

By: Director of Finance
To: Governance and Audit Committee – 17 September 2008
Subject: **TREASURY MANAGEMENT ANNUAL REVIEW**
Classification: Unrestricted

Summary: To report on treasury management activity in 2007-08.

FOR INFORMATION

INTRODUCTION

1. The purpose of this report is to review the main aspects of treasury management activity during the year in accordance with the CIPFA Code of Practice on Treasury Management.
2. The events of the last year linked to the global credit crunch has reinforced the importance of sound treasury management practices which seek to protect the finances of the Council.

LONG TERM BORROWING

3. Borrowing

- (1) As at 31 March 2008 long term borrowing was £1,002m of which £53.3m is pre-LGR debt which we are managing on behalf of Medway Council.
- (2) In 2007-08 we undertook the following borrowing against a requirement of £80.4m within the treasury strategy in the medium term plan:

Date	Amount	Interest	Period of	Source	Type
	£m	Rate	Loan Years		
		%			
09/01/08	20	4.40	33.5	PWLB	Maturity
13/02/08	5	4.26	3.5	PWLB	Maturity
13/02/08	5	4.23	3	PWLB	Maturity
26/03/08	20	4.05	4.5	PWLB	Maturity
Total	50				

- (3) The first half of 2007-08 saw a rising trend in UK interest rates with the Official Bank Rate rising to 5.5% in May 2008 and 5.75% in July in response to the deteriorating inflation outlook.

- (4) The problems in the market started in late August as the tightening of credit conditions, triggered initially by the failure of a selection of US mortgage lending institutions, undermined investor confidence. LIBOR rates rose to well over 6.5% as financial organisations' reluctant to lend money to counterparties sparked a severe shortage of funds in the market. In the UK, the crisis came to a head with the failure of the Northern Rock Bank (September) and while the danger of insolvency was defused by the Government's decision to guarantee all deposits with this institution, this failed to prevent a prolonged tightening of credit conditions.
- (5) The credit crisis provoked a significant change in the Bank of England's assessment of UK economic prospects over the medium term. It was clearly concerned that the tightening of liquidity and the consequent rise in borrowing rates across the entire economy could lead to a rapid slowdown in activity. This would help to contain inflation pressures. Bank Rate was cut by 0.25% on two occasions, December and February, to end the year at 5.25%.
- (6) Long-term rates (gilt yields and PWLB rates) charted an erratic course. The upward pressure on rates in evidence in the closing stages of 2006/07 continued into the new year as concerns persisted that international interest would need to rise further to combat mounting inflation pressures.
- (7) Gilt yields peaked in late June and started to slip lower in the summer months. The flight to safe investments triggered by the financial crisis placed strong downward pressure upon gilt-edged yields in August / September notably at the short end of the maturity range and the rally in this part of the market gained momentum as the year drew on. Progress to lower levels was erratic and limited in the early months of 2008, but the general trend in yields was to lower levels.
- (8) In light of these volatile market conditions and the rising trend of interest rates for much of the year, we held off any borrowing until January 2008. In a marked change to our normal practice we took advantage comparatively low short term rates to borrow for 3, 3.5 and 4.5 years.
- (9) This borrowing was very well timed as is shown below:

	Jan 08	Feb 08	Feb 08	March 08
Rate borrowed	4.4%	4.26%	4.23%	4.05%
Rate August 2007	4.8%	5.65%	5.7%	5.7%
Rate August 2008	4.64%	4.93%	4.92%	4.91%

4. **Debt Restructuring**

- (1) It has been our policy in recent years to periodically restructure loans taking advantage of short term variations in PWLB rates. In April and August 2007 major exercises were undertaken (Appendix 1) which rescheduled £175m of loans making an annual saving of £1,029k.
- (2) Unfortunately, and without consultation, in November 2007 the Government Debt Management Office changed its structure of interest rates so that any repayment of PWLB debt will have a more penal rate applied. As such the cost of any PWLB repayments will be higher in the future. In effect this means that we will no longer, apart from exceptional circumstances, be able to reschedule debt. This has been a major source of savings for the council which is now denied to us. The LGA have taken this matter up with CLG but to no effect.

5. **Performance Summary**

Overall the average rate of interest paid in 2007-08 reduced from 5.77% to 5.69%.

INVESTMENTS

6. **Balances**

During 2007-08 the average balance increased to £325m compared with £308m in 2006-07 and £259m in 2005-06. Much of this increase was due to the Superannuation Fund Committee's decision in September 2007 to retain Cash and not allocate additional monies to investment managers given conditions in equity, bond and property markets. £121m of Superannuation Fund cash was held at 31 March 2008 and under the regulations we pay interest on these funds at the prevailing LIBID rate.

7. **Duration**

- (1) At the end of March 2007 we had £124m invested for over 364 days and at 31 March 2008 this had reduced to £112m (Appendix 2).
- (2) Since the DCLG changed the investment regulations we have taken advantage of the higher interest rates payable for longer duration investments and this has been a major factor in our relatively strong performance compared with other Councils in recent years. The impact of the credit crunch was to significantly increase short term rates because of the shortage of liquidity in the market. This meant that overall some of our long term investments were below rates which could have been achieved with short term money. Over the medium term we believe that investing for longer duration has been highly beneficial.

8. **Performance Summary**

The investment return achieved was 6.0681% compared against the 7 day LIBID benchmark return of 5.5862%. The outperformance against LIBID generated an additional £1.6m for the Council.

RISK

9. The Council has complied with all relevant statutory and regulatory requirements which limit the levels of risk associated with treasury management activities. In-particular in our adoption and implementation of the CIPFA Code of Practice and the Prudential Code we have ensured that capital expenditure is prudent, affordable and sustainable; and that treasury practices demonstrate a low risk approach.
10. In recent years much of our emphasis on treasury management has been to add value through decisions such as prudent debt restructuring and investing for longer duration. The failure of Northern Rock in the UK and Bear Stearns and a range of other significant US financial institutions has been a reminder of the need for prudence in our investments and the priority for maintenance of our principal sum over return. This has been a conscious decision of the Director of Finance and Cabinet Member for Finance, and an approach discussed with the Chairman of Governance & Audit Committee and endorsed by him.
11. In practice this meant the withdrawal of funds held with Northern Rock well before a critical stage was reached, and discontinuing use of Alliance & Leicester and Bradford & Bingley, again well before the full extent of the problems they had were widely known. There is no doubt that this has impacted on returns but our view was, and still is, that we will accept lower returns for more security.

CIPFA BENCHMARKING

12. KCC participates in the CIPFA benchmarking group for Treasury Management along with around 90 Councils in total. In recent years our investment returns have been relatively high compared with other Councils. The 2007-08 results are shown below:

	KCC %	Benchmark %	Variance %
Investments < 365 days	5.78	5.90	-0.12
Investments > 365 days	5.80	5.65	+0.15
Call Accounts	5.70	5.68	+0.02
Callable / Structured Products	5.83	5.54	+0.29
Combined In-House Investments	5.78	5.80	-0.02
Externally Managed Funds	-	5.43	-
Combined Investments	5.78	5.79	-0.01

13. The KCC performance slightly underperformed the average, by 0.01%, and this was due to underperformance on Investments under 365 days. This

underperformance has been thoroughly examined with Butlers, our Treasury advisers, and they believe it is due to our priority for security against return. As an example of this we discontinued the use of an Alliance & Leicester reserve account which consistently produced better returns than the funds we used.

RECOMMENDATION

14. Members are asked to note this report

Nick Vickers
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APPENDIX 1

Debt Restructuring

DATE	AMOUNT £	INTEREST RATE %	REMAINING PERIOD OF LOAN YEARS	MATURITY DATE	ANNUAL SAVING	SOURCE	TYPE
Old Loans							
23/04/07	11,736,282.46	9.125	6.80	10/02/2014	350,406.48	PWLB	Maturity
23/04/07	5,000,000	4.875	16.55	10/11/2023	17,202.93	PWLB	Maturity
23/04/07	5,000,000	4.875	17.55	10/11/2024	17,249.79	PWLB	Maturity
23/04/07	3,750,000	4.875	19.05	10/05/2026	13,312.30	PWLM	Maturity
23/04/07	1,250,000	4.875	19.05	10/05/2026	4,437.43	PWLB	Maturity
23/04/07	5,000,000	4.75	20.55	10/11/2027	13,226.83	PWLB	Maturity
23/04/07	10,000,000	4.875	21.05	10/05/2028	25,246.82	PWLB	Maturity
23/04/07	20,000,000	4.85	23.30	10/08/2030	51,628.02	PWLB	Maturity
23/04/07	10,000,000	4.75	24.80	10/02/2032	27,817.68	PWLB	Maturity
23/04/07	14,000,000	4.85	24.80	10/02/2032	36,314.92	PWLB	Maturity
23/04/07	17,000,000	4.7	23.05	10/05/2030	66,824.15	PWLB	Maturity
23/04/07	10,000,000	4.7	24.05	10/05/2031	39,752.95	PWLB	Maturity
23/04/07	4,000,000	4.625	21.55	10/11/2028	15,056.74	PWLB	Maturity
23/04/07	7,000,000	4.625	23.55	10/11/2030	27,232.72	PWLB	Maturity
23/04/07	20,000,000	4.7	22.30	10/08/2029	77,280.31	PWLB	Maturity
10/08/07	20,000,000	4.7	24.75	10/05/2032	82,185	PWLB	Maturity
10/08/07	6,264,500	4.625	19.75	10/05/2027	31,785	PWLB	Maturity
10/08/07	3,020,025.31	9.125	6.51	10/2/2014	84,700	PWLB	Maturity
10/08/07	1,813,489.76	9	7	10/08/2014	47,289	PWLB	Maturity
TOTAL	174,834,297.53						
New Loans							
23/04/07	21,500,000	4.65	30.5	10/05/2037		PWLB	Maturity
23/04/07	31,000,000	4.65	31.5	10/05/2038		PWLB	Maturity
23/04/07	25,500,000	4.65	32.5	10/05/2039		PWLB	Maturity
23/04/07	30,600,000	4.5	56	23/04/2063		Barclays	LOBO
23/04/07	35,500,000	4.5	60	23/04/2067		Barclays	LOBO
10/08/07	31,000,000	4.65	36.5	10/11/2043		PWLB	Maturity
TOTAL	175,100,000						

APPENDIX 2

Longer Term Investments

Counterparty	Principal Amount £	Start Date	End date	Interest Rate %	Call Options
HSBC	5,000,000	18/07/05	16/07/10	5.30	6 monthly
HSBC	5,000,000	04/08/05	04/08/10	5.35	6 monthly
Toronto Dominion Bank	4,000,000	05/08/05	05/08/10	5.37	6 monthly
HSBC	5,000,000	05/09/05	07/09/09	4.95	6 monthly
Toronto Dominion Bank	5,000,000	25/10/05	27/10/08	5.05	6 monthly
National Australia Bank	4,000,000	12/12/05	14/12/09	5.25	6 monthly
HSBC	5,000,000	19/01/06	19/01/10	5.13	6 monthly
Citibank NA	5,000,000	04/04/06	06/04/10	5.33	6 monthly
Newcastle Building Society	5,000,000	12/04/06	14/04/09	5.18	None
Coventry Building Society	5,000,000	03/05/06	05/05/09	5.43	None
EBS Building Society	5,000,000	18/05/06	18/05/11	6.02	6 monthly
HSBC	5,000,000	03/07/06	01/07/11	5.52	Annual call, annual interest
HBOS	5,000,000	18/08/06	18/08/11	5.40	Annual – interest rate increases if not exercised.
HSBC	5,000,000	06/10/06	06/10/09	5.62	1 st year fixed then 6 monthly options
HSBC	5,000,000	06/12/06	06/12/09	6.17	Tied to 6 month LIBOR within 0 - 6.25% else 0% interest
National Australia Bank	5,000,000	05/03/07	07/03/11	5.85	Quarterly
National Australia Bank	6,000,000	15/03/07	15/03/11	6.26	Quarterly
HSBC	5,000,000	08/06/07	08/06/12	6.33	6 monthly
Lloyds TSB	5,000,000	19/07/07	19/07/12	7.32	Fixed for 2 years then semi-annual
Chelsea BS	5,000,000	06/08/07	06/08/10	6.25	None
Chelsea BS	5,000,000	06/08/07	06/08/10	6.25	None
National Australia Bank	2,000,000	06/08/07	08/08/11	6.97	First year fixed then semi-annual calls

National Australia Bank	5,000,000	22/10/07	22/10/12	6.73	Fixed for 1st year then 6 monthly call options for borrower
Dunfermline BS	5,000,000	07/11/07	09/11/09	6.526	No calls. Interest at 3m LIBOR + 25bps. Reviewed quarterly and interest matched
Dexia Bank	5,000,000	07/12/07	07/12/12	6.43	Fixed for 2 years then 6 monthly borrower call options for remaining 3 years
JP Morgan Chase	5,000,000	06/02/08	06/02/12	5.6	Fixed first year then quarterly call options. All interest at maturity.
Dexia Bank	5,000,000	15/02/08	15/02/13	6.0	Fixed first 2 years then semi-annual calls. All interest at maturity
Dexia Bank	5,000,000	17/03/08	16/03/12	6.05	First year fixed then semi-annual call options. All interest at maturity.