By:	Cabinet Member for Finance Director of Finance
To:	Governance and Audit Committee – 30 June 2010
Subject:	**TREASURY MANAGEMENT ANNUAL REVIEW 2009-10**
Classification:	Unrestricted

Summary: To present the Treasury Management Annual Review.

FOR DECISION

INTRODUCTION

1. The CIPFA definition of Treasury Management is "the management of the Council's investments and 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".

2. The Treasury Management Code requires public sector authorities to determine an annual Treasury Management Strategy and now, as a minimum, formally report on their treasury activities and arrangements to Members 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 for the treasury management function to scrutinise and assess its effectiveness and compliance with policies and objectives.

3. This report:

   - Is prepared in accordance with the revised CIPFA Treasury Management Code and the revised Prudential Code;

   - Presents details of capital financing, borrowing, debt rescheduling and investment transactions;

   - Reports on the risk implications of treasury decisions and transactions;

   - Gives details of the outturn position on treasury management transactions in 2009-10;

   - Confirms compliance with treasury limits and Prudential Indicators.

This report will also be presented to full Council, subject to comments from this Committee.

REVISIONS TO THE CIPFA TREASURY MANAGEMENT AND PRUDENTIAL CODES, CLG GUIDANCE ON INVESTMENTS

4. In November 2009 CIPFA released the revised Code of Practice for Treasury Management in the Public Services and accompanying Guidance Notes and the revised Prudential Code for Capital Finance in Local Authorities. The CLG also issued revised Guidance on Local Authority Investments for English authorities. The revised Codes / Guidance re-emphasise an appropriate approach to risk management, particularly in relation to the security and liquidity of invested funds. Authorities were also henceforth required to demonstrate value for money when borrowing in advance of need and ensure the security of such funds. Authorities are now also required to have a separate body or committee responsible for the scrutiny of the treasury function. For the Council the Treasury Advisory Group and Governance & Audit Committee undertake this role.

5. The Council has revised its treasury policy and practices documentation to take account of the requirements and changes in the revised Codes and Guidance.

ECONOMIC OUTLOOK FOR 2009-10

6. At the time of determining the Treasury Strategy Statement for 2009-10 in February 2009 the UK, Eurozone and US economies were contracting, globally economies faced a prolonged recession or period of weakness following the financial market meltdown in the autumn of 2008. Availability of credit was restricted as banks undertook to repair their balance sheets. This exacerbated the slowdown as finance for small businesses effectively came to a standstill. The UK Bank Rate had been cut to 0.5% and in March 2009 the Bank of England announced its initial £75bn of Quantitative Easing (QE). There remained a sizeable gap between short-dated LIBOR rates (i.e. the rates at which banks are willing to borrow from other banks) and the Bank Rate; this gap was forecast to narrow. Gilts were expected to benefit from QE, resulting in lower yields.

THE ECONOMY AND EVENTS IN 2009-10

7. The Bank of England forecast UK growth to fall by 3.9% in 2009, whilst inflation was forecast to be heading lower and staying lower for longer. The depth of the recession was borne out by the 5.9% year-on-year fall in GDP recorded at the end of the second quarter of 2009. The service sector – the dominant element of the UK economy – also stalled for

much of early 2009 despite a number of optimistic surveys to the contrary. Signs of recovery were finally evident in the final quarter of 2009 with growth registering 0.4% for the quarter.

8. In order to stimulate growth, the Bank of England maintained the Bank Rate at 0.5% throughout the year. The Bank also took extreme measures to revive the economy through its Quantitative Easing (QE) programme. Financed by the issuance of central bank reserves QE was initially announced at £75bn, and then extended in stages to £200bn.

9. Consumer Price Inflation, having hit a high of 5.2% in September 2008, began the year at 3.2% (February 2009 data), fell to a low of 1.1% in September 2009 as the oil, commodity, utility and food prices (the main drivers of high inflation in 2008) fell out of the year-on-year statistical calculations. Thereafter, inflation pushed higher with rising oil and transport costs and VAT reverting to 17.5%. CPI at year end was 3.0% (February 2010 data).

10. The November 2009 Budget was primarily about public debt. The Chancellor's forecast for net public sector borrowing in 2009-10 was £175bn or 12.4% of GDP. Gross gilt issuance was expected to hit £220bn in 2009-10. Standard & Poor's responded to the debt that the UK government was building up and a lack of credible plan to reduce the debt burden by changing the UK's rating from stable to negative.

11. LIBOR and LIBID rates (i.e. the rates at which banks are willing to borrow from and lend to other banks) which had been stubbornly high in early 2009, slowly moved lower towards the Bank Rate of 0.5%.

12. UK Government Gilts were the main beneficiary of the economic downturn (it is an asset class that responds positively to poor economic news); they also formed the significant bulk of the QE purchases and are thought to have pushed gilt yields, and consequently the cost of borrowing, lower by 0.5%.

TREASURY PORTFOLIO 2009-10

13. The treasury position is summarised in the table below:

31/3/2009 £m	%		**31/3/2010 £m**	%
		External Borrowing Long-term:		
(660.6)	63	• PWLB	(660.6)	54.8
(381.8)	37	• Market	(381.8)	31.7
(0)		Temporary Borrowing	(0)	
0		Other Long-term Liabilities	0	
(1,042.4)		Long-term liabilities*	(1,042.4)	
		PFI Schemes Lease Liability (a requirement for 2009-10)	(163.5)	13.6

(1,042.4)		**Total External Debt**	(1,205.9)	
		Investments:		
357 0	100	Managed in-house Managed externally	265 0	100
357		**Total Investments**	265	
(685.4)		**(Net Borrowing) / Net Investment Position**	(940.9)	

LONG TERM BORROWING / OTHER LONG TERM LIABILITIES

14. The Council's new borrowing requirement for 2009-10 was £106.2m with a further requirement of £74.4m in 2010-11. We also had loans maturing in 2009-10 of £60.48m.

15. The Prudential Code permits the Council the flexibility to bring forward or defer borrowing in relation to its Capital Financing Requirement. During the year the differential between debt costs and investment earnings was significant. In order to eliminate the high "cost of carry" associated with the higher cost of long term borrowing compared to temporary investment returns (between 0.5% and 1%), the Council used internal resources in lieu of borrowing. By doing so, the Council lowered overall treasury risk during the year. The Council recognises that utilising investments in lieu of borrowing clearly has a finite duration and that future borrowing will be required to support capital expenditure; this will be kept under review in 2010-11.

16. The Council's borrowing costs were £90.5m against a budget of £96.8m.

17. Our view on borrowing was arrived at with advice from our treasury advisors, Arlingclose and Butlers.

18. A debt maturity profile is shown in Appendix 1.

DEBT RESCHEDULING

19. The main objective of debt rescheduling is to either 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). Debt rescheduling became more challenging after the introduction by the PWLB of a separate, lower set of repayment rates in November 2007. This increased the costs associated with the premium payable and diminished the discount receivable, thus reducing the cost savings achievable.

20. No debt rescheduling was undertaken in the year.

DEBT RESTRUCTURING

21. In October 2009 £60.47m of PWLB loans maturing in January 2010 were refinanced with a 25 year loan at a rate of 4.1%.

ANNUAL INVESTMENT STRATEGY AND OUTTURN

22. The Council held average cash balances of £415m during the year. These represented working cash balances / capital receipts, Pension Fund monies and the Council's reserves.

    The CLG's Guidance on Investments, revised during 2009-10, reiterated security and liquidity as the primary objectives of a prudent investment policy. Although the Guidance becomes operative on 1 April 2010, its principal recommendations run parallel to the credit risk management requirements in the revised Treasury management Code. In the revised Guidance, Specified Investments are those made with a body or scheme of "high credit quality". Both the Guidance and the revised Treasury Management Code emphasise that counterparty credit criteria should not rely on credit ratings alone but should include a wider range of indicators. The revised Code nonetheless requires that ratings assigned by all three rating agencies – Fitch, Moody's and Standard & Poor's – be taken into account and the lowest rating be used.

23. The criteria agreed by Cabinet in October 2009 for the selection of counterparties were:

    - Access to the Government Credit Guarantee Scheme.
    - Credit rating / other information.
    - Reputational issues in the event of default by a counterparty - how could their use be justified.
    - Exposure to other parts of the same banking group.
    - Country exposure.

24. Prior to the October report to Cabinet all new and maturing monies had been placed with the Debt Management Office which is part of the Treasury. Primarily on the basis of access to the Credit Guarantee Scheme Cabinet agreed to add the following counterparties:

    - Royal Bank of Scotland
    - Lloyds Banking Group
    - Barclays

- HSBC

- Santander UK

Nationwide was added to this list in February 2010 by Cabinet. These institutions have been selected on the basis that they are too large for the UK Government to allow them to fail, so we are able to achieve slightly better returns than through the DMO but without reducing security.

25. As the ongoing problems with the Eurozone countries demonstrate the financial crisis is by no means over and we retain a position of predominantly seeking security for our funds. In support of this since October 2009 all deposits with non-DMO counterparties have been in call accounts, we have made no fixed term deposits.

26. The Council's investment income for the year was £2.8m compared with a budget of £2m.

27. Deposits at 31 March 2010 are shown in Appendix 2.

28. All investments made during the year complied with the Council's agreed Treasury Management Strategy, Prudential Indicators, Treasury Management Practices and prescribed limits. Maturing investments were repaid to the Council in full and in a timely manner.

ICELANDIC EXPOSURE

29. **Heritable**

(1) The Heritable recovery process is proceeding as the administrator initially set out. Ernst and Young have increased their base case recovery to 79-85p in the £ and to date we have received the following payments:

July 2009	16.13p in £
December 2009	12.66p in £
March 2010	6.19p in £

This gives a total return of £6.4m to date out of a total exposure of £18m and we anticipate quarterly returns through 2010 and 2011.

(2) A trust law issue which relates to the last deposit with Heritable is being pursued through the courts with KCC and the Financial Services Compensation Scheme.

30. **Glitnir and Landsbanki**

(1) The total exposure to Glitnir is £15m and Landsbanki £17m – of this £32m one-third relates to the Kent Superannuation Fund and £1m to Kent Fire.

(2) From the earliest visits to Iceland it has been clear that there would be litigation to confirm the preferred status of depositors. Other creditors, major banks and bondholders, were bound to challenge and have little to lose in doing so.

(3) The recovery work is coordinated by a steering committee including KCC. Bevan Brittan were commissioned at an early stage to provide the core legal input – they have also involved UK Queens Counsel and Icelandic legal advisers. The cost of the legal work is charged pro-rata to the value of deposits across all local authorities with deposits in Landsbanki and Glitnir.

(4) With preferred creditor status we anticipate a 100% recovery from Glitnir, with a rapid payout, and on Landsbanki around 90% but over a longer period. KCC's accounts have been closed on this basis using advice from CIPFA.

PRUDENTIAL CODE INDICATORS

31. The Council adopted the CIPFA Treasury Management Code at the budget meeting in February 2010. At the 2009 budget meeting the Prudential indicators for 2009-10 were agreed.

32. **Authorised Limit**

This is the maximum amount of external debt that can be outstanding at one time during the financial year. The limit, which is expressed gross of investments, is consistent with the Council's existing commitments, proposals for capital expenditure and financing and with its approved treasury policy and strategy and also provides headroom over and above for unusual cash movements. This limit was set at £1,219m for 2009-10.

33. **Operational Boundary**

This is set to reflect the Council's best view of the most likely prudent (i.e. not worst case) levels of borrowing activity and is based on the Authorised Limit excluding the headroom for unusual cash movements. For 2009-10 the limit was set at £1,179m.

The levels of debt were measured on an ongoing basis during the year for compliance with the Authorised Limit and the Operational Boundary.

The Council maintained its total external borrowing and other long-term liabilities within both limits; at its peak this figure was £1,102.8m.

34. **Upper Limits for Interest Rate Exposure**

These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates. The exposures are calculated on a net basis, i.e. fixed rate debt net of fixed rate investments. The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of investments.

	Estimated %	**Actual %**
Upper Limit for Fixed Rate exposure.	100	100
Upper Limit for Variable Rate exposure.	30	0

35. **Maturity Structure of Fixed Rate Borrowing**

This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates. It is calculated as the amount of projected borrowing that is fixed rate maturing in each period as a percentage of total borrowing that is fixed rate.

	Lower Limit %	**Upper Limit %**	**Actual Borrowing as at 31/3/2010 £m**	**Percentage of total as at 31/3/2010**
Under 12 months	0	25	45	4.32
12 months and within 24 months	0	40	55	5.28
24 months and within 5 years	0	60	99.2	9.52
5 years and within 10 years	0	80	120	11.51
10 years and above	40	100	723.1	69.37

36. **Total principal sums invested for periods longer that 364 days**

This indicator is set in order to allow the Council to manage the risk inherent in investments longer than 364 days. For 2009-10 this limit was set at £190m. At their peak, these investments totalled £91m.

TREASURY ADVISERS

37. During 2009-10 the Council has used two firms of Treasury advisers, Butlers and Arlingclose. This service is currently out to tender and the Director of Finance and Treasury Advisory Group will be making an appointment.

TRAINING

38. CIPFA's revised Code requires the Director of Finance to ensure that all members tasked with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities. Training has been provided to members of the Treasury Advisory Group, as well as attendance by members of that group on external training courses, and an awareness raising session was undertaken with Governance & Audit Committee. There is also a Treasury Management module in the Financial Management Development Programme.

RECOMMENDATION

39. Members are asked to agree the report and recommend that it is submitted to County Council.

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