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To: Governance and Audit Committee – 24 July 2014

Subject: **TREASURY MANAGEMENT ANNUAL REVIEW 2013-14**

Classification: Unrestricted

Summary: To report a summary of Treasury Management activities in 2013-14

FOR DECISION

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 fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the CLG Investment Guidance.
 - a. Reports on the implications of treasury decisions and transactions;
 - b. Gives details of the outturn position on treasury management transactions in 2013-14;
 - c. Confirms compliance with its Treasury Management Strategy Statement, Treasury Management Practices and Prudential Indicators.

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

DEBT MANAGEMENT

	Balance on 01/04/2013 £m	Debt Maturing £m	New Borrowing £m	Balance on 31/3/2014 £m	Average Rate % and Average Life (yrs)
Capital Financing Requirement (CFR)	1,465			1,435	
Long Term Borrowing	1,012	2		1,010	5.516% / 29.10
Other Long Term Liabilities					
TOTAL EXTERNAL DEBT	1,012			1,010	
Decrease in Borrowing				2	

6. The Council did not undertake any borrowing this year. With short-term interest rates having remained much lower than long-term rates, it was more cost effective in the short-term to use internal resources rather than take external borrowing. By doing so, the Council was able to reduce net borrowing costs despite foregone investment income and reduced overall treasury risk. It does not intend to borrow for the foreseeable future but the sustainability of this approach will be kept under review.
7. Changes in the debt portfolio over the year have achieved a reduction in the overall debt cost by £1.96m whilst reducing the average life from 29.86 years to 29.10 years.
8. No debt rescheduling was undertaken in the year.

INVESTMENT ACTIVITY

9. Both the CIPFA and the CLG's Investment Guidance require the Council to invest prudently and have regard to the security and liquidity of investments before seeking the optimum yield.
10. 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 2013-14 which defined "high credit quality" organisations as those having a long-term credit rating of A- or higher.

11. The Council assessed and monitored counterparty credit quality 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 and share price.
12. The Financial Services (Banking Reform) Act 2013 gained Royal Assent in December, legislating for the separation of retail and investment banks and for the introduction of mandatory bail-in in the UK to wind up or restructure failing financial institutions. EU finance ministers agreed further steps towards banking union, and the Single Resolution Mechanism (SRM) for resolving problems with troubled large banks which will shift the burden of future restructurings/rescues to the institution's shareholders, bondholders and unsecured investors.
13. The material changes to UK banks' creditworthiness were:
 - (1) The strong progress made by the Lloyds Banking Group in strengthening its balance sheet, profitability and funding positions and the government reducing its shareholding in the Group to under 25%,
 - (2) The announcement by Royal Bank of Scotland of the creation of an internal bad bank to house its riskiest assets (this amounted to a material extension of RBS' long-running restructuring, further delaying the bank's return to profitability),
 - (3) Substantial losses at Co-op Bank which forced the bank to undertake a liability management exercise to raise further capital and a debt restructure which entailed junior bondholders being bailed-in as part of the restructuring.

COUNTERPARTY UPDATE

14. In March Moody's downgraded the long-term ratings of both RBS and NatWest banks to Baa1. As this rating is below the Council's minimum credit criterion of A-, the banks were withdrawn from the counterparty list for further investment. NatWest is the Council's banker and will continue to be used for operational and liquidity purposes.
15. In September 2013 Cabinet approved the establishment of an investment portfolio to be managed externally. Since then £5million has been invested in the Pyrford absolute return fund, £5million in the CCLA Local Authorities Property Fund and £2.7m in Kent PFI (Holdings) Ltd shares.
16. During 2013-14 the Council's internally managed cash was primarily invested with banks and building societies in call accounts, fixed-rate term deposits and certificates of deposit. In addition the Council invested in T-Bills and deposits with the DMADF (Debt Management Office). In March the Council also made purchases of Covered Bonds - corporate bonds which have recourse to a pool of assets which secures or covers the bond if the issuer fails.

17. The maximum duration limit for bank deposits was 12 months.

18. Internally Managed Funds - Investment Activity in 2013-14

Investment Counterparty	Balance on 01/04/2013 £m	Net Investments Made £m	Balance on 31/03/2014 £m	Avg Rate % and Avg Life (yrs)
UK Central Government		0.7	0.7	0.25% / 0.04
Banks and building societies	261.0	31.4	292.4	0.52% / 0.14
Marketable instruments (Covered Bonds)		5.3	5.3	1.31% / 2.64
Total Internally Managed Investments	261.0		298.4	
Increase in Investments £m			37.4	

19. Investments as at 31 March 2014 are shown in Appendix 2.

20. 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.

21. The UK Bank Rate was maintained at 0.5% through the year. During the year short term money market rates fell to very low levels which had a significant impact on investment income. The average 7 day LIBID rate during 2013-14 was 0.3542%, the average 3-month LIBID rate was 0.45%, the 6-month LIBID rate averaged 0.53% and the 1-year LIBID rate averaged 0.78%. The low rates of return on the Council's short-dated money market investments reflect prevailing market conditions and the Council's objective of optimising returns commensurate with the principles of security and liquidity.

22. The Council's investment income for the year was £2.9m, an average rate of 0.6% which was slightly higher than 6-month LIBID. The portfolio return particularly reflects higher interest rates paid on bank deposits and call accounts in June – September 2013, and the recent diversification of investments.

23. The Council held average cash balances of £359m during the year. These represented the Council's reserves, working cash balances, capital receipts and schools' balances etc.

24. The Treasury team seeks to maximise the investment return within the parameters of the investment strategy by fully utilising the range of assets available through:

- (1) The initial allocation to the investment portfolio,
- (2) Using new asset classes such as Covered Bonds with a maximum duration of 5 years, which typically yield in excess of 1%,
- (3) Maximising investment with bank counterparties paying the better rates, for example a call account with the Swedish bank Handelsbanken paying 0.6%

COMPLIANCE WITH PRUDENTIAL INDICATORS

- 25. The Council confirms that it has complied with its Prudential Indicators for 2013-14, which were set as part of the Council's Treasury Management Strategy Statement. Details can be found in Appendix 1.
- 26. The Treasury Management activities were once again subject to review by Internal Audit whose assessment of the controls in place and the level of compliance with these controls was High assurance.

TREASURY ADVISER

- 27. KCC currently contracts with Arlingclose as Treasury Advisers.

RECOMMENDATION

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

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2013-14 Final Monitoring of Prudential Indicators**1. Estimate of Capital Expenditure (excluding PFI and Schools)**

	£m	
Actuals 2013-14	203.244	
Original estimate 2013-14	286.571	
Revised estimate 2013-14	253.429	(this includes the rolled forward re-phasing from 2012-13)

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

	2012-13 Actual £m	2013-14 Original Estimate £m	2013-14 Actual as at 31 March £m
CFR	1,464.961	1,483.590	1,435.263
Annual increase/(decrease) in underlying need to borrow	(30.912)	(2.825)	(29.698)

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 2012-13	14.55%
Original estimate 2013-14	13.42%
Actual 2013-14	13.62%

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

	Prudential Indicator £m	Position as at 31 March 2014 Actual £m
Borrowing	993	969
Other Long Term Liabilities	1,134	1,155
Total	2,127	2,124

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

	Prudential Indicator £m	Position as at 31 March 2014 £m
Borrowing	1,040	1,010
Other Long Term Liabilities	1,134	1,155
Total	2,174	2,165

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

	Prudential Indicator £m	Position as at 31 March 2014 £m
Borrowing	1,033	969
Other long term liabilities	1,134	1,155
Total	2,167	2,124

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

	Prudential Indicator £m	Position as at 31 March 2014 £m
Borrowing	1,080	1,010
Other long term liabilities	1,134	1,155
Total	2,214	2,165

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 2013-14

Fixed interest rate exposure	100%
Variable rate exposure	30%

These limits have been complied with in 2013-14.

8. Upper limits for maturity structure of borrowings

	Upper limit	Lower limit	As at 31 March 2014
	%	%	%
Under 12 months	10	0	0.00
12 months and within 24 months	10	0	2.59
24 months and within 5 years	15	0	9.40
5 years and within 10 years	15	0	9.11
10 years and within 20 years	15	5	10.50
20 years and within 30 years	20	5	14.70
30 years and within 40 years	20	10	12.95
40 years and within 50 years	25	10	17.88
50 years and within 60 years	30	10	22.88

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

Prudential Indicator	Actual
£m	£m
30.0	22.2

Appendix 2

Investments as at 31 March 2014

1) Internally Managed Investments

Instrument Type	Counterparty	Principal Amount	End Date	Interest Rate
Fixed Deposit	Bank of Scotland	£5,000,000	08/05/2014	0.75
Fixed Deposit	Bank of Scotland	£5,000,000	22/07/2014	0.75
Call Account	Barclays Bank	£10,000,000	n/a	0.3
Call Account	Barclays FIBCA	£30,000,000	n/a	0.6
Fixed Deposit	HSBC	£5,000,000	03/04/2014	0.3
Fixed Deposit	HSBC	£6,000,000	04/04/2014	0.3
Fixed Deposit	HSBC	£19,400,000	25/04/2014	0.35
Fixed Deposit	HSBC	£4,000,000	07/04/2014	0.3
Fixed Deposit	HSBC	£5,600,000	08/04/2014	0.3
Fixed Deposit	Lloyds Bank	£5,000,000	06/05/2014	0.75
Fixed Deposit	Lloyds Bank	£5,000,000	19/05/2014	0.75
Fixed Deposit	Lloyds Bank	£5,000,000	19/08/2014	0.7
Fixed Deposit	Lloyds Bank	£5,000,000	21/08/2014	0.7
Fixed Deposit	Lloyds Bank	£5,000,000	22/04/2014	0.75
Call Account	Santander UK	£40,000,000	n/a	0.4
Certificate of Deposit	Standard Chartered	£10,000,000	07/07/2014	0.55
Certificate of Deposit	Standard Chartered	£10,000,000	05/08/2014	0.49
Certificate of Deposit	Standard Chartered	£10,000,000	02/04/2014	0.54
Certificate of Deposit	Standard Chartered	£2,000,000	22/07/2014	0.52
Certificate of Deposit	Standard Chartered	£8,000,000	08/09/2014	0.59
Total UK Bank Deposits		£195,000,000		
Fixed Deposit	Nationwide Building Society	£35,300,000	25/04/2014	0.38
Fixed Deposit	Nationwide Building Society	£800,000	07/04/2014	0.35
Fixed Deposit	Nationwide Building Society	£3,900,000	07/04/2014	0.4
Fixed Deposit	Leeds Building Society	£5,000,000	30/06/2014	0.42
Total UK Building Society Deposits		£45,000,000		
Fixed Deposit	Debt Management Account Deposit Facility	£700,000	16/04/2014	0.25
Total UK Government Deposits		£700,000		
Fixed Deposit	Commonwealth Bank of Australia	£7,000,000	28/04/2014	0.47
Fixed Deposit	Commonwealth Bank of Australia	£6,000,000	30/04/2014	0.43

Fixed Deposit	Commonwealth Bank of Australia	£7,000,000	30/05/2014	0.44
Total Australian Bank Deposits		£20,000,000		
Instrument Type	Counterparty	Principal Amount	End Date	Interest Rate
Call Account	Handelsbanken	£20,000,000	n/a	0.6
Total Swedish Bank Deposits		£20,000,000		
Total Icelandic Deposits Outstanding		£12,416,710		
Fixed Rate Covered Bond	Bank of Scotland	£2,184,840	08/11/2016	1.293%
Fixed Rate Covered Bond	Bank of Scotland	£3,142,737	08/11/2016	1.309%
Total Covered Bonds		£5,327,577		
Total Internally Managed Investments		£298,444,286		

<i>Icelandic Deposits held in ESCROW (est GBP)</i>	<i>-£3,146,603</i>
<i>Net Icelandic Deposits outstanding</i>	<i>£9,270,107</i>

2) Externally Managed Investments

Investment Fund	Book cost	Market Value at 31 March 2014	Gross return for 3 months to 31 March 2014
CCLA	£5,000,000	£5,083,000	4.65%
Pyrford	£5,000,000	£4,916,000	0.37%
Total Investment Funds		£9,999,000	
Equity	Book cost	Market Value at 31 March 2014	Projected annual return
Kent PFI (Holdings) Ltd	£2,681,260	£2,681,260	7.6%
Total Externally Managed Investments		£12,680,260	

Total Investments	£311,124,546
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