By: John Simmonds, Cabinet Member for Finance & Business Support

To: County Council – 13 September 2012

Subject: Treasury Management Annual Review 2011-12

Classification: Unrestricted

Summary: To report a summary of Treasury Management activities in 2011-12

FOR INFORMATION

INTRODUCTION

1. The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which requires local authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities at least twice a year.

2. Treasury Management is defined as: "the management of the local Council'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".

   Overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

3. This report:

   - Is prepared in accordance with the revised CIPFA Treasury Management Code and the revised Prudential Code;
   - Reports on the implications of treasury decisions and transactions;
   - Gives details of the outturn position on treasury management transactions in 2011-12;
   - Confirms compliance with Treasury limits and Prudential Indicators.

4. This report was agreed by Governance & Audit Committee on 26 July.

ECONOMIC BACKGROUND

5. At the time of determining the strategy in March 2011, there were tentative signs that the UK was emerging from recession with the worst of the financial crisis behind it. Recovery in growth was expected to be slow and uneven as the

austerity measures announced in the 2010 Comprehensive Spending Review were implemented in order to bring down the budget deficit and government borrowing and rebalance the economy and public sector finances. Inflation measured by the Consumer Price Index (CPI) had remained stubbornly above 3%; unemployment was at a 16 year high at 2.5 million and was expected to rise further as the public and private sector contracted. There was also a high degree of uncertainty surrounding Eurozone sovereign debt sustainability.

Inflation

6. During 2011-12 inflation remained high with CPI (the official measure) and RPI rising in September to 5.2% and 5.6% respectively primarily due to escalating utility prices and the January 2011 increase in VAT to 20%. Inflation eased slowly as reductions in transport costs, food prices intensifying competition amongst retailers and supermarkets and the VAT effect falling out in 2012, pushed February 2012's CPI down to 3.4% and RPI to 3.7%. This, however, was not enough to offset low wage growth and, as a result, Britons suffered the biggest drop in disposable income in more than three decades.

Growth, Employment, House Prices

7. Growth, on the other hand, remained elusive. The Bank's Quarterly Inflation Reports painted a bleak picture as the outlook was downgraded to around 1% in 2011 and 2012 alongside. The unresolved problems in the Eurozone weighed negatively on global economic prospects. UK GDP was positive in only the first and third calendar quarters of 2011; annual GDP to December 2011 registered just 0.5%. Unemployment rose to 2.68 million and, worryingly, youth unemployment broke through the 1 million barrier. House prices struggled to show sustained growth and consumer confidence remained fragile.

Monetary Policy

8. (1) It was not surprising that the Bank of England's Monetary Policy Committee maintained the status quo on the Bank Rate which has now been held at 0.5% since March 2009, but increased asset purchases by £75bn in October 2011 and another £50bn in February 2012 taking the Quantitative Easing (QA) total to £325bn.

(2) The policy measures announced in the March 2012 Budget Statement were judged to be neutral. The government stuck broadly to its austerity plans as the economy was rebalanced slowly. The opinion of the independent Office for Budget Responsibility (OBR) was that the government was on track to meet its fiscal targets; the OBR identified oil price shocks and a further deterioration in Europe as the main risks to the outlook for growth and in meeting the fiscal target.

US

9. The US economy continued to show tentative, positive signs of growth alongside a gradual decline in the unemployment rate. The US Federal Reserve (the Fed) committed to keeping policy rates low until 2014, although a modest shift in the Fed's language in March, alongside an improvement in

economic activity, cast doubts about the permanence of the Fed's policy commitment.

Europe

10 (1) In Europe, sovereign debt problems for some peripheral countries became critical. Several policy initiatives were largely ineffectual; two bailout packages were required for Greece and one for Portugal, and the contagion spread to Spain and Italy whose sovereign bonds came under increased stress in November. Standard & Poor's downgraded nine European sovereigns and the EFSF bailout fund. The successful Greek sovereign bond swap in March 2012 shortly after its second bailout package allowed it to avoid bankruptcy later that month, but it was not a long-term solution. The ECB's €1.3 trillion Long-Term Refinancing Operations (LTROs) flooded the financial markets with ultra-cheap 3-year liquidity and relieved much of the immediate funding pressure facing European banks in 2012, but markets ultimately took the view that the LTROs simply served to delay a resolution of, rather than addressed, the fundamental issues underpinning Euroland's problems.

(2) Market sentiment oscillated between 'risk on' / 'risk off' modes, this swing becoming the norm for much of 2011-12 as investors shifted between riskier assets and the relative safety of higher quality government bonds. Gilts, however, were a principal beneficiary of the 'risk-off' theme which helped push yields lower. There was little market reaction to or impact on gilts by the decision by Fitch and Moody's to change the outlook on the UK's triple A rating from stable to negative. Over the 12-month period from April 2011 to March 2012, 5-year gilt yields more than halved from 2.40% to 1.06%; 10-year gilt yields fell from 3.67% to 2.25%; 20-year yields fell from 4.30% to 3.20% and 50-year yields from 4.20% to 3.35%. PWLB borrowing rates fell commensurately but the cost of carry associated with borrowing longer-term loans whilst investing the monies temporarily until required for capital financing remained high, in excess of 4.1% for 20-year PWLB Maturity borrowing.

Credit

11. Europe's banking sector was inextricably linked with the sovereign sector. Sharp moves in sovereign CDS and bond yields were fairly correlated with the countries' banking sector performance. The deterioration in the prospects for real growth had implications for earnings and profit growth and banks' creditworthiness. The European Banking Council's banking stress tests of 70 EU banks undertaken in October 2011 identified a collective €106 billion shortfall to banks' Core Tier 1 ratio of 9%. The slowdown in debt and equity capital Market activity also had implications for banks' funding and liquidity. These principal factors, as well as a reassessment by the rating agencies of future sovereign support for banks, resulted in downgrades to the long-term ratings of several UK and non-UK financial institutions in autumn 2011.

BORROWING REQUIREMENT AND DEBT MANAGEMENT

12. The overall borrowing position is summarised opposite:

	Balance on 31/3/2011 £000's	Debt Maturing £000's	New Borrowing £000's	Balance on 31/3/2012 £000's	Avg Rate %
Capital Funding Requirement	1,309,517				
Short Term Borrowing	0	0	0	0	0
Long Term Borrowing	1,096,333	57,024	50,000	1,089,309	5.30
TOTAL EXTERNAL DEBT	1,096,333	57,024	50,000	1,089,309	5.30

13. The PWLB remains the Council's preferred source of borrowing given the transparency and control that its facilities continue to provide.

Loans Borrowed during 2011-12	Principal £000's	Average Rate %	Average Maturity (years)
PWLB Fixed Rate Maturity Loans	0	0	0
PWLB Fixed Rate EIP Loans	0	0	0
Market Loans	50,000	3.83	46.5
Total	50,000	3.83	46.5

14. As significant cuts to local government funding have put pressure on Council finances, the strategy followed was to minimise debt interest payments without compromising the longer-term stability of the portfolio. The differential between the cost of new longer-term debt and the return generated on the Council's temporary investment returns was significant (between 2% - 4%). The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding £7.024m of maturing loans as well as £14.83m of capital expenditure. This has, for the time being, lowered overall treasury risk by reducing both external debt and temporary investments. This strategy is expected to be maintained in 2012/13.

15. No debt rescheduling was undertaken in the year.

16. Changes in the debt portfolio have increased the average life from 27.82 years to 30.13 years.

INVESTMENT ACTIVITY

17. The CLG's Investment Guidance requires local authorities to focus on security and liquidity, rather than yield.

18. 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 2011-12. Investments during the year included

- Deposits with the Debt Management Office
- Call accounts and deposits with Banks and Building Societies systemically important to the UK. These were:
  - Royal Bank of Scotland (RBS) Group
  - Lloyds Banking Group
  - Barclays
  - HSBC
  - Santander UK
  - Nationwide
  - Standard Chartered

19. Counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swaps, GDP of the country in which the institution operates, the country's net debt as a percentage of GDP, any potential support mechanisms and share price. The minimum long-term counterparty credit rating determined for the 2011-12 treasury strategy was A+ across rating agencies Fitch, S&P and Moody's. Downgrades in autumn 2011 of the long-term ratings of the RBS Group, the Lloyds Banking Group and Nationwide resulted in their ratings falling below the Authority's minimum threshold of A+. The downgrades were driven principally by the agencies' view of the extent of future government support (flowing from the recommendations to the government from the Independent Commission on Banking) rather than a deterioration in the institutions' creditworthiness. Further use of these counterparties was suspended until a revised criterion of A- was approved by Cabinet in February 2012. Santander UK remained suspended throughout the year.

20. In keeping with CLG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of overnight deposits and of call accounts.

21. The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Bank Rate was maintained at 0.5% through the year. The Council considered an appropriate risk management response to uncertain and deteriorating credit conditions in Europe was to shorten maturities for new investments.

22. The Council's investment income for the year was £1.7m compared with a budget of £2.0m. The Council held average cash balances of £307.98m during the year. These represented working cash balances / capital receipts, and the Council's reserves.

23. All investments made during the year complied with the Council's agreed Treasury Management Strategy, Prudential Indicators, Treasury Management Practices and prescribed limits. No control issues were identified when the treasury management activities were once again subject to internal audit by Deloittes.

24. Deposits as at 31 March 2012 are shown in Appendix 1.

ICELANDIC EXPOSURE

25. The Council had an exposure of £50.35m to Icelandic Banks (£15.0m Glitnir, £17.0m Landsbanki and £18.35m Heritable). In October 2011 the Icelandic Supreme Court confirmed that UK local authorities were preferred creditors in Glitnir and Landsbanki. This will result in 100% recoveries on both banks.

26. Glitnir – in March 2012 a full recovery was made – 18% of the total payment was in Icelandic Krona and this is still held in an escrow account in Iceland. UK local Council representatives continue to pursue a resolution of this issue.

27. Landsbanki – dividends to the value of 43p in the £ have now been made – only 2% was in Icelandic Krona. Regular dividend payments will now be made.

28. Heritable – the estimated recovery is 90% and to date 75% has been received.

29. Total recoveries received to date are £35.3m. The Council will comply with the CIPFA Guidance on the accounting arrangements for the deposits and dividends.

COMPLIANCE WITH PRUDENTIAL INDICATORS

30. The Council can confirm that it has complied with its Prudential Indicators for 2011-12, which were set as part of the Council's Treasury Management Strategy Statement. Details can be found in Appendix 2.

TREASURY ADVISER

31. KCC currently employs Arlingclose as Treasury Advisers.

RECOMMENDATION

32. Members are asked to note the report.

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Appendix 1

Deposits as at 31 March 2012

Instrument Type	Counterparty	Principal Amount	End Date	Interest Rate	Territory
	Total Icelandic Bank Deposits	**£21,131,926.92**			
Same Day Call Deposit	Bank of Scotland	£34,000,000.00	n/a	0.75	UK Bank
Fixed Deposit	Barclays Bank	£5,000,000.00	31/05/2013	6.8	UK Bank
Fixed Deposit	Barclays Bank	£2,000,000.00	10/04/2012	1.359	UK Bank
Fixed Deposit	Barclays Bank	£5,000,000.00	08/06/2012	1.37	UK Bank
Same Day Call Deposit	Barclays Bank	£22,000,000.00	n/a	0.5	UK Bank
Fixed Deposit	Barclays Bank	£3,000,000.00	28/05/2012	0.72	UK Bank
Fixed Deposit	HSBC	£5,000,000.00	02/04/2012	0.4	UK Bank
Fixed Deposit	HSBC	£4,000,000.00	03/04/2012	0.4	UK Bank
Fixed Deposit	HSBC	£6,000,000.00	04/04/2012	0.4	UK Bank
Fixed Deposit	HSBC	£9,200,000.00	10/04/2012	0.4	UK Bank
Fixed Deposit	HSBC	£7,400,000.00	13/04/2012	0.4	UK Bank
Fixed Deposit	HSBC	£8,000,000.00	11/04/2012	0.4	UK Bank
Fixed Deposit	Lloyds TSB	£4,000,000.00	08/05/2012	2.1	UK Bank
Fixed Deposit	Lloyds TSB	£5,000,000.00	26/06/2012	1.4	UK Bank
Fixed Deposit	Lloyds TSB	£5,000,000.00	31/05/2012	0.75	UK Bank
Fixed Deposit	Lloyds TSB	£5,000,000.00	29/06/2012	1.4	UK Bank
Fixed Deposit	Lloyds TSB	£6,000,000.00	10/05/2012	0.65	UK Bank
Same Day Call Deposit	NatWest	£35,000,000.00	n/a	1.15	UK Bank
LIBOR Fixed Deposit	Royal Bank of Scotland	£5,000,000.00	18/10/2013	1.68956	UK Bank
Same Day Call Deposit	Royal Bank of Scotland	£35,000,000.00	n/a	1.25	UK Bank
	Total UK Bank Deposits	**£210,600,000.00**			
Fixed Deposit	Nationwide Building Society	£1,200,000.00	04/05/2012	1.17	UK Building Society
Fixed Deposit	Nationwide Building Society	£10,000,000.00	04/05/2012	0.62	UK Building Society
Fixed Deposit	Nationwide Building Society	£10,650,000.00	25/04/2012	0.55	UK Building Society
Fixed Deposit	Nationwide Building Society	£13,000,000.00	25/06/2012	0.98	UK Building Society
Fixed Deposit	Nationwide Building Society	£1,500,000.00	27/06/2012	0.98	UK Building Society
Fixed Deposit	Nationwide Building Society	£3,650,000.00	30/04/2012	0.55	UK Building Society

Fixed Deposit	Nationwide Building Society	£5,000,000.00	01/06/2012	0.74	UK Building Society
Fixed Deposit	Nationwide Building Society	£5,000,000.00	02/07/2012	1.1	UK Building Society
	Total UK Building Society Deposits	**£50,000,000.00**			
	Grand Total of All Deposits	**£281,731,926.92**			

Appendix 2

PRUDENTIAL INDICATORS

1. Estimate of capital expenditure (excluding PFI)

Actual 2010-11	£377.147m	
Original estimate 2011-12	£305.448m	
Revised estimate 2011-12	£273.377m	(this includes the rolled forward re-phasing from 2010-11)

2. Estimate of capital financing requirement (underlying need to borrow for a capital purpose)

	2010-11 Actual £m	**2011-12 Original Estimate £m**	**2011-12 Outturn as at 31.03.12 £m**
Capital Financing Requirement	1,286.518	1,308.640	1,300.801
Annual increase in underlying need to borrow	36.902	35.527	14.283

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

3. Estimate of ratio of financing costs to net revenue stream

Actual 2010-11	12.85%
Original estimate 2011-12	11.77%
Revised estimate 2011-12	13.98%

The actual 2010-11 and revised estimate 2011-12 includes PFI Finance Lease costs but these costs were not included in the original estimate calculation.

4. 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 will not be exceeded in 2011-12

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

	Prudential Indicator 2011-12 £m	**Position as at 31.03.12 £m**
Borrowing	1,158	1,044
Other Long Term Liabilities	0	0
	1,158	1,044

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

	Prudential Indicator 2011-12 £m	Position as at 31.03.12 £m
Borrowing	1,204	1,089
Other Long Term Liabilities	0	0
	1,204	1,089

5. 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 2011-12 are:

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

	£m
Borrowing	1,198
Other long term liabilities	0
	1,198

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

£m	
Borrowing	1,204
Other long term liabilities	0
	1,204

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.

6. Compliance with CIPFA Code of Practice for Treasury Management in the Public Services

The Council has adopted the Code of Practice on Treasury Management and has adopted a Treasury Management Policy Statement. Compliance has been tested and validated by our independent professional treasury advisers.

7. Upper limits of fixed interest rate and variable rate exposures

The Council has determined the following upper limits for 2011-12

Fixed interest rate exposure	100%
Variable rate exposure	50%

These limits have been complied with in 2011-12.

8. Upper limits for maturity structure of borrowings

	Upper limit	**Lower limit**	**As at 31.03.12**
	%	**%**	**%**
Under 12 months	25	0	0
12 months and within 24 months	40	0	7.07
24 months and within 5 years	60	0	5.44
5 years and within 10 years	80	0	11.02
10 years and within 20 years	25	10	10.74
20 years and within 30 years	25	5	15.92
30 years and within 40 years	25	5	12.01
40 years and within 50 years	25	10	16.59
50 years and within 60 years	30	10	21.21

9. Upper limit for principal sums invested for periods longer than 364 days

Indicator	Actual
£50m	**£10m**