

By: Cabinet Member for Finance
Director of Finance

To: Governance and Audit Committee – 30 June 2009

Subject: **TREASURY MANAGEMENT ANNUAL REVIEW**

Classification:

Summary: To report on Treasury management activity in 2008-09.

FOR INFORMATION

INTRODUCTION

1. This report is to review the main aspects of treasury management activity during the year in accordance with the CIPFA Code of Practice on Treasury Management.
2. The last annual report was on 17 September 2008 only a few days before the collapse of Lehman Brothers proved to be the trigger point for the largest banking crisis for a century. Whilst this report will cover activities in 2008-09 it will also cover the current position and what action we have taken.

LONG TERM BORROWING

3. As at 31 March 2009 long term borrowing was £991.4m after allowing for £51.2m of debt which we manage on behalf of Medway Council.
4. **New Borrowing**

In 2008-09 we undertook the following borrowing against a requirement of £100.6m within the treasury strategy in the medium term plan:

Date	Amount	Interest Rate	Period of Loan Years	Source	Type
	£m	%			
09/10/08	10	4.39	35	PWLB	Maturity
30/01/09	10	3.95	60	RBS	LOBO
16/02/09	20	4.15	60	DEXIA	LOBO
Total	40				

5. Whilst short term interest rates have plummeted from 5% in October 2008 to 0.5%, long term PWLB rates have not moved significantly. So, for example, PWLB 49 ½ - 50 year funds started the year at 4.43% and at 31 March were at 4.58%, they fell below 4% for a very short period.

The need for Government to raise very substantial sums due to the increased budget deficit will mean that these longer term rates are unlikely to fall.

6. The RBS and Dexia borrowing were forward deals arranged well in advance. Given the very low rate of interest being received on deposits we are holding off any new borrowing and will effectively fund that requirement from our cashflow for as long as possible. This will be fully addressed within the new Treasury Strategy we are developing.

Debt Restructuring

7. Debt restructuring had become much more difficult because of the new structure of PWLB interest rates with differential rates for new and restructured borrowing. The extreme divergence of short and long PWLB rates in January gave some unprecedented opportunities for savings to be made as set out in the table below:

DATE	AMOUNT £	INTEREST RATE %	REMAINING PERIOD OF LOAN YEARS	MATURITY DATE	ANNUAL SAVING £	SOURCE	TYPE
Old Loans							
21/01/09	10,000,000	4.3	26.55	10/08/35	344,882	PWLB	Maturity
21/01/09	10,000,000	4.25	26.8	10/11/35	420,153	PWLB	Maturity
21/01/09	10,470,000	4	42.05	10/02/50	570,846	PWLB	Maturity
21/01/09	20,000,000	4.1	34.05	10/02/43	1,095,652	PWLM	Maturity
21/01/09	10,000,000	4.1	39.05	10/02/48	448,639	PWLB	Maturity
28/01/09	10,000,000	4.3	40.28	10/05/49	447,187	PWLB	Maturity
28/01/09	20,000,000	4.4	32.28	10/05/41	864,047	PWLB	Maturity
28/01/09	10,000,000	4.45	26.28	10/05/35	422,445	PWLB	Maturity
28/01/09	25,000,000	4.35	44.28	10/05/53	554,047	PWLB	Maturity
28/01/09	25,000,000	4.35	43.28	10/05/52	742,947	PWLB	Maturity
28/01/09	24,400,000	4.35	42.28	10/05/51	741,511	PWLB	Maturity
28/01/09	30,796,871	4.55	25.78	10/11/34	677,035	PWLB	Maturity
TOTAL	205,666,871				7,329,391		
New Loans							
21/01/09	60,470,000	1.17	1	21/01/10		PWLB	Maturity
28/01/09	40,000,000	1.55	2	10/08/10		PWLB	Maturity
28/01/09	50,000,000	2.11	3	10/08/11		PWLB	Maturity
28/01/09	55,000,000	2.59	4	10/08/12		PWLB	Maturity
TOTAL	205,470,000						

8. Looking at the restructuring in more detail:

- 21 January – 5 PWLB loans totalling £60.47m restructured to a 1 year loan at 1.17%. This produces a saving of £2,880,173 over a 12 month period.
- 28 January – 7 PWLB loans totalling £145.20m restructured over 2, 3 and 4 years at 1.55%, 2.11% and 2.59%. This produces a total saving of £12,845,061

The strategy will be to replace these loans in the medium term at a similar or lower level or reduce cash balances.

Performance summary

9. Overall in 2008-09 the average rate of interest paid reduced from 5.64% to 5.51%.

INVESTMENTS

10. **Balances at 31 March 2009**

During 2008-09 the average daily balance was £420m compared with £325m in 2007-08 and £308m in 2006-07. Much of this increase related to the Superannuation Fund Committee's decision to hold cash and not distribute it to equity or property managers. This was a highly beneficial financial decision estimated at saving the Fund around £40m. In late 2008-09 £70m of cash was put out to equity managers and the Superannuation Fund Cash balance at 31 March 2009 was £103.3m.

11. **Icelandic Deposits**

(1) Of the total of £50.35m around £1m relates to the Fire Authority and £16m to the Pension Fund. The estimated loss based on the CIPFA calculations is in total £4.5m. The latest position on the Icelandic deposits is:

- Heritable has £18.35m of KCC deposits currently trapped. This is a UK domiciled bank and the insolvency process is therefore being run by Ernst & Young under UK legislation. This bank retained strong ratings until 30 September but due to human error a deposit of £3.3m was placed for 30 days on 1 October. KCC is one of 2 local authorities representing local authority creditors on the Creditor Committee but we cannot give specific information due to confidentiality provisions. It can be said that this is a well managed administration of what was a viable bank and the base case return

is now published between 70-80p in the pound. This is a prudent recovery estimate.

- Landsbanki and Glitnir has £17m and £15m of KCC deposits respectively currently trapped. KCC is with the London Borough of Barnet leading the recovery process in Iceland with legal advice from Bevan Brittan and financial advice from Ernst & Young. In the last 2 months the local authority creditors have also started to work closely with HM Treasury. Again confidentiality provisions limit what can be said but it is now in the public arena that under Icelandic law depositors are preferred creditors and are therefore in a strong recovery position.
- (2) Whilst public attention has focussed on the local authority exposure to Iceland this is tiny in comparison with the exposure of major bond holders and the Western banks to Iceland. Western banks have exposure of £60bn to Iceland.

The exposure to financial loss on these Icelandic deposits needs to be put in the context of base budget savings on Treasury Management in excess of £70m over recent years.

12. Current Balances

- (1) The analysis of our cash as at 5 June the Council's Cash position was:

Institution	Exposure (£m)	%
UK Government (DMO)	351.0	68
UK Banks	60.0	12
UK Building Societies	42.10	8
Belgian Bank	10.0	2
Iceland Bank	50.35	10
TOTAL	513.45	100%

A full list of deposits is attached in the Appendix.

- (2) While there is a clear reduction in diversification towards holding in the Debt Management Office (DMO), there remains cash previously deposited in UK banks, building societies and foreign banks.
- (3) In October we had £127m on deposit with Irish financial institutions. This was all on short term deposits and this has been reduced to zero, well in advance of the significant problems which have now affected Ireland.

- (4) Our sole overseas exposure outside Iceland is now with Dexia Bank which is a Belgium based local authority bank and the largest shareholder in CDC the French State bank. This deposit has been restructured to bring it within the guarantee provided by the French / Belgian and Luxembourg Governments.

PERFORMANCE

13. The investment return achieved during the year was 4.59% compared with the 7 day LIBID benchmark of 3.69%. From 8 October all new and maturing deposits have been placed with the Debt Management Agency which is part of the Treasury. Interest rates are very low but funds are subject to UK Government guarantee.

INTERNAL CONTROL

14. Immediately after the Icelandic banks collapse the Chief Executive and Director of Finance commissioned PwC to undertake a review of treasury management activities. The main failing identified relates to a £3.3m transaction with Heritable which was made after they should have been removed from the counterparty list-management identified this transaction before PwC commenced their work.
15. Since 9 October we have used the DMO for new and maturing funds. A return to dealing with other financial institutions will only happen when all the issues identified in the PwC report have been addressed.
16. The main actions being taken are:
 - (1) Appointment of a Treasury & Investments Manager – this is a new post at a senior level which will have prime responsibility for treasury management. A permanent appointment was made on 12 June following the use of an interim manager. This post will report to a post of Head of Investments & Pensions – redefining a post reporting directly to the Director of Finance.
 - (2) External Adviser – Arlingclose have been commissioned to advise on investment issues for a 6 month period. Their remit is focussed on assisting KCC in moving forward with a more diversified investment strategy (which Cabinet will agree), rewriting the Treasury Management Manual, reviewing the detailed operational procedures below the Treasury Manual and ensuring that all specific issues raised by PwC are addressed. The high level action plan is attached in Appendix 2.

GOVERNANCE

18. The Council's Treasury Strategy was agreed by County Council as part of the MTP process and implementation is the responsibility of the Director of Finance in consultation with the Cabinet Member for Finance. An annual report was made to this Committee.
19. As set out in the MTP paper treasury policy decisions will be taken by Cabinet. It is proposed that this Committee will now receive quarterly reports on Treasury management.
20. To support this work a Treasury Advisory Group has been established which will take on the advisory role played by the Economic Management Group since October 2008.
21. The draft minutes of the first meeting of the Treasury Advisory Group on 14 May are attached in Appendix 3.

RECOMMENDATION

22. Members are asked to note this report.

Nick Vickers
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