By:	Cabinet Member for Finance Acting Director of Finance
To:	Governance and Audit Committee – 30 November 2010
Subject:	**TREASURY MANAGEMENT 6 MONTH REVIEW 2010-11**
Classification:	Unrestricted

Summary: To present the Treasury Management 6 Month Review.

FOR DECISON

1 INTRODUCTION

1.1 The Treasury Management Strategy for 2010 - 11 has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year. The Code also recommends that members are informed of Treasury Management activities at least twice a year.

1.2 This authority is reflecting Best Practice in accordance with CIPFA's recommendations as Governance and Audit Committee now receive quarterly updates on Treasury Management and Cabinet have received Treasury reports in June and September.

1.3 There has been no Treasury Advisory Group (TAG) meeting since the last report to this Committee however members of that group do receive weekly details of the KCC deposit portfolio and monthly reports. TAG will be meeting on 8 December to look at options on treasury strategy

1.4 Treasury management is defined as: "The management of the local authority's investments and 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."

1.5 This report for the six months to 30 September 2010:

- 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;
- Provides details of the estimated outturn position on treasury management transactions for 2010 – 11;

- Confirms compliance with treasury limits and Prudential Indicators.

2 ECONOMIC BACKGROUND

2.1 The UK continued to emerge from recession but the level of activity remained well below pre-crisis levels. GDP registered 0.3% growth in the first calendar quarter of 2010 and 1.2% in the second.

2.2 The Bank of England's Monetary Policy Committee (MPC) maintained the Bank Rate at 0.5% and Quantitative Easing at £200bn. However, the minutes of the Bank of England's September meeting contained the possibility of further Quantitative Easing to keep the economy and inflation on track in the medium term.

2.3 Inflation continued to decline although the annual CPI to August 2010 still stood at 3.1%. This has resulted in two open explanatory letters from the Bank of England's Governor to the Chancellor. In the coming months higher food and fuel prices raise the risk that we may not see inflation come down much more until 2011, and then it will rise back again in January with the signalled hike in VAT to 20%.

2.4 The Bank of England's August Quarterly Inflation Report showed inflation remaining above the 2% target for longer than previously projected. Although the recovery in economic activity was expected to continue, the overall outlook for growth was weaker than presented in the May report.

2.5 The formation of a coalition government dispelled uncertainty surrounding a hung parliament result in May's General Election. The new government's Emergency Budget laid out tough action to address the UK's budget deficit, aiming to eliminate the structural deficit by 2014/15. This is to be achieved through austerity measures – £32bn of spending cuts and £8bn of net tax increases. Gilts have benefitted from this decisive plan as well as expected reductions in supply for each year of the forecast. The expected level of spending cuts and tax rises looks to be enough to extinguish the recent concern about inflation expectations.

2.6 The US Federal Reserve kept rates on hold at 0.25% following signs of a slowdown in American growth. At its meeting in September the Fed sent a strong signal that it is prepared to do more and moving closer to a second wave of unconventional monetary easing, and indeed commenced additional action on 4 November. The European Central Bank maintained rates at 1%. The major ongoing worries in Europe extended from sovereign weakness in the 'PIIGS' nations (Portugal, Italy, Ireland, Greece and Spain), the exposure of the continent's banking sector to the sovereign and corporate debt of these nations and the risk of contagion extending to other countries. The sovereign ratings of Greece, Ireland, Portugal and Spain were downgraded by the rating agencies.

2.7 The results from the EU Bank Stress Tests, co-ordinated by the Committee of European Banking Supervisors, highlighted that only 7 (2 Greek, 1 German and 4 Spanish "caja" banks) of the 91 institutions that made up the scope of the analysis were classed to have failed the adverse scenario tests. The tests are a helpful step forward, but there were doubts if they were far-reaching or demanding enough. The main UK Banks' (Barclays, HSBC, Lloyds and RBS)

Tier 1 ratios all remained above 9% under both the 'benchmark scenario' and the 'adverse scenario' stress tests.

2.8 Gilts rallied as the growth momentum faded and the UK seemed to offer a safe harbour from Euroland's turbulence. 5- and 10-year gilt yields fell to lows of 1.57% and 2.83% respectively.

3 BORROWING REQUIREMENT AND STRATEGY

	Balance on 01/04/2010 £000s	**Debt Maturing £000s**	**Debt Repaid £000s**	**New Borrowing £000s**	**Balance on 30/09/2010 £000s**	**Increase/ Decrease in Borrowing**
Short Term Borrowing	0	0	0	0	0	0
Long Term Borrowing	1,042,363	46,031	40,027	90,000	1,092,336	49,974
TOTAL BORROWING	1,042,363	46,031	40,027	90,000	1,092,336	49,974

3.1 During the six months the differential between debt costs and investment earnings continued to be significant. The Council's strategy is to fund its capital expenditure from internal resources as well as consider borrowing at advantageous points in interest rate cycles.

3.2 In total £90m of new loans have been arranged which include the replacement of maturing debt. The PWLB remains the Council's preferred source of borrowing given the transparency and control that its facilities continue to provide.

3.3 In May the Council borrowed £50m from the PWLB to finance maturing debt at an average rate of 4.28% over 22/48 years. In early September as rates had fallen to a historic low the Council borrowed a further £40m from the PWLB, £20m over 10 years at a rate of 1.94% and £20m over 49/50 years at 3.95%. In addition in May, having taken advice from Butlers, the Council arranged 2 future dated Market loans from Barclays to be drawn in August 2011 at a rate of 3.83%.

3.4 There was no rescheduling of existing debt during the period.

3.5 Changes in the debt portfolio over the 6 months have achieved a reduction in the overall debt cost by £3.8m whilst increasing the average life from 27.22 years to 28.04 years.

4 INVESTMENT STRATEGY

4.1 The 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.

4.2 Investments

	Balance on 01/04/2010 £000s	Investments Made £000s	Investments Repaid £000s	Balance on 30/09/2010 £000s	Increase/ Decrease in Investments £000s
Short Term Investments	210,220	1,658,512	1,617,451	251,281	41,061
Long Term Investments	55,000	0	25,000	30,000	(25,000)
TOTAL INVESTMENTS	265,220	1,658,512	1,642,451	281,281	16,061

4.3 Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2010 - 11. This restricted new investments to the Debt Management Office and Deposits with UK Banks and Building Societies systemically important to the UK banking system.

4.4 Counterparty credit quality is assessed and monitored with reference to:

- Credit Ratings (Council's minimum long-term counterparty rating of A+ across all three rating agencies, Fitch, S&P and Moody's)
- Credit Default Swaps
- Country exposure eg Sovereign support mechanisms, GDP, the country's net debt as a Percentage of GDP
- Share Price

4.5 The counterparties currently approved by Cabinet are:

- Barclays
- HSBC
- Lloyds Banking Group
- Royal Bank of Scotland
- Nationwide

Santander UK was suspended on 30 April 2010 as a result of concerns about the creditworthiness of the Banco Santander group following the downgrading of Spain's long-term sovereign credit rating.

4.6 In June Cabinet approved an increase in duration to 1 year and in early September longer term deposits were placed with Nationwide

4.7 Counterparty credit quality has been maintained through the first half of the year, as can be demonstrated by the Credit Score Analysis summarised below:

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating
31/03/2010	5.4	A+	3.8	AA-
30/06/2010	4.4	AA-	4.4	AA-
30/09/2010	4.4	AA-	4.4	AA-

Scoring:
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-AAA = highest credit quality = 1
- D = lowest credit quality = 15
-Aim = A+ or higher credit rating, with a score of 5 or lower, to reflect current investment approach with main focus on security

4.8 Average cash balances were £313m during the period. These included schools balances in the corporate scheme (£65.3m), KCC working capital (£60m) created by differences in income and expenditure profiles, Iceland deposits (£43m) and other reserves and funds held in trust

4.9 The UK Bank Rate has been maintained at 0.5% since March 2009 and short-term money market rates have remained at very low levels. New deposits have been made at an average rate of 0.61% and the Council's forecast investment income for the year has been estimated at £2.0m / 0.64% for the whole year.

4.10 Icelandic Investments Update

Following guidance from CIPFA, issued in September 2010, the following is now known:

- ***Heritable*** – It is now expected that 79p-85p/£ will be recovered overall. In July a further quarterly dividend was received of 6.27p in the £ or £1.15m and a further 4.14p in the £ or £0.75m received in October 2010. Total recoveries from the £18m deposited are now £8.4m. The Head of Financial Services continues to be actively involved as a member of the Creditors Committee in key decisions over the future administration of the bank.

- ***Glitnir and Landsbanki*** – The Winding-Up Boards have classed Local Authority deposits as non-priority claims however local authorities' legal advice remains that deposits have priority status under Icelandic law. KCC is a test case on both banks. The test cases will be submitted to the District Court in Reykjavik in September and court hearings will take place in early 2011.

5. COMPLIANCE WITH PRUDENTIAL INDICATORS

The Council can confirm that it has complied with its Prudential Indicators for 2010 - 11, which were set as part of the Council's Treasury Management Strategy Statement. Details can be found in Appendix 1.

6. TREASURY ADVISERS

6.1 KCC continues to use two firms of treasury advisers, Arlingclose and Butlers. An EU tender process was undertaken and responses received in May from Arlingclose, Butlers and Sector. However in October Sector announced that they were taking over Butlers and based on this change the Director of Finance, after consulting with TAG, decided to retender the advisor contract. The Butlers contract already runs to 31 March 2011 and the Arlingclose contract has been extended to this date.

7. TRAINING

7.1 The Director of Finance provides training to individuals or collective groups. KCC officers have attended conferences and workshops organised by CIPFA and Arlingclose.

8. SUMMARY

8.1 In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during the first quarter of 2010 - 11. As indicated in this report none of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

9. RECOMMENDATION

9.1 Members are asked to endorse this report and recommend that it is submitted to full Council.

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