

By: Mr J Simmonds – Cabinet Member for Finance and Business Support
Mr A Wood – Acting Corporate Director of Finance & Procurement

To: County Council – 20 October 2011

Subject: **Treasury Management Annual Review – 2010/11**

Classification: Unrestricted

Summary: **This report invites the County Council to approve the annual review of treasury management activity for 2010/11**

1. At its meeting on 30 June 2011, the Governance and Audit Committee considered and approved the Treasury Management Annual Review for 2010/11 (attached as **Appendix 1**) for onward submission to the County Council. The review report included a high rating from Internal Audit, which had been reported to the quarterly meeting of the Treasury Advisory Group.
2. During the discussion of the report at the Governance and Audit Committee meeting, the Head of Financial Services replied to questions from Members of the Committee by saying that it was anticipated that, assuming that the County Council maintained its Preferred Creditor status, it was projected that 95% of its investment in Icelandic Banks would be recovered. He also informed the Committee that the Treasury Advisory Group was meeting in July to look at the approach to counter parties. The Treasury Advisory Group met twice in July and determined that no changes could be made to counter parties given the volatility of financial markets.

3. **RECOMMENDATION**

That the County Council agrees to note the Treasury Management Annual Review for 2010/11.

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By: Cabinet Member for Finance
Acting Director of Finance & Procurement

To: Governance and Audit Committee – 30 June 2011

Subject: **Treasury Management Annual Review 2010-11**

Classification: Unrestricted

Summary: To report a summary of Treasury Management activities in 2010-11

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 local 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. When this report is agreed by this Committee it will then go forward to full Council.

ECONOMIC BACKGROUND

3. At the time of determining the strategy for 2010-11, interest rates were expected to remain low in response to the fragile state of the UK economy. Spending cuts and tax increases seemed inevitable post the General Election if the government had a clear majority. The markets had, at the time, viewed a hung parliament as potentially disruptive particularly if combined with a failure to articulate a credible plan to bring down government borrowing. The outlook for growth was uncertain due to consumers and corporates trimming their spending and financial institutions exercising restraint in new lending.
4. The economy’s two headline indicators moved in opposite directions – growth was lacklustre whilst inflation spiked sharply higher. The economy grew by just 1.3% in calendar year 2010; the forecast for 2011 was revised down to 1.7% by the Office of Budget Responsibility in March. Higher commodity, energy and food prices and the increase in VAT to 20% pushed the February 2011 annual inflation figure to 4.4%. The Bank Rate was held at 0.5% as the economy

grappled with uneven growth and the austerity measures set out in the coalition government's Comprehensive Spending Review.

5. Gilts benefitted from the Comprehensive Spending Review (CSR) plans as well as from their relative 'safe haven' status in the face of European sovereign weakness. 5-year and 10-year gilt yields fell to lows of 1.44% and 2.83% respectively. However yields rose in the final quarter across all gilt maturities on concern that higher inflation would become embedded and greatly diminish the real rate of return for fixed income investors.
6. During the year money market rates increased marginally at the shorter end (overnight to 3 months). 6-12 month rates increased by between 0.25% to 0.3% over the 12 month period reflecting the expectation that the Bank Rate would be raised later in 2011. Relevant interest rate indices are attached in Appendix A.

BORROWING REQUIREMENT AND DEBT MANAGEMENT

7. The overall borrowing position is summarised below:

	Balance on 31/3/2010 £000's	Debt Maturing £000's	New Borrowing £000's	Balance on 31/3/2011 £000's	Increase in Borrowing £000's
Capital Funding Requirement	1,236,211			1,309,517	
Short Term Borrowing					
Long Term Borrowing	1,042,363	46,030	100,000	1,096,333	53,970
TOTAL EXTERNAL DEBT	1,042,363	46,030	100,000	1,096,333	53,970

8. Following the CSR on 20 October 2010, on instruction from HM Treasury, the PWLB increased the margin for new borrowing to average 1% above the yield on the corresponding UK Government Gilt. New fixed rate borrowing rates increased by approximately 0.87% across all maturities, and new variable rate borrowing rates by 0.90%. Premature repayment rates did not benefit from the increase in the margin which potentially makes future rescheduling of PWLB loans more challenging.

9. The type of borrowing taken was:

Loans Borrowed during 2010-11	Principal £000's	Average Rate %	Average Maturity (years)
PWLB Fixed Rate Maturity Loans	70,000	4.12	39.75
PWLB Fixed Rate EIP Loans	20,000	1.94	10
Market Loans	10,000	4.20	31
Total	100,000		

10. Given the large differential between short and longer term interest rates, which is likely to remain a feature for some time in the future, as well as the pressure on Council finances, the debt management strategy sought to lower debt costs within an acceptable level of volatility (interest rate risk). Changes in the debt portfolio over the year have achieved a reduction in the overall debt cost by £4.6m whilst increasing the average life from 27.22 years to 27.82 years.
11. The PWLB remains the Council's preferred source of borrowing given the transparency and control that its facilities continue to provide.
12. No debt rescheduling was undertaken in the year.

INVESTMENT ACTIVITY

13. The Council held average cash balances of £278.67m during the year. These represented working cash balances/capital receipts, and the Council's reserves. This is a significant reduction in the level of balances which is the result of the deliberate decision to run down balances and defer borrowing (due to the low return on deposits and the lack of counterparties) and the separation of Pension Fund working cash.
14. 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 became 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.
15. The criteria agreed by Cabinet on 2 February 2011 for the approval of counterparties are:
 - A strong likelihood of Government intervention in the event of liquidity issues based on systematic importance to the UK economy.
 - Credit rating (Council's minimum long term counterparty rating of A+ across all 3 rating agencies, Fitch, Standard & Poor's and Moody's).
 - Credit default swaps.
 - Share price.
 - Reputational Issues.
 - Exposure to other parts of the same banking group.
 - Country exposure.

16. The agreed counterparties were:
- Royal Bank of Scotland
 - Lloyds Banking Group
 - Barclays
 - HSBC
 - Santander UK
 - Nationwide
 - Clydesdale Bank
 - Standard Chartered
17. Santander has been suspended since 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.
18. Clydesdale has also been suspended linked to issues in the Australian economy for its parent National Australia Bank. Standard Chartered have not been in the market for deposits. This leaves the Council with the 5 largest UK financial institutions and the Debt Management Office. The Treasury Advisory Group, advised by Arlingclose, continues to look at other options but the parlous state of the banking sector worldwide supports a highly judicious approach.
19. Deposits as at 31 March 2011 are shown in Appendix B.

ICELANDIC EXPOSURE

20. Heritable – this administration, managed by Ernst & Young, continues to run well. The base case forecast return is 79-85p in the £ and to date 56p in the £ has been recovered realising £10.28 m. Quarterly dividends continue to be received.
21. Landsbanki and Glitnir – on 1 April 2011 the Reykjavik District Court ruled that the funds placed by UK local authorities were deposits and enjoy priority status. This was not only the right outcome but the ruling was highly supportive. International bank and bond holder creditors and the Glitnir Winding Up Board are appealing the decisions to the Icelandic Supreme Court as expected. If priority status holds the anticipated level of recoveries are 100% for Glitnir and 95% for Landsbanki.

COMPLIANCE WITH PRUDENTIAL INDICATORS

22. 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 C.

TREASURY ADVISER

23. On 2 March 2011 Arlingclose was appointed by the Acting Director of Finance & Procurement in conjunction with the Treasury Advisory Group as the Council's sole treasury adviser for a 5 year period. This ended the use of both Sector and Arlingclose. Butlers contracts and staff had transferred to Sector in October 2010. The Office of Fair Trading has referred the Butlers acquisition by Sector to the Competition Commission.

RECOMMENDATION

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

Nick Vickers
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Interest Rates

Table 1: Bank Rate, Money Market Rates

Date	Bank Rate	O/N LIBID	7-day LIBID	1-month LIBID	3-month LIBID	6-month LIBID	12-month LIBID	2-yr SWAP Bid	3-yr SWAP Bid	5-yr SWAP Bid
01/04/2010	0.50	0.35	0.35	0.42	0.51	0.81	1.26	1.54	2.07	2.82
30/04/2010	0.50	0.30	0.30	0.43	0.53	0.83	1.29	1.70	2.23	2.95
31/05/2010	0.50	0.45	0.50	0.61	0.60	0.85	1.35	1.46	1.89	2.58
30/06/2010	0.50	0.35	0.35	0.45	0.61	0.94	1.38	1.40	1.79	2.42
31/07/2010	0.50	0.40	0.40	0.50	0.71	1.01	1.46	1.36	1.75	2.39
31/08/2010	0.50	0.40	0.55	0.50	0.71	1.00	1.45	1.20	1.47	2.02
30/09/2010	0.50	0.30	0.25	0.51	0.72	1.01	1.46	1.24	1.51	2.05
31/10/2010	0.50	0.48	0.40	0.51	0.72	1.01	1.46	1.26	1.53	2.08
30/11/2010	0.50	0.40	0.51	0.51	0.72	0.88	1.46	1.32	1.66	2.30
31/12/2010	0.50	0.40	0.40	0.51	0.72	1.01	1.47	1.49	1.94	2.61
31/01/2011	0.50	0.40	0.55	0.52	0.64	1.04	1.52	1.74	2.21	2.90
28/02/2011	0.50	0.40	0.54	0.53	0.68	1.09	1.56	1.85	2.29	2.95
31/03/2011	0.50	0.30	0.50	0.54	0.80	1.11	1.58	1.85	2.31	2.96
Minimum	0.50	0.30	0.25	0.42	0.51	0.75	1.00	1.13	1.37	1.92
Average	0.50	0.39	0.43	0.50	0.67	0.98	1.44	1.50	1.90	2.54
Maximum	0.50	0.55	0.55	0.80	0.80	1.11	1.58	1.97	2.49	3.19
Spread		0.25	0.30	0.38	0.29	0.36	0.58	0.84	1.12	1.26

Table 2 : PWLB Borrowing Rates - Fixed Rate, Maturity Loans

Change Date	Notice No	1 year	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
01/04/2010	064/10	0.81	2.84	4.14	4.21	4.60	4.61	4.63
30/04/2010	089/10	0.85	2.86	4.13	4.20	4.61	4.61	4.60
28/05/2010	127/10	0.73	2.46	3.76	3.83	4.36	4.38	4.38
30/06/2010	171/10	0.67	2.27	3.54	3.62	4.22	4.28	4.27
30/07/2010	217/10	0.70	2.29	3.55	3.62	4.32	4.41	4.40
31/08/2010	259/10	0.63	1.84	3.05	3.13	3.82	3.93	3.93
30/09/2010	303/10	0.64	1.88	3.14	3.86	4.00	4.03	4.02
29/10/2010	346/10	1.58	2.90	4.23	5.06	5.2	5.22	5.2
30/11/2010	390/10	1.56	3.05	4.40	5.18	5.26	5.25	5.23
31/12/2010	430/10	1.65	3.33	4.58	5.18	5.23	5.20	5.16
31/01/2011	040/11	1.79	3.57	4.80	5.40	5.46	5.44	5.40
28/02/2011	080/11	1.87	3.61	4.75	5.33	5.38	5.35	5.31
31/03/2011	126/11	1.89	3.57	4.71	5.27	5.30	5.27	5.24
	Low	0.60	1.81	3.05	3.82	3.93	3.93	3.92
	Average	1.19	2.79	4.05	4.72	4.79	4.78	4.76
	High	1.99	3.84	5.00	5.50	5.55	5.53	5.48

Table 3: PWLB Borrowing Rates - Fixed Rate, EIP Loans

Change Date	Notice No	1 year	4¹/₂-5 yrs	9¹/₂-10 yrs	19¹/₂-20 yrs	29¹/₂-30 yrs	39¹/₂-40 yrs	49¹/₂-50 yrs
01/04/2010	064/10	--	1.78	2.94	4.18	4.53	4.60	4.62
30/04/2010	089/10	--	1.82	2.96	4.16	4.53	4.61	4.62
28/05/2010	127/10	--	1.52	2.55	3.79	4.24	4.36	4.39
30/06/2010	171/10	--	1.38	2.36	3.58	4.06	4.23	4.27
30/07/2010	217/10	--	1.42	2.38	3.58	4.11	4.33	4.40
31/08/2010	259/10	--	1.12	1.92	3.09	3.61	3.82	3.91
30/09/2010	303/10	--	1.14	1.96	3.18	3.67	3.87	3.96
29/10/2010	346/10	--	2.11	2.98	4.27	4.84	5.07	5.16
30/11/2010	390/10	--	2.19	3.14	4.44	4.99	5.19	5.25
31/12/2010	430/10	--	2.43	3.42	4.62	5.05	5.19	5.23
31/01/2011	040/11	--	2.62	3.66	4.84	5.25	5.40	5.45
28/02/2011	080/11	--	2.71	3.69	4.79	5.18	5.33	5.38
31/03/2011	126/11	--	2.69	3.65	4.74	5.14	5.28	5.31
	Low		1.10	1.89	3.09	3.61	3.82	3.91
	Average		1.91	2.87	4.08	4.55	4.72	4.77
	High		2.88	3.93	5.03	5.38	5.51	5.55

Deposits as at 31 March 2011

Instrument Type	Counterparty	Principal Deposit Amount at 31/03/11	End Date	Interest Rate	Territory
Fixed Deposit	Dexia Bank	£10,000,000	31/10/2011	0.5050	Belgian Bank
	Total Belgian Bank Deposits	£10,000,000			
	Total Icelandic Bank Deposits	£41,155,209			
Fixed Deposit	Barclays Bank	£5,000,000	31/05/2013	6.8000	UK Bank
Fixed Deposit	Barclays Bank	£5,000,000	08/08/2011	1.0900	UK Bank
Fixed Deposit	Barclays Bank	£5,000,000	06/09/2011	1.1700	UK Bank
Fixed Deposit	Lloyds TSB	£5,000,000	05/04/2011	1.1700	UK Bank
Fixed Deposit	Lloyds TSB	£5,000,000	05/07/2011	1.3000	UK Bank
Fixed Deposit	Lloyds TSB	£5,000,000	07/10/2011	1.6000	UK Bank
Fixed Deposit	Lloyds TSB	£5,000,000	09/01/2012	2.0000	UK Bank
LIBOR Fixed Deposit	Royal Bank of Scotland	£5,000,000	19/09/2011	1.0556	UK Bank
Fixed Deposit	Royal Bank of Scotland	£5,000,000	06/01/2012	1.4000	UK Bank
LIBOR Fixed Deposit	Royal Bank of Scotland	£5,000,000	18/10/2013	1.3700	UK Bank
Same Day Call Deposit	Bank of Scotland	£19,999,975	n/a	0.8500	UK Bank
Same Day Call Deposit	Barclays Bank	£25,000,000	n/a	0.7000	UK Bank
Same Day Call Deposit	Royal Bank of Scotland	£20,600,000	n/a	1.1500	UK Bank
	Total UK Bank Deposits	£115,599,975			
Fixed Deposit	Nationwide Building Society	£5,000,000	05/05/2011	0.7400	UK Building Society
Fixed Deposit	Nationwide Building Society	£5,000,000	06/06/2011	0.8500	UK Building Society

Instrument Type	Counterparty	Principal Deposit Amount at 31/03/11	End Date	Interest Rate	Territory
LIBOR Fixed Deposit	Principality Building Society	£5,000,000	21/04/2011	1.3756	UK Building Society
	Total UK Building Society Deposits	£15,000,000			
Fixed Deposit	Debt Management Office	£18,000,000	01/04/2011	0.2500	UK Govt.
Fixed Deposit	Debt Management Office	£2,800,000	05/04/2011	0.2500	UK Govt.
Fixed Deposit	Debt Management Office	£8,000,000	06/04/2011	0.2500	UK Govt.
Fixed Deposit	Debt Management Office	£10,000,000	07/04/2011	0.2500	UK Govt.
Fixed Deposit	Debt Management Office	£8,950,000	08/04/2011	0.2500	UK Govt.
	Total UK Govt. Deposits	£47,750,000			
	Grand Total of All Deposits	£229,505,184			

PRUDENTIAL INDICATORS**1. Estimate of capital financing requirement (underlying need to borrow for a capital purpose)**

Estimates of the Council's cumulative maximum external borrowing requirement for 2010 -11 to 2012 -13 are shown in the table below:

	31/3/2010 Actual £000s	31/3/2011 Actual £000s	31/3/2012 Estimate £000s	31/3/2013 Estimate £000s
Capital Financing Requirement	1,236,211	1,309,517	1,308,640	1,300,156
Less: Existing Profile of Borrowing	1,042,363	1,096,333	1,096,333	1,096,333
Less: Other Long Term Liabilities	0	0	0	0
Cumulative Maximum External Borrowing Requirement	193,848	213,184	212,307	203,823

In the light of current commitments and planned expenditure, forecast net borrowing by the Council will not exceed the Capital Financing Requirement.

2. Operational Boundary for External Debt

The operational boundary for debt is determined having regard to actual levels of debt, borrowing anticipated in the capital plan, the requirements of treasury strategy and prudent requirements in relation to day to day cash flow management. The operational boundary for debt has not been exceeded in 2010 -11

(a) Operational boundary for debt relating to KCC assets and activities

	Prudential Indicator 2010-11 revised £m	Actual as at 31/3/2011 £m
Borrowing	1,142	1,046
Other Long Term Liabilities	0	0
	<hr/> 1,142	<hr/> 1,046

- (b) Operational boundary for total debt managed by KCC including that relating to Medway Council etc (pre Local Government Reorganisation)

	Prudential Indicator 2010-11 revised £m	Actual as at 31/3/2011 £m
Borrowing	1,192	1,096
Other Long Term Liabilities	0	0
	1,192	1,096

3. **Authorised Limit for External Debt**

The authorised limit includes additional allowance, over and above the operational boundary to provide for unusual cash movements. It is a statutory limit set and revised by the County Council. The revised limits for 2010 -11 are:

- (a) Authorised limit for debt relating to KCC assets and activities

£m	
Borrowing	1,182
Other long term liabilities	0
	1,182

- (b) Authorised limit for total debt managed by KCC including that relating to Medway Council etc

£m	
Borrowing	1,232
Other long term liabilities	0
	1,232

The additional allowance over and above the operational boundary has not needed to be utilised and external debt, has and will be maintained well within the authorised limit.

4. **Upper Limits for Fixed Interest Rate and Variable Interest Rate Exposures**

- These 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 allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of deposits.

	Limits for 2010/11 %
Upper Limit for Fixed Rate Exposure	100
Compliance with Limits:	Yes
Upper Limit for Variable Rate Exposure	50
Compliance with Limits:	Yes

5. 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.

Maturity Structure of Fixed Rate Borrowing	Upper Limit %	Lower Limit %	Actual Fixed Rate Borrowing as at 31/03/11 £000's	% Fixed Rate Borrowing as at 31/03/11	Compliance with Set Limits?
under 12 months	25	0	57,024	5.20	Yes
12 months and within 24 months	40	0	77,021	7.03	Yes
24 months and within 5 years	60	0	91,209	8.32	Yes
5 years and within 10 years	80	0	108,003	9.85	Yes
10 years and above	90	40	763,076	69.60	Yes

6. Upper Limit for Principal Sums Invested for Periods Longer than 364 days

- This indicator allows the Council to manage the risk inherent in deposits longer than 364 days.
- The limit for 2010 -11 was set at £50m.
- The Council's policy has been to keep deposit maturities to a maximum of 12 months and no deposits were made for a period greater than 364 days during this period.