By:	John Simmonds - Cabinet Member for Finance Nick Vickers - Head of Financial Services
To:	Governance and Audit Committee – 16 March 2011
Subject:	**TREASURY MANAGEMENT QUARTER 3 REVIEW 2010-11**
Classification:	Unrestricted

Summary: To present the Treasury Management Quarter 3 Review.

FOR ASSURANCE

---

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 2010 and February 2011

1.3 At its meeting on 8 December 2010 the Treasury Advisory Group (TAG) members received some training from the Council's investment advisor Arlingclose and considered the Treasury Management Strategy for 2011-12 for recommendation to Cabinet. TAG members continue to receive weekly details of the KCC deposit portfolio and monthly reports.

1.4 This report for the third quarter to 31 December 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 BORROWING REQUIREMENT AND STRATEGY

	Balance 01/04/10 £000s	Debt Maturing £000s	Debt Repaid £000s	New Borrowing £000s	Balance 31/12/10 £000s	Increase/ Decrease £000s
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

2.1 PWLB Borrowing Rates post-CSR: Announced in the Spending Review on 20th October was the instruction from HM Treasury to the PWLB to increase the interest rate on all new loans by an average of 1% above UK Government Gilts. PWLB Circular 147 released on the same day detailing the changes to the rate setting system. The new borrowing rates for fixed loans increased by approximately 0.87% across all maturities, and variable rates by 0.90%. Premature repayment rates did not benefit from the corresponding increase and the PWLB's methodology remained unchanged. HM Treasury determined that these changes ensured that the rate at which loans are made available to local authorities better reflect the availability of capital funding post-Spending Review and will encourage optimal borrowing and investment decisions.

2.2 During the quarter due to the rise in PWLB rates the differential between debt costs and investment earnings continued to be significant. The Council therefore maintained its strategy of funding capital expenditure from internal resources as well as consider borrowing at advantageous points in interest rate cycles.

2.3 During the quarter the Council did not undertake any borrowing or rescheduling of existing debt.

2.4 Changes in the debt portfolio over the 9 months of 2010 -11 have achieved a reduction in the overall debt cost by £4.2m whilst increasing the average life from 27.22 years to 27.8 years.

3 INVESTMENT STRATEGY

3.1 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.

3.2 Deposits

	Balance 01/04/10 £000s	Deposits Made £000s	Deposits Repaid £000s	Balance 31/12/10 £000s	Increase/ (Decrease) £000s
Short Term Deposits	210,220	2,270,547	2,299,296	181,471	(28,749)
Long Term Deposits	55,000	0	25,000	30,000	(25,000)
TOTAL DEPOSITS	265,220	2,270,547	2,324,296	211,471	(53,749)

3.3 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 deposits to the Debt Management Office and with UK Banks and Building Societies systemically important to the UK banking system.

3.4 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

3.5 The counterparties currently approved by Cabinet are:

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

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

3.6 In June Cabinet approved an increase in duration to 1 year however during the 3 months the majority of deposits continued to be of 6 months or less duration.

.

3.7 Counterparty credit quality has been maintained through the nine months of 2010 -11, 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-
31/12/2010	3.8	AA-	4.2	AA-

<u>Scoring:</u>
-Value weighted average reflects the credit quality of deposits according to the size of the deposit
-Time weighted average reflects the credit quality of deposits 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

3.8 Average cash balances were £268m during the quarter. These included schools balances in the corporate scheme (£68.8m), KCC working capital (£60m) created by differences in income and expenditure profiles, Iceland deposits (£42m) and other reserves and funds held in trust

3.9 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 0.67% and the Council's forecast investment income for the year has been estimated at £2.1m / 0.74% for the whole year.

3.10 Icelandic Deposits Update

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.

- Court hearings to secure our preferred creditor status take place in Iceland on 17-18 February on Landsbanki and 11 March on Glitnir. The court decisions are expected in two months.

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

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. OUTLOOK FOR QUARTER 4

At the time of writing this activity report in February 2011, the outlook for interest rates is as follows:

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun - 13	Sep - 13	Dec - 13	Mar - 14
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	+0.50	+0.50	+0.50
Central Case	0.50	0.50	0.75	1.00	1.25	1.50	2.00	2.50	2.75	2.75	3.00	3.00	3.00
Downside risk	-	-	-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50

- The recovery in growth is likely to be slow and uneven.
- The upward revision to the Bank's inflation projection increases the risk of a rate hike sooner than forecast, but it is not a foregone conclusion given the precarious outlook for growth. Rates will rise once there is firm evidence the economy has survived the fiscal consolidation.
- Gilts will be vulnerable as investors respond to the difference between the theory and practice of the government's deficit reduction plans in the CSR.
- Consumer Price Inflation has risen to 4% reflecting sharp increases in commodity and import prices and the increase in VAT. The Bank of England's February Inflation Report's shows CPI rising further throughout 2011 with a higher inflation profile than the November report
- The underlying momentum in the economy is weak. Whilst there will be a bounce back from the 2010 Q4 fall in GDP of 0.5%, the outlook for growth remains uncertain. The strength of the recovery is likely to be tempered by the reduced purchasing power of households due to high consumer prices, the impact of the recession, and adjustment of personal balance sheets with higher savings and debt repayment.
- Consumer confidence and spending continues to be affected by modest wage increases, weak house price growth and dearth of

cheap credit. Unemployment remains near a 16 year high at just over 2.5million and is set to increase as the Public Sector shrinks.

- With the full impact of the national insurance increases, tax rises and public spending cuts yet to be felt, it is unlikely that the MPC would take any risks with economic recovery by raising interest rates soon.
- The framework announced in the Comprehensive Spending Review (CSR) to reduce the budget deficit and government debt will be put to the test; meeting the 2010 borrowing target of £149bn will be crucial to the gilt market's confidence in the credibility of the deficit reduction plans.
- The ECB has maintained rates at 1%. Whilst inflation remains high, there is a growing divergence in the business cycles and GDP outlook for the core and peripheral countries as well as the speed at which fiscal deficits and high debt levels are being addressed.
- Uncertainty surrounding Eurozone sovereign debt and the risk of contagion will remain a driver of global credit market sentiment.

7. TREASURY ADVISERS

7.1 KCC continues to use two firms of treasury advisers; Arlingclose and Sector. Both contracts run to 31 March 2011 and the service has been retendered from 1 April 2011.

8. TRAINING

8.1 The Director of Finance provides training to individuals and groups. KCC officers and Members have attended conferences and workshops organised by CIPFA and Arlingclose. Members have also received training from Arlingclose at TAG meetings.

9. SUMMARY

9.1 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 third 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.

10. RECOMMENDATION

10.1 Members are asked to note this report.

Alison Mings
Treasury and Investments Manager
7000-6294