By:	Cabinet Member for Finance Acting Director of Finance
To:	Cabinet – 2 February 2011
Subject:	**TREASURY MANAGEMENT STRATEGY**
Classification:	Unrestricted

Summary: To propose a Treasury Management strategy for 2011-12.

FOR DECISION

INTRODUCTION

1. The Chartered Institute of Public Finance and Accountancy's Code of Practice for Treasury Management in Public Services (the "CIPFA TM Code") and the Prudential Code require local authorities to determine the Treasury Management Strategy Statement (TMSS) and Prudential Indicators on an annual basis. The TMSS also incorporates the Investment Strategy as required under the Department for Communities and Local Government's (CLG's) Investment Guidance.

2. CIPFA has defined Treasury Management as:
"the management of the organisation'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".

3. The Council is responsible for its treasury decisions and activity. No treasury management activity is without risk. The successful identification, monitoring and control of risk are integral elements to treasury management activities and include Credit and Counterparty Risk, Liquidity Risk, Market or Interest Rate Risk, Refinancing Risk and Legal and Regulatory Risk.

4. The strategy takes into account the impact of the Council's Revenue Budget and Capital Programme on the Balance Sheet position, the current and projected Treasury position, the Prudential Indicators and the outlook for interest rates.

5. The purpose of this TMSS is to approve:

   - The Treasury Management Strategy for 2011-12
   - Prudential Indicators
   - The revised list of Counterparties and investments

6. The Council approved the adoption of the CIPFA Treasury Management Code at its February 2010 meeting and has incorporated the changes from the revised CIPFA Code of Practice into its treasury policies, procedures and practices.

7. All treasury activity will comply with relevant statute, guidance and accounting standards.

BALANCE SHEET AND TREASURY POSITION

8. The underlying need to borrow for capital purposes, as measured by the Capital Financing Requirement (CFR), together with Balances and Reserves, are the core drivers of Treasury Management Activity. The estimates, based on the current Revenue Budget and Capital Programmes, are:

	31/03/2011	31/03/2012	31/03/2013	31/03/2014
	£m	£m	£m	£m
Total CFR	1,315	1,312	1,300	1,274
Less existing profile of Borrowing	(1,096)	(1,096)	(1,096)	(1,096)
Cumulative Maximum Borrowing Requirement	**219**	**216**	**204**	**178**
Balances & Reserves	(318)	(318)	(318)	(318)
Cumulative Net Borrowing Requirement / (Investment Capacity)	**(99)**	**(102)**	**(114)**	**(140)**

9. The Council's level of physical debt and investments is linked to these components of the Balance Sheet. Market conditions, interest rate expectations and credit risk considerations will influence the Council's strategy in determining the borrowing and investment activity against the underlying Balance Sheet position. The Council does not anticipate that net physical external borrowing (i.e. net of investments) will exceed the Capital Financing Requirement.

BORROWING AND RESCHEDULING STRATEGY

10. The Council's profile of long term debt is attached at Appendix 1. Its balance of actual gross borrowing plus other long-term liabilities is measured in a manner consistent for comparison with the Operational Boundary and Authorised Limit.

11. The **Authorised Limit** sets the maximum level of external borrowing on a gross basis (i.e not net of investments) and is the statutory limit determined under Section 3(1) of the Local Government Act 2003 (referred to in the legislation as the Affordable Limit). It is measured on a daily basis against all external borrowing items on the Balance Sheet and has been set on the estimate of the most likely, prudent scenario with sufficient headroom over and above this to allow for unusual cash movements.

Authorised Limit for External Debt relating to KCC assets and activities

	2010 -11 Approved £m	2010 -11 Revised £m	2011-12 Estimate £m	2012-13 Estimate £m	2013-14 Estimate £m
Borrowing	1,168	1,182	1,198	1,200	1,202
Other Long Term Liabilities					
Total	**1,168**	**1,182**	**1,198**	**1,200**	**1,202**

Authorised Limit for External Debt managed by KCC including that relating to Medway Council (pre Local Government reorganisation)

	2010 -11 Approved £m	2010 -11 Revised £m	2011-12 Estimate £m	2012-13 Estimate £m	2013-14 Estimate £m
Borrowing	1,219	1,232	1,244	1,244	1,244
Other Long Term Liabilities					
Total	**1,219**	**1,232**	**1,244**	**1,244**	**1,244**

12 The **Operational Boundary** links directly to the Council's estimates of the CFR and estimates of other cashflow requirements. This indicator is based on the same estimates as the Authorised Limit reflecting the most likely, prudent but not worst case scenario but without the additional headroom included within the Authorised Limit.

Operational Boundary for External Debt relating to KCC assets and activities

	2010 -11 Approved £m	2010 -11 Revised £m	2011-12 Estimate £m	2012-13 Estimate £m	2013-14 Estimate £m
Borrowing	1,128	1,142	1,158	1,160	1,162
Other Long Term Liabilities					
Total	**1,128**	**1,142**	**1,158**	**1,160**	**1,162**

Operational Boundary for total debt managed by KCC including that relating to Medway Council etc

	2010 -11 Approved £m	2010 -11 Revised £m	2011-12 Estimate £m	2012-13 Estimate £m	2013-14 Estimate £m
Borrowing	1,179	1,192	1,204	1,204	1,204
Other Long Term Liabilities					
Total	**1,179**	**1,192**	**1,204**	**1,204**	**1,204**

13. The Acting Director of Finance has delegated authority, within the total limit for any individual year, to effect movement between the separately agreed limits for borrowing and other long-term liabilities. Decisions will be based on the outcome of financial option appraisals and best value considerations. Any movement between these separate limits will be reported to the next meeting of the Cabinet.

14. In conjunction with advice from its treasury advisors the Council will keep the following borrowing options under review.

- PWLB loans
- Borrowing from other local authorities
- Borrowing from institutions such as the European Investment Bank and directly from Commercial Banks
- Borrowing from the Money Markets

15. After the Comprehensive Spending Review announcement on 20 October the PWLB still in relative terms is the most attractive source of funds albeit at a higher cost than previously. The types of PWLB borrowing that are considered appropriate for a low interest rate environment are:

- Variable rate borrowing
- Medium-term year Equal Instalments of principal (EIP) or Annuity Loans
- Long-term Maturity loans, where affordable

16. Capital expenditure levels, market conditions and interest rate levels will be monitored during the year in order to minimise borrowing costs over the medium to longer term and maintain stability. The differential between debt costs and investment earnings, despite long term borrowing rates being at low levels, remains acute and this is expected to remain a feature during 2011-12. The "cost of carry" associated with medium- and long-term borrowing compared to temporary investment returns means that new fixed rate borrowing could entail additional short-term costs. The use of internal resources in lieu of borrowing may again, in 2011-12, be the most cost effective means of financing capital expenditure. The borrowing undertaken in 2010, including advance

borrowing in 2011 has put the Council in a strong position and we will not be forced to borrow at disadvantageous times.

17. PWLB variable rates are expected to remain low as the bank rate is maintained at historically low levels for an extended period. Exposure to variable interest rates will be kept under regular review and options will be considered in conjunction with the Authority's Treasury Advisors.

18. The Council has £381.8m loans which are LOBO loans (Lender's Options Borrower's Option) of which £110m of loans are currently in or will be in their call period in 2011-12. In the event that the lender exercises the option to change the rate of terms of the loan, the Council will consider the terms being provided and also repayment of the loan without penalty. The Council may utilise cash resources for repayment or may consider replacing the loan(s) by borrowing from the PWLB. The default response will however be early repayment without penalty.

19. The rationale for rescheduling loans would be one or more of the following:

    - Savings in interest costs with minimal risk.
    - Balancing the volatility profile (i.e. the ratio of fixed to variable rate debt) of the debt portfolio.
    - Amending the profile of maturing debt to reduce any inherent refinancing risks.

20. Borrowing and rescheduling activity will be reported to the Treasury Advisory Group, Governance & Audit Committee and the Cabinet.

21. The following Prudential Indicators allow the Council to manage the extent to which it is exposed to changes in interest rates. The upper limit for variable rate exposure has been set to ensure that the Council is not exposed to interest rate rises which could adversely impact on the revenue budget. The limit allows for the use of variable rate debt to offset exposure to changes in short-term rates on investments.

    All the Council's existing external debt is held at fixed interest rates.

	2010 - 11 Approved %	**2010 - 11 Revised %**	**2011-12 Estimate %**	**2012 -13 Estimate %**	**2013 - 14 Estimate %**
Upper Limit for Fixed Interest Rate Exposure	**100**	**100**	**100**	**100**	**100**
Upper Limit for Variable Interest Rate Exposure	**30**	**30**	**50**	**50**	**50**

22. The Council will also limit and monitor large concentrations of fixed rate debt needing to be replaced. Limits in the following table are intended to control excessive exposures to volatility in interest rates when refinancing debt.

Maturity structure of fixed rate borrowing	**Existing level at 30/10/10 %**	**Lower Limit for 2011-12 %**	**Upper Limit for 2011-12 %**
Under 12 months	0.6	0	25
12 months and within 24 months	5.2	0	40
24 months and within 5 years	9.6	0	60
5 years and within 10 years	11.9	0	80
10 years and within 20 years	12.6	10	25
20 years and within 30 years	15.0	5	25
30 years and within 40 years	12.0	5	25
40 years and within 50 years	11.1	10	25
50 years and above	22.1	10	30

INVESTMENT POLICY AND STRATEGY

23. Guidance from CLG on Local Government Investments in England requires that an Annual Investment Strategy be set.

24. The Council's investment priorities are:

- Security of the invested capital;
- Liquidity of the invested capital
- An optimum yield which is commensurate with security and liquidity.

25. Investments are categorised as "Specified" or "Non Specified" investments based on the criteria in the CLG Guidance. The Acting Director of Finance under delegated powers will undertake the most appropriate form of investment in keeping with the investment objectives, income and risk management requirements and Prudential Indicators. Decisions taken on the core investment portfolio will be subject to consultation with Treasury Advisory Group and key decisions will be taken by Cabinet.

COUNTERPARTIES

26. The current counterparties used by the Council are:

- Debt Management Office
- Barclays
- HSBC
- Lloyds Banking Group

- Royal Bank of Scotland
- Nationwide

Santander UK has been suspended since April 2010. The DMO has a £450m limit. All the financial institutions have a £40m limit except Nationwide which is £20m.

27. The criteria applied to the approval of a counterparty as agreed by Cabinet are:

    - Access to the Government Credit Guarantee Scheme
    - Credit rating (Council's minimum long-term counterparty rating of A+ across all three rating agencies, Fitch, S&P and Moody's)
    - Credit Default swaps
    - Share Price.
    - Reputational issues
    - Exposure to other parts of the same banking group.
    - Country exposure

    The period of access to the Credit Guarantee Scheme is now over so it is proposed that this is replaced with the criteria: "A strong likelihood of Government intervention in the event of liquidity issues based on systemic importance to the UK economy".

28. Clearly the overwhelming criteria for the Council is the security of funds, even now the Council could achieve significantly higher returns but has taken a deliberate decision not to do so. Effectively any decision to use a counterparty other than the Government Debt Management Office means taking on an element of risk. The 5 counterparties which we currently use meet the criteria above, including the amended criteria.

29 Proposed New Counterparties

On 8 December Arlingclose presented a range of options on counterparties and other types of investment to the Treasury Advisory Group. Officers have also had discussions with Sector on the same subject. The conclusions of the group are set out below with recommendations on how to proceed:

Counterparty	**Rationale**	**TAG Recommendation**
National Westminster Bank plc	Part of the RBS group but with a separate credit rating.	ADD - but maintain a £40m limit across RBS and Nat West.
Standard Chartered Bank	Recently uprated to meet our credit ratings with very low credit default swap rates.	ADD – with £20m limit

Clydesdale Bank	Meet criteria but not previously included due to ownership by National Australia Bank. Major Australian bank in a strong economy.	ADD – with £20m limit
Debt Management Office Treasury Bills	Short dated financial instruments issued by UK Government with maturities of 1, 3 or 6 months. Issued by the Debt Management Office with implied AAA rating as DMO is a Government agency. Rate of return broadly twice fixed deposits with the DMO but with no additional risk and improved liquidity.	ADD - maintain £450m limit for the DMO.
Money Market Funds	Very tightly regulated AAAm funds none of which have ever failed in the UK. Investing in a very wide range of financial securities. Widely used by local authorities and offering rates a little above base rate. However, they will have exposure to overseas banks and to financial instruments the Council would not invest in directly.	NO - TAG will investigate in 2011 and come back to Cabinet with recommendations.
Sterling Government Money market Funds	Relatively new and operating as a MMF but only holding UK Government guaranteed investments. Rates a little below base rate.	NO – tend to have lower rates and no greater security than Treasury Bills.
CCLA Public Sector Deposit Fund	A AAAm Money market Fund. Heralded earlier in the year in conjunction	NO - observe developments.

	with the Local Government Association. Has not yet received Financial Services Authority approval. Major issues to be overcome.	
Other Local Authorities	Previously considered by TAG and rejected on the basis of ease of explanation.	NO
Gilts and Bonds	Major investment for the Pension Fund – complexity issues.	NO - TAG to investigate in 2011 and come back to Cabinet with recommendations.
European Investment Bank (and other supra-national) bonds	Used by many Arlingclose local authority clients. Very strongly capitalised and AAA rated. Eurozone concerns weighing at present on minds of some.	NO - TAG to investigate in 2011 and come back to Cabinet with recommendations.

30 The Council's investments at 7 January 2011 are detailed in Appendix 3.

31 The Council's investments are made with reference to the outlook for UK bank rate and money market rates.

32 In any period of significant stress in the market the default position will be for investments to be made with the Debt Management Office.

33 The Council with its treasury advisors will continue to analyse and monitor key indicators and credit developments. The Acting Director of Finance with the Cabinet Member for Finance can suspend a Counterparty at any time.

34 In 2010 Cabinet agreed to extend the maximum duration of investments from 6 months to 12 months.

35 Interest rates on short term deposits are likely to remain at very low levels for an extended period. But the massive uncertainty in credit markets is also likely to remain. Therefore at this stage it is recommended that we retain 12 months as the longest period for any deposit – there is no case in this market for deposits for over 12 months.

OUTLOOK FOR INTEREST RATES

36 The economic interest rate outlook provided by the Council's treasury advisor, Arlingclose Ltd, is attached at Appendix 2. The Council will reappraise its strategy from time to time and, if needs be, realign it with evolving market conditions and expectations for future interest rates.

BALANCED BUDGET REQUIREMENT

37 The Council complies with the provisions of S32 of the Local Government Finance Act 1992 to set a balanced budget.

MONITORING AND REPORTING ON THE TREASURY OUTTURN AND PRUDENTIAL INDICATORS.

38 Treasury activity is monitored regularly and reported to TAG monthly, Governance and Audit Committee quarterly and Council half yearly. The Prudential Indicators will be monitored through the year by the Acting Director of Finance and reported to Cabinet.

ICELAND

39 Around 120 UK local authorities had £1billion deposited in Icelandic banks. Many other bodies such as Cambridge and Oxford Universities, many charities and the Audit Commission had funds in Iceland. KCC had £32 million in Icelandic banks, the Pension Fund £16 million and the Fire Authority £1 million giving a total of £50 million. The split of this was:

- Heritable, an Icelandic owned but UK based bank - £18m
- Landsbanki - £17m
- Glitnir **-** £15m

40. In September/October 2008 the world experienced its largest financial crisis for a century. The world's banking system was undermined by the exposure of major financial institutions to the so called sub-prime US mortgages. For a period banks were no longer prepared to lend to each other which meant there was insufficient funds for them to function. Governments provided huge financial support to the banks. In the UK alone support to banks totals £547bn and the Government also took major share holdings in Royal Bank of Scotland and Lloyds Group. One of the main reasons why UK local authorities had placed money with the Icelandic banks was because they had no exposure to the US sub-prime market and at the time the banks had a top star credit rating. What undermined the Icelandic banks was that the Icelandic Government did not have the funds to step in and bail out the banks in the same way as the UK Government could

41. The latest position on the Icelandic banks is:

- Heritable is in administration in the UK with Ernst & Young the appointed administrator. Heritable was a viable bank which was forced to cease trading by the Financial Services Authority when its parent Landsbanki became insolvent. The forecast recovery is 79-85%. To date we have received £9.1m or 50.1p in the £.

- Landsbanki and Glitnir are being managed through processes in Iceland under Icelandic law. Both Landsbanki and Glitnir have very substantial assets, mainly outside Iceland and they are increasing in value so there is a good prospect of recovery. Under Icelandic law depositors are preferred creditors and they should receive a full payout before any other creditors are paid. If preferred creditor status holds in Iceland we are forecast to make an 86% recovery on Landsbanki and 100% on Glitnir.

This gives a projected overall recovery, with depositor priority, of around 90%.

42. When the crisis hit UK local authorities KCC put itself at the forefront of leading the recovery work. A KCC officer is one of 2 local authority representatives on the small Heritable Creditors Committee and a KCC officer together with a representative from the Local Government Association represent local authorities on the Landsbanki and Glitnir Informal Creditors Committee which liaises with the banks Resolution Committees.

43. The court hearings to determine the depositor preference issue in Iceland take place in February for Landsbanki and March for Glitnir. UK local authorities are working as a group in these actions and KCC has been selected as a test case by our legal advisers for each of the banks due to the strength of our underlying records. We expect it to be a matter of weeks after the hearings that a verdict is given.

44. The www.kent.gov.uk website is regularly updated for news on developments in Iceland.

OTHER ITEMS

45 Training

CIPFA's Code of Practice requires the Acting 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. This training will focus on the Treasury Advisory Group members but all members can attend the Financial Management Development Programme Treasury Management module.

46 Investment Consultants

The Council is currently out to tender for treasury advisors and the appointment will be made by the Treasury Advisory Group.

RECOMMENDATION

47 Members are asked to approve:

(1) The Treasury Management Strategy for 2011-12

(2) The 2011-12 Prudential Indicators

(3) The revised list of Counterparties and investments as recommended by TAG:

- Addition of NatWest, as part of the RBS group limit of £40m,
- Addition of Standard Chartered and Clydesdale banks each with a limit of £20m
- UK Treasury bills, maintaining the DMO limit of £450m

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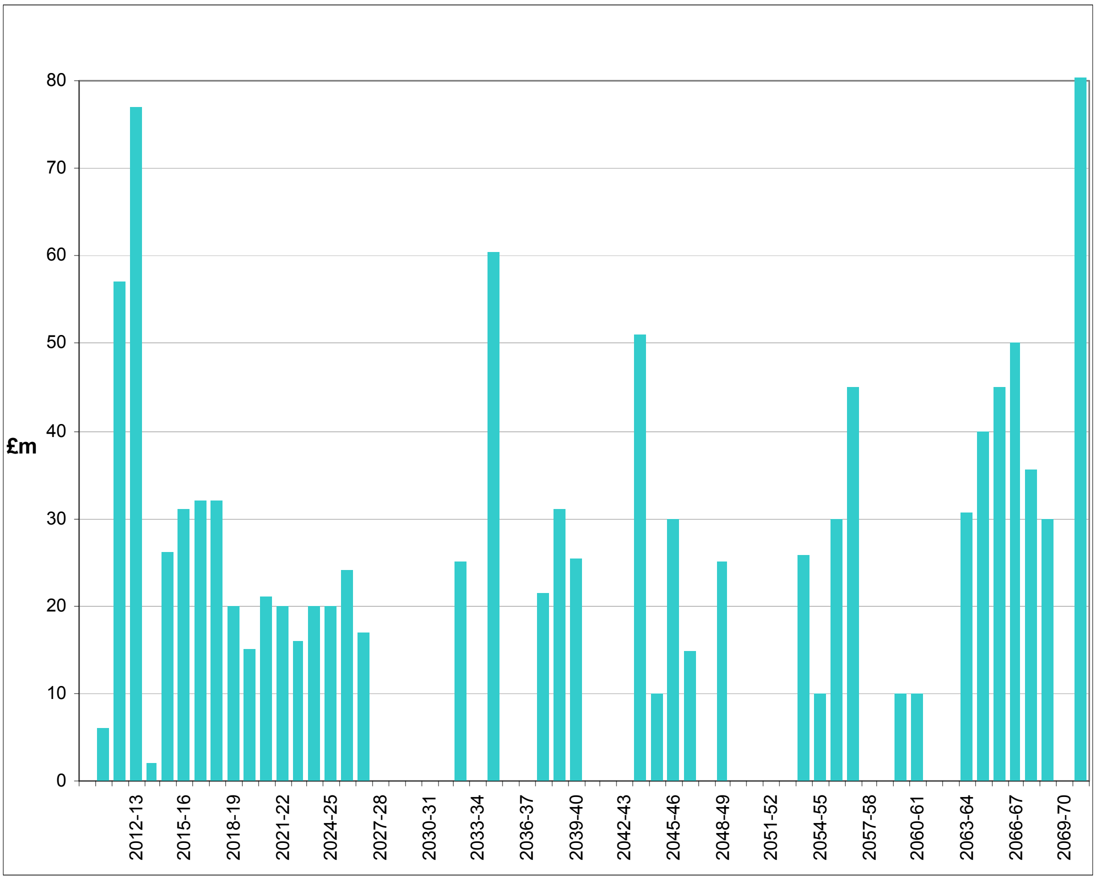
APPENDIX 1

KENT COUNTY COUNCIL
LONG TERM DEBT MATURITY PROFILE



APPENDIX 2

Arlingclose's Economic and Interest Rate Forecast (November 2010)

	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
Official Bank Rate											
Upside risk	-	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	**0.50**	**0.50**	**0.50**	**0.75**	**1.00**	**1.25**	**1.50**	**2.00**	**2.50**	**2.75**	**2.75**
Downside risk	-	-	-	-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
1-yr LIBID											
Upside risk	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	**1.50**	**1.75**	**2.00**	**2.25**	**2.50**	**2.75**	**3.00**	**3.25**	**3.50**	**3.50**	**3.50**
Downside risk	-0.25	-0.25	-0.25	-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
5-yr gilt											
Upside risk	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	**2.00**	**2.25**	**2.75**	**3.25**	**3.50**	**3.75**	**4.00**	**4.00**	**4.00**	**4.00**	**4.00**
Downside risk	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25
10-yr gilt											
Upside risk	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50
Central case	**3.50**	**3.75**	**3.75**	**4.00**	**4.25**	**4.50**	**4.75**	**4.75**	**4.75**	**4.75**	**4.75**
Downside risk	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25
20-yr gilt											
Upside risk	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50
Central case	**4.25**	**4.50**	**4.75**	**5.00**	**5.00**	**5.00**	**5.00**	**5.00**	**5.00**	**5.00**	**5.00**
Downside risk	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25
50-yr gilt											
Upside risk	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	**4.25**	**4.25**	**4.50**	**4.75**	**4.75**	**4.75**	**4.75**	**4.50**	**4.50**	**4.50**	**4.50**
Downside risk	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25

- The recovery in growth is likely to be slow, uneven and more "Square root" than "V" shaped.
- The initial reaction to the CSR is positive but implementation risks remain.
- The path of base rates reflects the fragility of the recovery and the significantly greater fiscal tightening of the emergency budget. With growth and underlying inflation likely to remain subdued, the Bank will stick to its lower for longer stance on policy rates.
- Uncertainty surrounding Eurozone sovereign debt and the risk of contagion will remain a driver of global credit market sentiment.

Underlying assumptions:

- The framework and targets announced in the Comprehensive Spending Review (CSR) to reduce the budget deficit and government debt are the same as announced in June and focus on how the cuts are to be distributed. The next big fiscal milestone will be the Office Of Budget Responsibility's assessment of the CSR's implications for growth, employment and inflation.
- The minutes of the Monetary Policy Committee's meeting suggest an increased likelihood of further Quantitative Easing. Money supply is weak and growth prospects remain subdued. The analysis and projections in November's Quarterly Inflation Report will give the Bank of England the opportunity to re-evaluate the outlook for economic activity and inflation and the fiscal impact of the CSR.
- Consumer Price Inflation is stubbornly above 3% will likely spike above 4% in January as VAT, Utilities and Rail Fares are increased.

- Unemployment remains near a 16 year high at just under 2.5 Million. And is set to increase as the Public Sector shrinks. Meanwhile employment is growing but this is due to part time work, leaving many with reduced income.
- Recently announced Basel III capital/liquidity rules and extended timescales are positive for banks. Restructuring of UK bank balance sheets is ongoing and expected to take a long time to complete. This will be a pre-condition for normalisation of credit conditions and bank lending.
- Mortgage repayment, a reduction in net consumer credit and weak consumer confidence are consistent with lower consumption and therefore future trend rate of growth despite Q3's fairly strong performance.
- The US Federal Reserve downgraded its outlook for US growth; the Fed is concerned enough to signal further QE through asset purchases might be required. Industrial production and growth in the Chinese economy are showing signs of slowing. Both have implications for the global economy.