'specified' and 'non specified' investments for use during the year.

8. This report is
   (a) prepared in accordance with the CIPFA Treasury Management Code and the Prudential Code;
   (b) presents details of capital financing, borrowing, debt rescheduling and investment transactions during the year;
   (c) gives details of the outturn position on treasury management transactions in 2008/09;
   (d) confirms compliance with treasury limits and Prudential Indicators.

Borrowing Limits

9. A comparison between the revised borrowing limits approved by Council on 18th February 2008 and the highest borrowing position incurred during the course of the financial year is provided below.

		Approved Operation Limit 2008/09	Highest Level of Borrowing in 2008/09
(i)	Overall Borrowing Limit	£350M	£161M
(ii)	Proportion of Variable Debt	50%	18.7%

10. 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.

Long Term Borrowing

11. 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.

12. 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.

13. The Council's borrowing requirement for financial year 2008-09 and that of two succeeding financial years was estimated at £63M. 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.

14. The Council prefers to maintain maximum control over its borrowing activities as well as flexibility on its loans portfolio. The economic backdrop during 2008/09 was uncertain and the forecast for official rates and gilt yields was subject to material change. Capital expenditure levels, market conditions and interest rate levels were monitored during the year in order to minimise borrowing costs over the medium to longer term. A prudent and pragmatic approach to borrowing was maintained to minimise borrowing costs without compromising the longer-term stability of the portfolio, consistent with the Council's Prudential Indicators.

15. Therefore, in conjunction with advice from its treasury advisors, the Council kept 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).

16. 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%), was redeemed. This was achieved at no cost to the Council by grouping together premiums and discounts. This was financed in the short term through the use of internal funds and short term borrowing at an average rate of 0.81%, which achieve savings of £152,000 in 2008/09.

17. No new debt was taken out during 2008/09 and both PWLB rates and investment rates will be continually monitored to assess the best time to refinance with long term debt.

18. PWLB Borrowing Rates summary 2008/09

Gilt yields and PWLB rates were dragged noticeably lower in response to heightened concerns about the evolving economic outlook and the financial crisis. Lower PWLB rates presented borrowing opportunities across all maturities (see table below). The substantial fall in short-dated rates (5-10 year) provided attractive borrowing opportunities. The fall in long-dated rates to below 4% for a brief period also provided attractive borrowing potential in the 40-50 year maturity area.

	1yr	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
Minimum	0.65	2.31	3.11	3.85	3.94	3.90	3.86
Average	**3.17**	**3.97**	**4.44**	**4.71**	**4.56**	**4.49**	**4.43**
Maximum	5.61	5.59	5.48	5.26	4.97	4.87	4.84
Spread	4.96	3.28	2.37	1.41	1.03	0.97	0.98

Debt Restructuring

19. 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).

20. The PWLB introduced a separate, lower set of repayment rates on 1st November 2007 to calculate the premium paid or the discount received on premature redemption of loans. These lower repayment rates have resulted in reducing, but not eliminating; PWLB rescheduling opportunities because the lower rates have increased the costs associated with the premium payable or diminished the discount receivable, thus reducing the cost savings achievable.

21. Debt rescheduling has become more challenging and places greater emphasis on the timing and type of new borrowing. Nevertheless, volatility in PWLB rates provided opportunities to reschedule debt. The following loans were repaid / borrowed:

Loans repaid/restructured:

Date	Lender	Principal £'000	Average Rate %	Average Period outstanding	Premium/ (Discount) £'000
Oct 2008	PWLB	20,000	4.47	31 years	51
Jan 2009	PWLB	65,000	4.31	42.5 years	(1,940)
Total		**85,000**	**4.41**		

Replacement Borrowing:

Date	Lender	Principal £'000	Rate %	Period of loan
Oct 2008	PWLB	10,000	3.13	1 Years
Oct 2008	PWLB	5,000	3.59	2.5 Years
Oct 2008	PWLB	5,000	3.72	3 Years
Jan 2009	PWLB	5,000	1.97	5 years
Jan 2009	PWLB	5,000	1.97	5 years
Jan 2009	PWLB	5,000	1.84	2 years
Jan 2009	PWLB	5,000	1.84	2 years
Jan 2009	PWLB	5,000	0.92	1 years
Jan 2009	PWLB	5,000	0.92	1 years
Jan 2009	PWLB	5,000	1.15	1 years
Jan 2009	PWLB	5,000	1.15	1 years
Total		**60,000**		

22. 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.

23. 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.

24. The above restructuring achieved £280,000 savings in 2008/09 and it is anticipated that this 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.

25. 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.

26. As a result of maturities during the year and debt restructuring activity, the average rate on the Council's debt changed from 4.41% at 1st April 2008 to 2.88% at 31st March 2009. The portfolio average life decreased from 36 to 10 years, with a spread of 1 - 47 years.

Premiums/discounts were amortised in accordance with the accounting requirements of the local authority SoRP and regulatory requirements of the Capital Finance and Accounting Regulations (SI 2007 No 573).

Short Term Borrowing

27. During 2008/09, the Council raised loans through the London Money Market from financial institutions and other Local Authorities on a short term basis. The following table illustrates the level of short term borrowing activity which has taken place during 2008/09 and shows the average rate for 2008/09.

Number of Transactions	91
Total Transaction Value	£219,120,000
Average Interest Rate	3.11%
Interest Paid/Earned	£237,200

Outstanding Debt

28. Appendix 2 shows that the Council's net external borrowing has increased by £29M to £97M from £68M and that the average interest rate on loans outstanding at 31st March 2009 was 2.86% compared to 4.41% on 31st March 2008. Appendix 2 also compares the source of outstanding loan debt on 31st March 2008 and 2009 respectively.

29. Appendix 2 also shows that the average period to maturity for outstanding loans has decreased from 36 years to 10 years, with a spread of 1 to 47 years. This has been achieved by borrowing for shorter periods. This does however expose the Council to interest risk as detailed in paragraphs 24 and 25 above.

30. Appendix 3 illustrates the Long Term debt maturity profile at 31st March 2009.

Short Term Investments

31. The Council held cash balances during the year of between £30 -£100M averaging £81M. These represent working cash balances / capital receipts and the Council's reserves

32. The ODPM's Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles. Having assessed the risks associated with the various potential investment instruments, the Council determined the 'specified' and 'non-specified' investments it would use during the year (Appendix 5). These decisions were taken at local level to suit the Council's particular circumstances, return aspirations and risk tolerances.

33. The Council's existing investments are a combination of long-dated investments (i.e. with maturities in excess of one year) and short-term investments and reflect previous treasury management strategies and decisions. The mix of long- and short-term investments enables the Council to maintain an appropriate level of liquidity and enables it to mitigate re-investment risk (the risk that a large proportion of maturing investments is reinvested when interest rates are at a cyclical low).

The Council's investment income for the year was £4.3M compared to a budget of £2.6M and the variance is principally due to a combination of the following:

- Average investment balances held during the financial year were higher than originally budgeted. This was mainly due to slippage in capital expenditure.
- The prevailing money market rates of interest were initially higher than forecast primarily due to the financial crisis which benefited the new term deposits made during the year.

34. Credit risk arises from deposits with banks and financial institutions, as well as credit exposures to the Authority's customers. The Council had a credit risk policy of not placing deposits with banks and financial institutions unless they were rated independently with a minimum score (Fitch Long Term rating) of A. However, since the recent uncertainties in the financial markets associated with the 'credit crunch' the Council has proactively reviewed this policy and increased the minimum criteria.

35. Following market uncertainty in the early part of 2008, it was decided to try to place all of the Council's investments with AA- institutions or above. In May 2008, following the downgrading of many banks within the market this was further tightened so that the Council 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

36. 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.

Icelandic institutions : The Council confirms that Icelandic banks (Glitnir, Kaupthing and Landsbanki) or their UK subsidiaries (Heritable Bank and Kaupthing Singer and Friedlander) did not feature on the Council's lending list. No investments were therefore placed with any of these banks.

37. In the early part of 2009, following advice from the Council's Treasury advisors, it was decided to reintroduce certain UK banks and building societies who had 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 was £5M. The maximum maturity period for any of these investment deals was 3 months. All other funds were still invested with the Debt Management Office and AAA money market funds. This strategy is kept under constant review until the markets settle down and revert to more normal levels.

38. The table below summarises the nominal value of the Council's short term investment portfolio at the end of each financial year into the relevant credit rating.

	31st March 2008		31st March 2009	
Credit Rating	**£000**	**%**	**£000**	**%**
A-	0	0%	9,000	37%
A	2,000	3%	0	0%
A+	10,368	14%	0	0%
AA-	44,225	59%	8,400	35%
AA	11,900	16%	0	0%
AA+	3,132	4%	0	0%
AAA	3,525	4%	6,635	28%
Total Investments	**75,150**	**100%**	**24,035**	**100%**

39. The table below summarises the maturity profile of the Council's short term investments together with the long and short term credit ratings of the institutions with which funds have been deposited. As at the 3rd July 2009 there was £2M of investments deposited with Irish Banks which fell below the Council's investment policy of placing deposits with institutions with AA- long term credit ratings which is due be repaid on 17th August 2009. The authority does not expect any losses from non-performance by any of its counterparties in relation to its investments.

Outstanding Investments as at 31st March 2009

Country	UK Gov't Credit Guarantee Scheme	Long Term rating	Short term rating	Under 1 Month	1-3 Months	3-6 Months	Over 12 Months	Total
UK								
Bank Deposits	Yes	AA-	F1 +	1,575	825	3,000	3,000	8,400
Money Market Funds	-	AAA	-	6,635	0	0	0	6,635
Ireland								
Bank Deposits	No	A-	F1 +	0	3,000	4,000	0	7,000
Bank Deposits	No	A-	F1	0	2,000	0	0	2,000
Total Investments				**8,210**	**5,825**	**7,000**	**3,000**	**24,035**

40. The following table illustrates the level of investment activity which has taken place during 2008/09 and shows the average rates for 2008/09. It also shows those funds which have been invested for a year which were part of the Council's rolling programme of investment of Core balances to generate higher interest, which is currently suspended until the market settles down . 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 £0.268M in interest.

41.

	Short Term Investments	One yearly Investments
Number of Transactions	111	6
Total Transaction Value	£288,075,000	£13,000,000
Average Interest Rate	4.61%	6.33%
Interest Paid/Earned	£1,878,000	£1,014,400

42. In line with the Council's Investment strategy and strong eurosterling bond yields, bonds totalling £5m, detailed below, were purchased during 2008/09 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
4/10/2008	Royal Bank of Canada	3,000,000	4.5	14/01/2013
4/10/2008	Royal Bank of Canada	1,000,000	5.5	15/04/2025
4/10/2008	Royal Bank of Canada	1,000,000	5.375	07/06/2021

Minimum Revenue Provision (MRP)

43. There is now a statutory requirement to make a "prudent provision" for MRP (SI 2008 No.414). 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

44. 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.

45. The Council's approved its policy at its meeting of 16th July 2008 and determined that for 2008/09 Option 1 would be adopted for Supported Borrowing and Option 3 for Unsupported Borrowing.

Compliance with treasury limits

46. 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

47. 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

48. The Council complied with the Balanced Budget requirement.

Other Items

49. At the end of March 2009 CIPFA's Treasury Management Panel issued an interim bulletin "Treasury Management in Local Authorities – Post Icelandic Collapse". CIPFA intends to revise both the Treasury Management Code and Guidance Notes in the light of some local authorities' exposures to the failed Icelandic banks. Formal guidance will follow after consultation on and publication of the revised Treasury Management Code.

50. The interim bulletin, which constitutes advice and does not have the status of formal guidance, reiterates treasury management objectives and risk (security, liquidity and yield risk). The bulletin treasury monitoring and corporate governance issues (involvement of portfolio holders / audit committees in treasury management policy setting), providing transparency on gross and net borrowing, skills, resources and training for treasury staff, counterparty lists, use of treasury management advisors, and benchmarking of treasury management performance.

51. The Council will review its Treasury Management practices in light of the findings and implement any changes required.

FINANCIAL/RESOURCE IMPLICATIONS

Capital

52. None.

Revenue

53. The report is a requirement of the Treasury Management Strategy, which was approved at Council on 18th February 2009.

54 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 £7.6M in 2008/09 compared with an estimate of £9.7M, a reduction of £2.1M, which was mainly due to savings as a result on restructuring as detailed in paragraph 21 and the refinancing of long term debt through the temporary markets which currently is significantly lower (0.81% as opposed to the estimated rate of 4.5%).

55. In addition interest earned on temporary balances invested externally is credited to the Income and Expenditure account. In 2008/09 £4.3 M was earned against a budget of £2.6M, an increase of £1.7M, this was a result of higher than expected interest rates primarily due to lack of available funds in the market which benefited new term deposits made early in the financial year, and increased funds, mainly capital balances earmarked to be spent in later years. Appendix 1 gives further details surrounding the Economic climate for 2008/09.

56. 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 £108,400 in 2008/09 compared to an estimate of £96,700. This was mainly as a result of additional PWLB commission paid as a result of the debt restructure.

Property

57. None.

Other

58. None.

LEGAL IMPLICATIONS

Statutory power to undertake proposals in the report:

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

60. 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:

61. None.

POLICY FRAMEWORK IMPLICATIONS

62. 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 18th February 2009

SUPPORTING DOCUMENTATION

Non-confidential appendices are in the Members' Rooms and can be accessed on-line

Appendices

1.	Summary of Economic Outturn 2008/09
2.	Summary of debt by type of loan
3.	Long Term maturity profile as at 31st March 2009
4.	Prudential Indicators 2008/09 and Outturn
5.	Specified and Non Specified Investments

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: N/A

FORWARD PLAN No N/A **KEY DECISION** No

WARDS/COMMUNITIES AFFECTED NOT APPLICABLE