

DECISION-MAKER:	GOVERNANCE COMMITTEE		
SUBJECT:	REVIEW OF PRUDENTIAL LIMITS AND TREASURY MANAGEMENT MIDYEAR 2019/20		
DATE OF DECISION:	11 NOVEMBER 2019		
REPORT OF:	Director Finance and Commercialisation (S151)		
<u>CONTACT DETAILS</u>			
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STATEMENT OF CONFIDENTIALITY			
NOT APPLICABLE			
BRIEF SUMMARY			
The purpose of this report is to inform Governance Committee of the Treasury Management activities and performance for 2019/20 to date against the approved Prudential Indicators for External Debt and Treasury Management.			
This report specifically highlights that:			
	(i)	Borrowing activities have been undertaken within the borrowing limits approved by Council on 20 February 2019.	
	(ii)	Current Investment strategy is to continue to diversify Strategic funds into more secure and/or higher yielding asset classes and to use short term investments for cash flow purposes. Forecast returns for the year are £1.44M with a current weighted average rate of 1.58%.	
	(iii)	The Council's strategy is to minimise borrowing to below its Capital Financing Requirement (CFR), the difference representing balances, reserves, provisions and working capital. This approach lowers interest costs, reduces credit risk and relieves pressure on the Council's counterparty list. Throughout the year, capital expenditure levels, market conditions and interest rate levels are monitored to minimise borrowing costs over the medium to longer term and to maintain stability.	
	(iv)	The differential between debt costs and investment earnings continued to be acute, resulting in the use of internal resources in lieu of external borrowing often being the most cost effective means of financing capital expenditure. The forecast is for internal borrowing to be at £152M by 31 March 2020.	
	(v)	In achieving interest rate savings the Council is exposed to interest rate risk, this was and continues to be very financially favourable in current markets but does mean that close monitoring of the markets is required to ensure that the Council can act quickly should the situation begin to change, such as the drop in gilt rates which lead to the decision to borrow from PWLB in September.	
	(vi)	Net loan debt has decreased slightly since the 31 March from £248M to £244M (£4M) as detailed in table 3, appendix 3.	

	(vii)	There has been full compliance with the Prudential Indicators approved by Full Council on 20 February 2019.
	(viii)	Security of investment continues to be the highest priority, and credit scores are one way this risk is managed. The average credit rating for the institutions the council has invested in (at AA-) is above our target level (A) set in the strategy.
RECOMMENDATIONS:		
It is recommended that Governance committee:		
	(i)	Notes the Treasury Management (TM) activities for 2019/20 and performance against the Prudential Indicators.
	(ii)	Notes that the continued proactive approach to TM has led to reductions in borrowing costs and safeguarded investment income during the year.
	(iii)	Continues to delegate authority to the S151 Officer to make any future changes which benefit the authority and to report back at the next Treasury update.
REASONS FOR REPORT RECOMMENDATIONS		
1.	The Treasury Management Code requires public sector authorities to determine an annual TM Strategy and now, as a minimum, formally report on their treasury activities and arrangements to Governance Committee mid-year and after the year-end. These reports enable those tasked with implementing policies and undertaking transactions to demonstrate they have properly fulfilled their responsibilities, and enable those with ultimate responsibility/governance of the TM function to scrutinise and assess its effectiveness and compliance with policies and objectives.	
ALTERNATIVE OPTIONS CONSIDERED AND REJECTED		
2.	No alternative options are relevant to this report.	
DETAIL (Including consultation carried out)		
CONSULTATION		
3.	Not applicable.	
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 Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires that authorities report on the performance of the treasury management function at least twice a year (mid-year and at year end).	
6.	The Authority's TM Strategy for 2019/20 was approved by full Council on 20 February 2019 as part of the Council's Treasury Management Strategy Statement for 2019/20.	
7.	Overall responsibility for treasury management remains with the Council. No TM activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives. The Authority	

	has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. This report covers treasury activity and the associated monitoring and control of risk.
8.	Appendix 1 summarises the economic outlook and events in the context of which the Council operated its treasury function during 2019/20 and forecast movement in interest rates.
BORROWING REQUIREMENT AND DEBT MANAGEMENT	
9.	The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR) while useable reserves and working capital the underlying resources available for investments. These are the core drivers of TM Activity and the year-on-year change is summarised in table 1, appendix 2. This highlights that the authority has an increasing CFR over the medium term, due to its ongoing capital programme and will need to externalise this debt due to forecast reduced reserves. Movement in the forecast CFR, based on the approved capital programme at the end of September, is shown in table 2, appendix 2.
10.	Due to the current low interest rate environment for short term borrowing it was envisage that the authority would continue to use short term borrowing during 2019/20, however as a result of the current economic uncertainty the benchmark gilt rates for PWLB loans fell to historic lows, so a decision was made to take a £90M 15 year EIP (Equal Instalment Payment) loan at 1.12% in early September in order to secure this advantageous rate, in line with our identified borrowing need. Rates have since risen following the government's announcement on 9th October that the margin on loans has increased from 0.8% to 1.8% an increase of 100 base points or £10k for each £1M borrowed.
11.	Despite taking this loan, the Authority's continues its strategy to maintain borrowing and investments below their underlying levels in order to reduce risk and keep interest costs low and expects to have internal borrowing of £152M by the end of the year (i.e. the authority is applying its overall cash resources in lieu of external borrowing).If we were to borrow the £152M, based on the current rates for a 15 year PWLB maturity loan (2.82%), this would add £4.29M to the cost of borrowing and as this money would not be needed due to excess working balances it would need to be invested at rates that are likely to be below the cost of borrowing.
12.	The Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective.
MONITORING AND BENCHMARKING	
13.	The treasury management position at 30 September 2019 and the change during the year is shown in appendix 3. As a result of taking the PWLB loan, investment balances are higher than usual at £131.5M (per table 3, total investments at 30 Sept 2019) but are expected to fall throughout the year to an estimated £42M by the end of the year (table 3, 31 March 2020 forecast) as we have a number of debt maturities in the second half of the year and spending via the ongoing capital programme. If we had not taken the £90M in September our forecast borrowing position would have shown a forecast

	borrowing need of £48.1M as opposed to having an expected surplus cash balance of £41.9M, (see appendix 2, table 1).
14.	Our advisors produce quarterly benchmarking which shows the breakdown of our current investments and how we compare with their other clients and other English Unitary Authority's, details can be seen in Appendix 3. It shows that on average the return on our current internal investments at 1.58% is higher than the average of 1.22% and our overall return including the LAPF fund is 1.56% as opposed to the average of 1.34%. This has been achieved without adversely impacting on our average credit rating which at AA- is in line with both other Local Authorities and Unitary Authorities. Due to the timing of taking the £90M PWLB loan our balances are higher than normal and a higher proportion are being held in instant access accounts which is depressing the figures which are normally higher due to our strategic approach to investments and borrowing, our weighted average return for the year is expected to be near to 3%.
15.	The Authority's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short and long term borrowing was maintained.
<u>Public Works Loan Board (PWLB) Update</u>	
16.	The PWLB has historically been the Council's preferred source of long term borrowing given the transparency and control that its facilities continue to provide. However following the increase in its margin over the prevailing gilt rate from 0.8% to 1.8%, this will be kept under review and alternative sources of borrowing will be assessed to ensure that the most suitable form of borrowing is taken to resource the authority's ongoing capital programme.
17.	The increase in PWLB rates can be accommodated within the existing budget up to 2022/23 (based on the approved capital programme at the end of September) as increased interest rates were inbuilt within future years.
<u>Internal Borrowing</u>	
18.	Given the pressures on the revenue budget and significant reduction in revenue support grant, the strategy followed was to minimise the cost of TM by keeping debt interest payments as low as possible without compromising the longer-term stability of the portfolio.
19.	As at the 31 March 2019 the Council used £179M of internal resources in lieu of borrowing which has been the most cost effective means of funding past capital expenditure to date. This has lowered overall treasury risk by reducing both external debt and temporary investments. However, this position is not sustainable over the medium term and available balances are expected to fall to £152M by the end of the financial year, see table 1, appendix 3. The Council will need to borrow externally to cover this amount as balances fall. Additional borrowing will also be required in future years to cover the refinancing of existing maturing debt, the externalising of internal debt to cover the expected fall in balances and to support the capital programme. This is likely to be a mixture of short and long term borrowing and our requirements will be determined in conjunction with our financial advisors.
<u>Lender's Option Borrower's Option Loans (LOBOs)</u>	
20.	The council continues to hold £9M of LOBO loans where the lender has the option to propose an increase in the interest rate at set dates, following which the council has the option to either accept the new rate or to repay the loan at

	no additional cost. All of these LOBOS had options during the year, none of which were exercised by the lender, but if they were it is likely that they would be replaced by alternative borrowing.
<u>Other Debt Activity</u>	
21.	Although not classed as borrowing the Council has previously raised capital finance via Private Finance Initiative (PFI). The forecast balance for 2019/20, after allowing for repayment in year of £2.88M is £54M.
22.	In addition, the Authority holds debt in relation to debt transferred from Hampshire County Council on the 1 April 1997 when we became a unitary authority which is being repaid over 50 years at £0.36M per annum, the 2019/20 forecast balance is £13.8M.
TREASURY INVESTMENT ACTIVITY	
23.	Both the CIPFA and DCLG's Investment Guidance requires the council to invest prudently and have regard to the security and liquidity of investments before seeking the optimum yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low income returns.
24.	The council has held significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2019/20 the council's investment balances have ranged between £45.3M and £152.8M. As detailed in paragraph 13, balances are higher than usual as a result of taking a £90M PWLB loan. Work will be undertaken during October to move some of the cash in instant access to the medium term. Movement in year is summarised in appendix 3, table 6.
25.	Security of capital has remained the council's main investment objective. This has been maintained by following the Authority's counterparty policy as set out in its TM Strategy Statement for 2019/20. The council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. At AA-our score is over and above the target level A for the average rating.
Liquidity Management	
26.	In keeping with the DCLG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds and call accounts. There is no perceived risk that the Council will be unable to raise finance to meet its commitments. The Council also has to manage the risk that it will be exposed to replenishing a significant proportion of its borrowing at a time of unfavourable interest rates. The Council would only borrow in advance of need where there is a clear business case for doing so and will only do so for the current capital programme or to finance future debt maturities.
Readiness for Brexit	
27.	The scheduled date for the UK to leave the EU has been extended from 31st October 2019 to 31st January with the option to leave earlier if an agreement can be made. The Authority will monitor the situation so action can be taken to ensure there are sufficient funds in UK-domiciled banks and Money Market Funds to hold sufficient liquidity required, including its account with the Debt Management Account Deposit Facility (DMADF).

28.	Following the agreement with the EU for an extension, the Prime Minister has called for an early general election which has been scheduled for 12 December. We will continue to monitor the market and take appropriate action if there is a significant movement as a result.
Externally Managed Funds	
29.	The Council has invested £27M in property funds which offer the potential for enhanced returns over the longer term, but will be more volatile in the shorter term. These funds are managed by professional fund managers.
30.	During 2019/20 this investment has returned an average yield of 4.3% against the initial investment and made a notional “gain” of £0.19M being valued at £27.19M, which compares with the end of March value of £27.45M. Any gain would only be realised at the point of sale.
31.	The funds have no defined maturity date, and are available for withdrawal after a notice period. Hence, their performance and suitability is regularly reviewed. In light of their strong performance, extra investment in these funds is a possibility.
NON-TREASURY INVESTMENTS	
32.	The definition of investments in CIPFA’s revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. This is replicated in MHCLG’s Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.
33.	As detailed in the outturn report, between 2016 and 2017, SCC implemented a strategy to invest in commercial properties with the expected return on investment being used to fund council services, known as the Property investment fund (PIF). To date the authority has purchased 3 properties. The rate of return on these investment in 2018/19 was 5.95% gross and 2.05% net (after borrowing costs of £1.16M were incurred), which therefore represents a contribution to the revenue account of around £0.61M. All of the properties remain fully let and the tenants are meeting their financial obligations under the leases.
34.	We are currently exploring options on whether to resume the PIF investments strategy. A report was submitted to Cabinet on the 15 th October which set out the proposals to renew the previously agreed policy for investment in commercial property and it is proposed that an allocation of up to £200m is included in the capital programme. Allocations will be made provided investment and other criteria are met and in accordance with the governance processes outlined in the report and as previously adopted by the authority when a property investment fund was agreed in 2016. Further details will be reported as part of the Strategy report for 2020/21 in February.
COMPLIANCE WITH PRUDENTIAL INDICATORS	
35.	It can be confirmed that the Council has complied with its Prudential Indicators for 2019/20, approved by Full Council on 20 February 2019.
36.	In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of TM activity during 2019/20. None of the Prudential Indicators has been breached and a prudent approach has been taken in relation to investment activity with priority being given to

	security and liquidity over yield. Table 7, appendix 3 summarises the Key Indicators, External debt is forecast to be £365M at year end so there would be sufficient headroom within the authorised limit for future spending plans.
RESOURCE IMPLICATIONS	
<u>Capital/Revenue</u>	
37.	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 is forecast to be £14.6M in 2019/20 of which £5.5M relates to the HRA. However this will be subject to movement as the need for further borrowing during the year becomes more certain.
38.	As a result of taking the PWLB loan at favourable rates, £120k has been released from the capital asset management (CAM) budget for the current year and £940k for 2020/21 and 2021/22, as detailed in the medium term financial strategy report submitted to Cabinet on 15 October.
39.	In addition interest earned on temporary balances invested externally is credited to the Income and Expenditure account, this is forecast to be £1.44M in 2019/20.
40.	The expenses of managing the Authority's loan debt consist of brokerage and internal administration charges. These are pooled and borne by the HRA and General Fund proportionately to the related loan debt. Debt management expenses are forecast to be £0.31M in 2019/20.
<u>Property/Other</u>	
41.	None.
LEGAL IMPLICATIONS	
<u>Statutory power to undertake proposals in the report:</u>	
42.	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.
<u>Other Legal Implications:</u>	
43.	None.
RISK MANAGEMENT IMPLICATIONS	
44.	Not Applicable
POLICY FRAMEWORK IMPLICATIONS	

45.	This report has been prepared in accordance with the CIPFA Code of Practice on TM and is a requirement of the TM Strategy, which was approved at Council on 20 February 2019.	
KEY DECISION?	Yes/No	
WARDS/COMMUNITIES AFFECTED:	NONE	
<u>SUPPORTING DOCUMENTATION</u>		
Appendices		
1.	2019/20 Economic Background	
2.	Capital Financing Requirement	
3.	Monitoring and Benchmarking 30 September 2019	
4.	Glossary of Treasury Terms	
Documents In Members' Rooms		
1.	None.	
Equality Impact Assessment		
Do the implications/subject of the report require an Equality and Safety Impact Assessments (ESIA) to be carried out.		Yes/No
Privacy Impact Assessment		
Do the implications/subject of the report require a Privacy Impact Assessment (PIA) to be carried out.		Yes/No
Other Background Documents		
Equality Impact Assessment and Other Background documents available for inspection at:		
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	