By: John Simmonds, Cabinet Member for Finance and Procurement

To: County Council – 19 September 2013

Subject: Treasury Management Annual Review 2012-13

Classification: Unrestricted

Summary: To report a summary of Treasury Management activities in 2012-13

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".

3. 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.

4. 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 2012-13;

   - Confirms compliance with its Treasury Management Strategy Statement, Treasury Management Practices and Prudential Indicators.

5. This report was agreed by the Governance & Audit Committee on 24 July 2013 prior to being brought to full Council.

Economic Background

6. The global outlook stabilised mainly due to central banks maintaining low interest rates and expansionary monetary policy for an extended period. Equity market assets recovered sharply with the FTSE 100 registering a 9.1% increase over the year. This was despite economic growth in G-7 nations being either muted or disappointing and economic growth in China cooling.

7. In the UK the economy shrank in the first, second and fourth quarters of calendar year 2012. It was the 0.9% growth in the third quarter, aided by the summer Olympic Games, which allowed growth to register 0.2% over the calendar year 2012. The expected boost to net trade from the fall in the value of sterling did not materialise, but raised the price of imports, especially low margin goods such as food and energy. Avoiding a 'triple-dip' recession became contingent on upbeat services sector surveys translating into sufficient economic activity to overhaul contractions in the struggling manufacturing and construction sectors.

8. Household financial conditions and purchasing power were constrained as wage growth remained subdued at 1.2% and was outstripped by inflation. Annual CPI dipped below 3%, falling to 2.4% in June before ticking up to 2.8% in February 2013. Higher food and energy prices and higher transport costs were some of the principal contributors to inflation remaining above the Bank of England's 2% CPI target.

9. The lack of growth and the fall in inflation were persuasive enough for the Bank of England to maintain the Bank Rate at 0.5% and also sanction additional £50 billion asset purchases (QE) in July, taking total QE to £375 billion. The possibility of a rate cut was discussed at some of Bank's Monetary Policy Committee meetings, but was not implemented as the potential drawbacks outweighed the benefits of a reduction in the Bank Rate. In the March 2013 Budget the Bank's policy was revised to include the 2% CPI inflation remit alongside the flexibility to commit to intermediate targets.

10. The resilience of the labour market, with the ILO unemployment rate falling to 7.8%, was the main surprise given the challenging economic backdrop. Many of the gains in employment were through an increase in self-employment and part time working.

11. The Chancellor largely stuck to his fiscal plans with the austerity drive extending into 2018. In March the Office for Budgetary Responsibility (OBR) halved its forecast growth for 2013 to 0.6% which then resulted in the lowering of the forecast for tax revenues and an increase in the budget deficit. The government is now expected to borrow an additional £146bn and sees gross debt rising above 100% of GDP by 2015-16. The fall in debt as a percentage of GDP, which the coalition had targeted for 2015-16, was pushed two years beyond this horizon. With the national debt metrics out of kilter with a triple-A rating, it was not surprising that the UK's sovereign rating was downgraded by Moody's to Aa1. The AAA status was maintained by Fitch and S&P, albeit with a Rating Watch Negative and with a Negative Outlook respectively.

12. The government's Funding for Lending (FLS) initiative commenced in August 2012 which gave banks access to cheaper funding on the basis that it would then result in them passing this advantage to the wider economy. There was an improvement in the flow of credit to mortgagees, but was still below expectation for SMEs.

13. Gilt yields ended the year lower than the start in April. By September the 2-year gilt yield had fallen to 0.06%, raising the prospect that short-dated yields could turn negative. 10-year yields fell by nearly 0.5% ending the year at 1.72%. The reduction was less pronounced at the longer end; 30-year yields ended the year at 3.11%, around 25bp lower than in April. Despite the likelihood that the Debt Management Office would revise up its gilt issuance for 2012-13, there were several gilt-supportive factors: the Bank of England's continued purchases of gilts under an extended QE programme; purchases by banks, insurance companies and pension funds driven by capital requirements and the preference for safe harbour government bonds.

14. One direct consequence of the Funding for Lending Scheme was the sharp drop in rates at which banks borrowed from local government. 3-month, 6-month and 12-month Libid rates which were 1%, 1.33% and 1.84% at the beginning of the financial year fell to 0.44%, 0.51% and 0.75% respectively.

Borrowing Requirement and Debt Management

15. The overall borrowing position is summarised below:

	Balance on 01/04/2012 £m	**Debt Maturing £m**	**New Borrowing £m**	**Balance on 31/3/2013 £m**	**Average Rate %**
CFR	1,496			1,465	
Long Term Borrowing	1,089	77		1,012	5.44
Other Long Term Liabilities	1,134			1,155	
TOTAL EXTERNAL DEBT	2,223			2,167	
Decrease in Borrowing				77	

16. The PWLB remains the Council's preferred source of borrowing given the transparency and control that its facilities continue to provide. The Certainty Rate was introduced by the PWLB in November 2012, allowing the authority to borrow at a reduction of 20bps on the Standard Rate.

17. 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). 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 2-3%). The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding £77.0m of maturing loans as well as £22.3m 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 2013-14.

18. No debt rescheduling was undertaken in the year.

19. Changes in the debt portfolio over the year have achieved a reduction in the overall debt cost by £2.27m whilst reducing the average life from 30.13 years to 29.86 years.

Investment Activity

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

Investment Activity in 2012-13

Investments	Balance on 01/04/2012 £m	Deposits Made £m	Maturities £m	Balance on 31/03/2013 £m	Avg Rate % / Avg Life (yrs)
Short Term Investments	272	2,498	2,509	261	0.81%/ 0.05
Long Term Investments	10	0	10	0	3.95% / 0.36
TOTAL INVESTMENTS	282	2,498	2,519	261	0.93% / 0.06
Decrease in Investments				21	

21. 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 2012-13. Investments during the year included

22. Term Deposits and Certificates of Deposit (CDs) with the following UK Banks and Building Societies systemically important to the UK:

- Barclays
- HSBC
- Lloyds Banking Group
- Royal Bank of Scotland
- NatWest
- Santander UK
- Standard Chartered
- Nationwide

and in T-Bills and DMADF (Debt Management Office) deposits.

23. 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 2012-13 treasury strategy was A-/A-/A3 across rating agencies Fitch, S&P and Moody's. In June 2012 Moody's completed its review of banks with global capital market operations, downgrading the long-term ratings of all of them by between one to three notches. The banks on the Council's lending list which were affected by the ratings downgrades were Barclays, HSBC, Royal Bank of Scotland. Separately, the agency also downgraded the ratings of Lloyds Bank, Bank of Scotland, National Westminster Bank and Santander UK plc. None of the long-term ratings of the banks on the Council's lending list were downgraded to below the Council's minimum A- credit rating threshold.

24. As a result of the ratings downgrades deposit durations were shortened in June. They were then extended at the end of July having taken account of advice from Arlingclose whose assessment of the creditworthiness of the financial institutions had shown continued signs of stabilisation, and in some cases, considerable improvement. At the present time the Council's maximum maturities for new investments are:

- Santander UK - **overnight**
- Royal Bank of Scotland, NatWest, Barclays and Nationwide for a maximum period of **100 days**
- Lloyds TSB and Bank of Scotland, for a maximum period of **6 months**
- HSBC Bank and Standard Chartered for a maximum period of **12 month**

25. At its meeting in September Cabinet approved the use of the following Australian and Canadian counterparties. At the current time not all of the banks listed take deposits and rates are quite low. However, we now have alternative options to using the DMO in the event of further downgrades of UK financial institutions.

- Australia and New Zealand Banking Group
- National Australia Bank
- Westpac Banking Corp
- Commonwealth Bank of Australia
- Bank of Montreal
- Bank of Nova Scotia
- Canadian Imperial Bank of Commerce
- Royal Bank of Canada
- Toronto Dominion Bank

26. The maximum duration is 12 months and the maximum limit with any one bank is £25m with the maximum exposure to either country being £50m. To date no deposits have been made with these counterparties.

27. Counterparty credit quality has weakened slightly as demonstrated by the Credit Score Analysis summarised below. The table in Appendix 4 explains the credit score.

Credit Score Analysis

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

29. 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. Short term money market rates also remained at very low levels (as shown in table 1 in Appendix 3) which had a significant impact on investment income.

30. The Council's investment income for the year was £2.0m compared with a budget of £2.7m. The Council held average cash balances of £297.67m during the year. These represented working cash balances / capital receipts, and the Council's reserves.

31. Deposits as at 31 March 2013 are shown in Appendix 2.

<u>Icelandic Exposure</u>

32. 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.

33. 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 interest bearing escrow account in Iceland. UK local Council representatives continue to pursue a resolution of this issue.

34. Landsbanki – it is expected that 100% will be recovered overall. Dividends to the value of 49.65p in the £ have now been made – only 2% was in Icelandic Krona. Regular dividend payments are expected every December until December 2019.

35. Heritable – formally the expected recovery is 88p/£ and 77.28% has been recovered to date with a further 2% due in 2013-14. There have been positive developments since the CIPFA accounting guidance was issued and the projected recovery will move up significantly in August. 2013.

36. Total recoveries received to date are £36.99m. The Council will comply with the CIPFA Guidance on the accounting arrangements for the deposits and dividends.

Compliance

37. The Council can confirm that it has complied with its Prudential Indicators for 2012-13, which were set as part of the Council's Treasury Management Strategy Statement. Details can be found in Appendix 1.

38. The Council's Treasury activity has complied with its Treasury Management Strategy and Treasury Management Practices. No control issues were identified when the treasury management activities were once again subject to internal audit by Deloittes.

Treasury Adviser

39. KCC currently contracts with Arlingclose as Treasury Advisers.

Recommendation

40. Members are asked to note the report.

Alison Mings
Treasury and Investments Manager
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Appendix 1

2012-13 Prudential Indicators

1. Estimate of capital expenditure (excluding PFI and Schools)

Actual 2011-12 £266m

Original estimate 2012-13 £279m

Revised estimate 2012-13 £207m (this includes the rolled forward re-phasing from 2011-12)

Actual 2012-13 £161m

2. Capital Financing Requirement (CFR)

	2011-12 Actual £m	2012-13 Original Estimate £m	2012-13 Actual £m
CFR	1,496	1,538	1,465
Annual increase/(decrease) in underlying need to borrow	(22)	22	(31)

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 2011-12 12.85%
Original estimate 2012-13 11.77%
Actual 2012-13 14.55%

The 2011-12 and 2012-13 Actual percentages include PFI Finance Lease costs but these were not included in the 2012-13 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.

Operational boundary for debt relating to KCC assets and activities

	2012-13 Approved £m	2012-13 Actual £m
Borrowing	1,154	969
Other Long Term Liabilities	0	1,155
Total	**1,154**	**2,124**

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

	2012-13 Approved £m	**2012-13 Actual £m**
Borrowing	1,198	1,012
Other Long Term Liabilities	0	1,155
Total	**1,198**	**2,167**

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.

Authorised limit for debt relating to KCC assets and activities

	2012-13 Approved £m	**2012-13 Actual £m**
Borrowing	1,195	1,195
Other long term liabilities	0	1,155
Total	**1,195**	**2,350**

Authorised limit for total debt managed by KCC including that relating to Medway Council etc (pre Local Government Reorganisation)

	2012-13 Approved £m	**2012-13 Actual £m**
Borrowing	1,238	1,238
Other long term liabilities	0	1,155
Total	**1,238**	**2,393**

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 2012-13

Fixed interest rate exposure	100%
Variable rate exposure	50%

These limits have been complied with in 2012-13.

8. **Upper limits for maturity structure of Fixed Rate Borrowings**

	Upper limit	Lower limit	Actual
	%	%	%
Under 12 months	10	0	0
12 months and within 24 months	25	0	0.2
24 months and within 5 years	40	0	8.8
5 years and within 10 years	30	0	10.7
10 years and within 20 years	30	10	12.0
20 years and within 30 years	30	5	14.7
30 years and within 40 years	30	5	12.9
40 years and within 50 years	40	10	17.8
50 years and within 60 years	40	10	22.9

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

Approved	Actual
£m	£m
50	10

Appendix 2

Deposits as at 31 March 2013

Instrument Type	Counterparty	Principal Amount	End Date	Interest Rate	Territory
	Total Icelandic Bank Deposits	**£16,342,120**			
Same Day Call Deposit	Bank of Scotland	£15,000,000	n/a	0.75	UK Bank
Fixed Deposit	Bank of Scotland	£5,000,000	07/05/2013	1.6	UK Bank
Fixed Deposit	Bank of Scotland	£5,000,000	30/09/2013	0.8	UK Bank
Fixed Deposit	Barclays Bank	£5,000,000	31/05/2013	6.8	UK Bank
Same Day Call Deposit	Barclays Bank	£19,400,000	n/a	0.35	UK Bank
Same Day Call Deposit	Barclays FIBCA	£20,000,000	n/a	0.7	UK Bank
Fixed Deposit	Lloyds TSB	£5,000,000	03/05/2013	1.6	UK Bank
Same Day Call Deposit	Lloyds TSB	£15,000,000	n/a	0.75	UK Bank
Fixed Deposit	Lloyds TSB	£10,000,000	15/05/2013	0.7	UK Bank
Fixed Deposit	Lloyds TSB	£5,000,000	19/08/2013	0.8	UK Bank
Fixed Deposit	Lloyds TSB	£5,000,000	21/08/2013	0.8	UK Bank
Fixed Deposit	Lloyds TSB	£5,000,000	27/06/2013	0.7	UK Bank
Fixed Deposit	Lloyds TSB	£5,000,000	27/09/2013	0.8	UK Bank
Same Day Call Deposit	NatWest	£25,000,000	n/a	0.8	UK Bank
LIBOR Fixed Deposit	Royal Bank of Scotland	£5,000,000	18/10/2013	1.1113	UK Bank
Same Day Call Deposit	Royal Bank of Scotland	£45,000,000	n/a	1.25	UK Bank
Same Day Call Deposit	Santander UK	£50,000,000	n/a	0.8	UK Bank
	Total UK Bank Deposits	**£244,400,000**			
	Grand Total of All Deposits	**£260,742,120**			

Appendix 3

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
01/04/2012		0.50		0.55	0.55	0.61	1.00	1.33	1.84	1.24	1.30	1.59
30/04/2012		0.50		0.50	0.65	0.60	0.99	1.32	1.84	1.35	1.43	1.68
31/05/2012		0.50		0.48	0.65	0.57	0.97	1.30	1.82	1.20	1.20	1.34
30/06/2012		0.50		0.50	0.50	0.55	0.83	1.13	1.65	0.96	0.99	1.25
31/07/2012		0.50		0.50	0.65	0.45	0.63	0.92	1.43	0.76	0.77	1.02
31/08/2012		0.50		0.50	0.52	0.40	0.57	0.81	1.23	0.75	0.78	1.01
30/09/2012		0.50		0.25	0.52	0.40	0.47	0.66	0.95	0.70	0.76	1.00
31/10/2012		0.50		0.25	0.44	0.40	0.44	0.55	0.82	0.69	0.77	1.05
30/11/2012		0.50		0.25	0.30	0.40	0.44	0.54	0.80	0.73	0.80	1.05
31/12/2012		0.50		0.25	0.43	0.40	0.44	0.54	0.80	0.69	0.76	1.00
31/01/2013		0.50		0.42	0.43	0.40	0.44	0.54	0.80	0.73	0.86	1.17
29/02/2013		0.50		0.41	0.42	0.40	0.44	0.54	0.80	0.59	0.69	1.05
31/03/2013		0.50		0.40	0.40	0.40	0.44	0.51	0.75	0.59	0.68	0.97
Minimum		0.50		0.25	0.30	0.40	0.44	0.51	0.75	0.55	0.65	0.90
Average		**0.50**		0.39	0.49	0.45	0.62	0.82	1.19	0.84	0.90	1.17
Maximum		0.50		0.55	0.65	0.61	1.00	1.33	1.84	1.38	1.45	1.72
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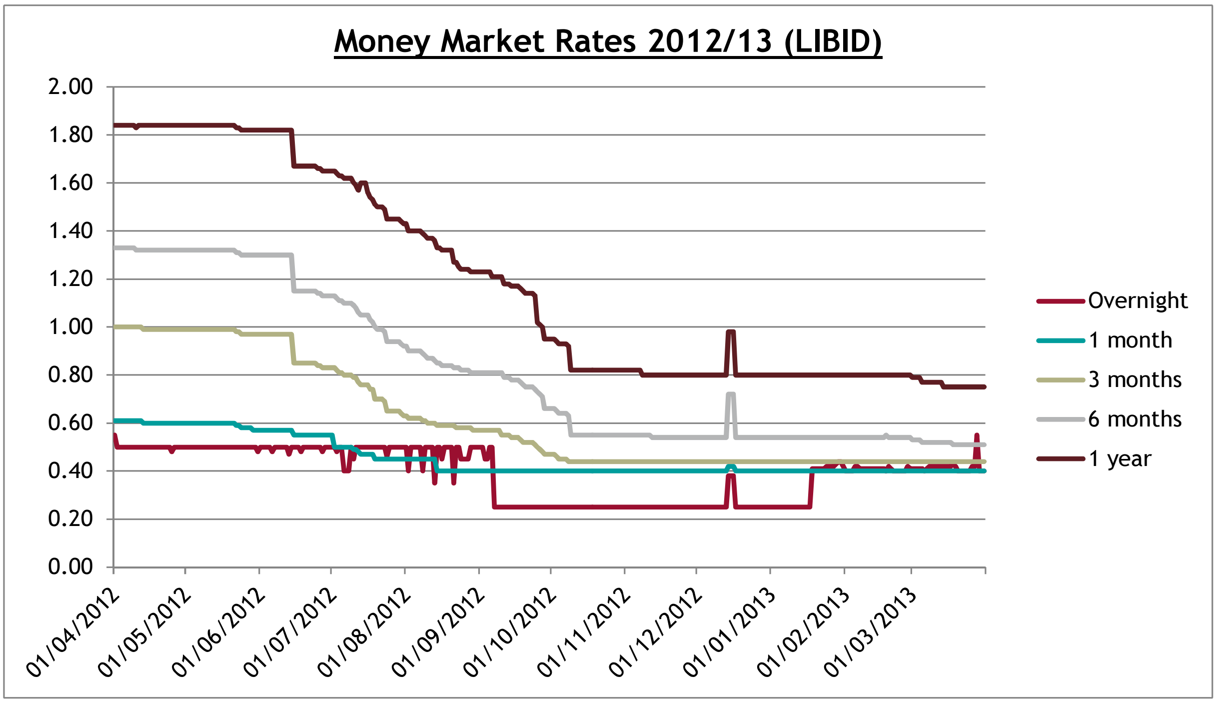
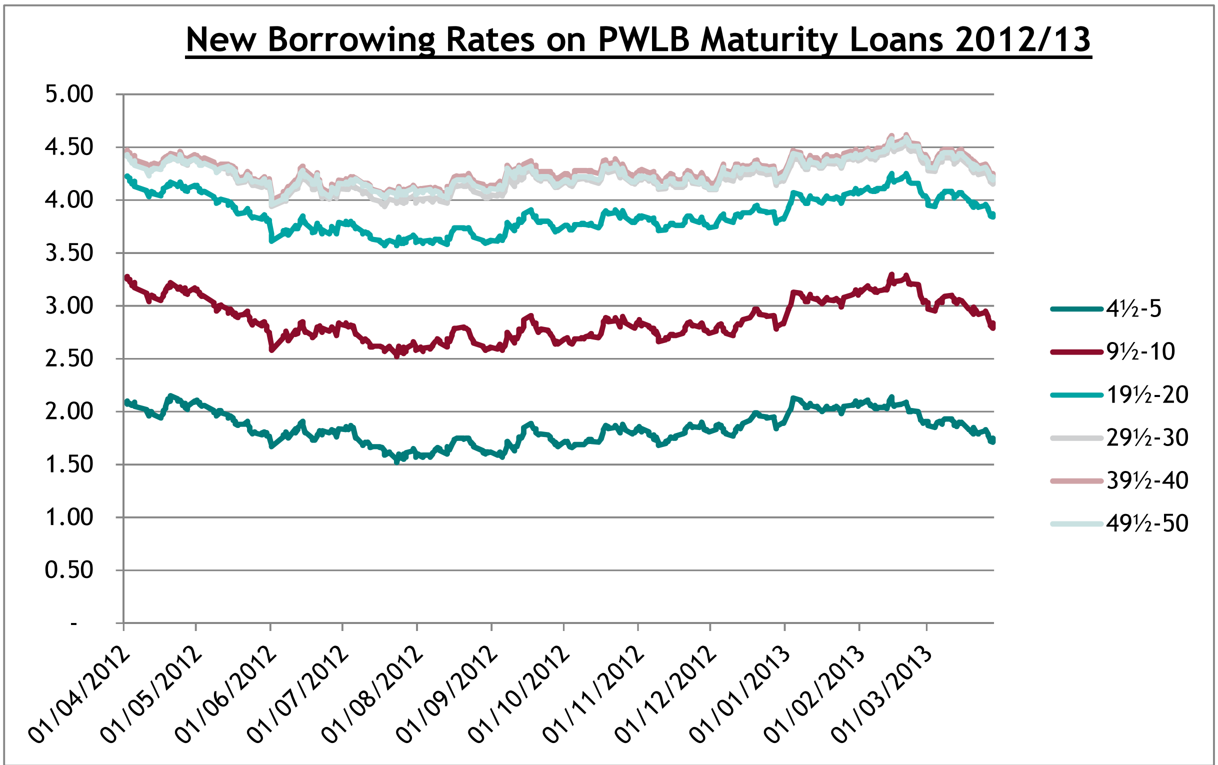


Table 2: PWLB Borrowing Rates – Fixed Rate, Maturity Loans

Change Date	Notice No	1 year	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
02/04/2012	130/12	1.29	2.07	3.25	4.22	4.43	4.46	4.41
30/04/2012	166/12	1.31	2.09	3.15	4.13	4.38	4.42	4.39
31/05/2012	210/12	1.19	1.76	2.74	3.79	4.13	4.19	4.16
29/06/2012	248/12	1.2	1.84	2.83	3.79	4.11	4.19	4.16
31/07/2012	292/12	1.01	1.57	2.58	3.6	3.97	4.07	4.05
31/08/2012	336/12	1.07	1.62	2.61	3.62	4.05	4.14	4.11
28/09/2012	376/12	1.15	1.67	2.64	3.71	4.12	4.2	4.14
28/10/2012	422/12	1.19	1.82	2.82	3.81	4.17	4.25	4.19
30/11/2012	466/12	1.22	1.81	2.74	3.74	4.1	4.16	4.11
31/12/2012	504/12	1.22	1.89	2.83	3.82	4.18	4.25	4.21
31/01/2013	044/13	1.26	2.06	3.1	4.06	4.37	4.43	4.4
28/02/2013	084/13	1.16	1.91	3.04	4.04	4.36	4.43	4.4
28/03/2013	124/13	1.13	1.75	2.84	3.87	4.18	4.25	4.22
	Low		1.57	2.58	3.60	3.97	4.07	4.05
	Average		1.84	2.86	3.86	4.20	4.26	4.23
	High		2.09	3.25	4.22	4.43	4.46	4.41



Appendix 4

Credit Score Analysis

Scoring:

Long-Term Credit Rating	**Score**
AAA	1
AA+	2
AA	3
AA-	4
A+	5
A	6
A-	7
BBB+	8
BBB	9
BBB-	10
Not rated	11
BB	12
CCC	13
C	14
D	15

The value weighted average reflects the credit quality of investments according to the size of the deposit. The time weighted average reflects the credit quality of investments according to the maturity of the deposit

The Council aimed to achieve a score of 7 or lower, to reflect the Council's overriding priority of security of monies invested and the minimum credit rating of threshold of A- for investment counterparties.