By:	John Simmonds, Cabinet Member - Finance Lynda McMullan, Director of Finance
To:	Cabinet -11 January 2010
Subject:	**TREASURY MANAGEMENT STRATEGY**
Classification:	Unrestricted

Summary: To propose a Treasury Management Strategy for 2010-11.

FOR DECISION

INTRODUCTION

1. This report sets out a Treasury management Strategy for 2010-11. The report is included in the Medium Term Plan papers but in the interests of transparency is also brought to Cabinet as a stand alone item.

2. The report consists of:

   - Background
   - Regulatory Framework
   - KCC Governance
   - Borrowing Requirement and Strategy
   - Debt Rescheduling
   - Investment Strategy
   - Treasury Advisers
   - Training

BACKGROUND

3. The Chartered Institute of Public Finance and Accountancy's Code of Practice for Treasury Management in Public services (the "CIPFA TM Code") requires local authorities to determine the Treasury Management Strategy Statement (TMSS). This statement also incorporates the Investment Strategy. Together, these cover the financing and investment strategy for the forthcoming financial year.

In response to the financial crisis in 2008, CIPFA has revised the TM Code and Guidance Notes as well as the Prudential Indicators which CIPFA publicised in late November 2009. Communities and Local Government (CLG) is consulting on a revised and updated Investment Guidance.

4. CIPFA has defined Treasury Management as:

   "The management of the organisation's 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."

5. The Council is responsible for its treasury decisions and activity. No treasury management activity is without risk. The successful identification, monitoring and control of risk is an important and integral element of its treasury management activities. The main risks to the Council's treasury activities are:

   - Credit and Counterparty Risk (Security of Investments)
   - Liquidity Risk (Inadequate cash resources)
   - Market or Interest Rate Risk (Fluctuations in interest rate levels)
   - Inflation Risk (Exposure to inflation)
   - Refinancing Risk (Impact of debt maturing in future years)
   - Legal & Regulatory Risk

REGULATORY FRAMEWORK

6. There are two main elements to the regulatory framework for treasury management, the CIPFA TM Code and the CLG Investment Guidance. As both of these have been revised in November a summary of the main changes is set out below.

7. **CIPFA Treasury Management Code**

   The main issues to highlight are:

   (1) Treasury Management Policy Statement
   CIPFA recommends that organisations adopt the following words in their Treasury Management Policy Statement to be agreed by full Council:

This organisation defines its treasury management activities as:

"The management of the organisation'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".

This organisation regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation.

This organisation acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.

(2) In the new code CIPFA identify the following Key Principles:

Key Principle 1

Public service organisations should put in place formal and comprehensive objectives, policies and practices, strategies and reporting arrangements for the effective management and control of their treasury management activities.

Key Principle 2

Their policies and practices should make clear that the effective management and control of risk are prime objectives of their treasury management activities and that responsibility for these lies clearly within their organisations. Their appetite for risk should form part of their annual strategy and should ensure that priority is given to security and liquidity when investing funds.

Key Principle 3

They should acknowledge that the pursuit of value for money in treasury management, and the use of suitable performance measures, are valid and important tools for responsible organisations to employ in support of their business and service objectives; and that within the context of effective risk management, their treasury management policies and practices should reflect this.

(3) CIPFA recommends that the following four clauses are adopted as part of Financial Regulations:

1. This organisation will create and maintain, as the cornerstones for effective treasury management:

- A treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities.

- Suitable treasury management practices (TMPs), setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

The content of the policy statement and TMPs will follow the recommendations contained in Sections 6 and 7 of the Code, subject only to amendment where necessary to reflect the particular circumstances of this organisation. Such amendments will not result in the organisation materially deviating from the Code's key principles.

2. This organisation (ie full body/council) will receive reports on its treasury management policies, practices and activities, including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close, in the form prescribed in its TMP's.

3. This organisation delegates responsibility for the implementation and regular monitoring of its treasury management policies and practices to Cabinet, and for the execution and administration of treasury management decisions to Director of Finance, who will act in accordance with the organisation's policy statement and TMPs and, if he/she is a CIPFA member, CIPFA's standard of professional practice on treasury management.

4. This organisation nominates the Treasury Advisory Group and Governance & Audit Committee to be responsible for ensuing effective scrutiny of the treasury management strategy and policies.

The Director of Finance is currently revising Financial Regulations and these clauses will be incorporated.

(3) Detailed revisions to the Treasury Management Practices. This is being done.

(4) Revised Treasury Indicators within the Prudential Code. These are contained within the Draft Medium Term Plan.

8. **CLG Investment Guidance**

CLG are currently out to consultation on their Guidance. The main issues to highlight are:

- Reiterates Security, Liquidity and Yield in that order.
- Emphasis on ongoing risk assessment.
- Credit ratings alone should not be the only criteria for selecting counterparties.
- Borrowing purely to invest at a profit is unlawful. There still appears to be no legal obstacle to the temporary investment of funds borrowed for the purpose of expenditure in the reasonably near future.
- Clarity on the role of investment consultants.
- Training for Members and officers.

KCC GOVERNANCE

9. The Director of Finance is responsible for the Council's treasury management operations, day to day responsibility is delegated to the Head of Financial Services. The detailed responsibilities are set out in the Council's Treasury Management Practices. These have been fully revised and updated and will now incorporate changes resulting from the new CIPFA TM Code.

10. A new sub-group of Cabinet has been established to work with the Director of Finance on treasury management issues – the Treasury Advisory Group. The group consists of the Cabinet Member for Finance, Deputy Leader, Chairman Corporate Policy Overview Committee, Chairman Superannuation Fund Committee, Liberal Democrat Finance spokesman and Leader Labour Group. The agreed terms of reference are "The Treasury Advisory group will be responsible for advising the Cabinet and Director of Finance on treasury management policy within KCC's overarching Treasury management Policy". TAG meets the new requirement in the CIPFA TM Code for a member body focussing specifically on treasury management. TAG meets quarterly and members of the group receive detailed information on a weekly and quarterly basis.

11. Whilst Council will agree the Treasury Management Strategy all amendments to the strategy during the year will be agreed by Cabinet. This will help to make the strategy more dynamic.

12. Governance & Audit Committee previously received an annual review in accordance with the requirements of the CIPFA TM Code. The Director of Finance has already put in place quarterly reporting to GAC which goes beyond the mid-year review proposed in the new CIPFA TM Code.

13. These arrangements put an emphasis on openness and transparency – Officers would welcome any ideas members have on how we can improve and develop our reporting processes to support these principles.

BORROWING REQUIREMENT AND STRATEGY

14. **Borrowing**

As at 31 December 2009 long term borrowing to fund capital expenditure was £991m excluding £51m attributable to Medway Council. The budgeted borrowing figures for the next 3 years are £96m in 2010-11, £44m in 2011-12 and £26m in 2012-13.

15. **Interest Rate Forecasts**

(1) The economic interest rate forecast provided by Arlingclose one of the Council's treasury advisers is summarised in the table below:

Arlingclose's Economic and Interest Rate Forecast

	Dec-09	*Mar-10*	*Jun-10*	*Sep-10*	*Dec-10*	*Mar-11*	*Jun-11*	*Sep-11*	*Dec-11*	*Mar-12*
Official Bank Rate										
Upside Risk				+0.25	+0.25	+0.50	+0.50	+0.50	+0.50	+0.50
Central Case	**0.50**	**0.50**	**0.50**	**0.50**	**1.00**	**1.50**	**2.25**	**3.00**	**4.00**	**4.00**
Downside risk					-0.50	-0.50	-0.50	-0.25	-0.25	**-0.25**
1-yr LIBID										
Upside Risk				+0.25	+0.50	+0.50	+0.50	+0.50	+0.50	+0.50
Central Case	**1.25**	**1.25**	**1.25**	**1.50**	**2.00**	**2.75**	**3.50**	**4.00**	**4.25**	**4.25**
Downside risk					-0.25	-0.25	-0.25	-0.25	-0.25	-0.25
5-yr gilt										
Upside risk		+0.25	+0.25	+0.25	+0.50	+0.50	+0.50	+0.50	+0.50	+0.50
Central Case	**2.60**	**2.70**	**2.80**	**2.90**	**3.00**	**3.25**	**3.50**	**3.75**	**4.00**	**4.25**
Downside risk		-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25
10-yr gilt										
Upside risk			+0.25	+0.25	+0.25	+0.25	+0.25	+0.25	+0.25	+0.25
Central Case	**3.60**	**3.75**	**3.75**	**4.00**	**4.00**	**4.25**	**4.25**	**4.50**	**4.50**	**4.75**
Downside risk			-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25

	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
20-yr gilt										
Upside risk		+0.25	+0.25	+0.25	+0.25	+0.25	+0.25	+0.25	+0.25	+0.25
Central case	**4.10**	**4.25**	**4.50**	**4.75**	**4.75**	**5.00**	**5.00**	**5.00**	**5.00**	**5.00**
Downside risk		-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25
50-yr gilt										
Upside risk	+0.25	+0.25	+0.25	+0.50	+0.50	+0.50	+0.50	+0.50	+0.50	+0.50
Central case	**4.00**	**4.25**	**4.50**	**4.50**	**4.50**	**4.75**	**4.75**	**4.75**	**4.75**	**4.75**
Downside risk			-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25

Source: Arlingclose Ltd

(2) Forecasts for gilts are a good proxy for rates the Council will pay for long term borrowing. Longer term rates have not fallen in the dramatic way which base rates have and are forecast to rise further. There are very significant risks that they will need to be higher as the Government tries to fund much higher levels of borrowing, inflation may become an issue in the short term and there is also a possibility of the UK's sovereign rating being reduced which would also put an upward pressure on rates.

16. **Borrowing Strategy**

(1) The very low interest rates received on deposits and the limited non Debt Management office counterparties available to the Council means that we are actively trying to reduce our cash holdings. The cost of carry i.e. the difference between rates we can earn for deposits and the cost of borrowing long term money; means that the Council has been deferring long term borrowing. The use of internal cash resources in lieu of borrowing has been the most cost effective way of financing capital expenditure. This does have limits on it as internal resources become depleted, the balance sheet analysis undertaken shows that we will come towards the limit of this approach in 2010-11. This may require short term borrowing for cashfow purposes.

(2) In light of this our principles for borrowing over the period will be:

- Continue where possible to defer borrowing and fund from internal resources.

- Use the Public Works Loan Board (PWLB) as the main source of funding.

- Consider use of market loans and Lender Option Borrower Option (LOBO) loans. Currently there is very little interest from banks in this market.

- The Council has historically borrowed at fixed rates. This gives certainty over debt financing costs and can be seen as reducing interest rate risk. Fixed rate borrowing will remain a core part of the strategy with the Council seeking to borrow at advantageous points in interest rate cycles.

- Consideration will also be given to borrowing at variable rates – the Council currently has no variable rate borrowing. PWLB variable rates have fallen below 1% and may remain at these levels for an extended period. When longer term rates move below the cost of variable rate borrowing any strategic exposure to variable interest rates will be reviewed and if appropriate reduced.

DEBT RESTRUCTURING

17. It is possible to repay PWLB loans in certain circumstances – these have to be very carefully managed as the PWLB imposes penalties for early redemption which have to be offset.

18. The Council has been active in debt restructuring and this is a core part of our strategy. In early 2009 the Council took advantage of the very low short term rates to restructure £260m of debt over 1,2,3 and 4 year periods. A total revenue saving of £15.9m was achieved.

19. The Council will continue to maintain a flexible policy for debt rescheduling. Market volatility and the steep yield curve may provide opportunities for rescheduling debt from time to time. The rationale for rescheduling would be one or more of the following:

    - Savings in interest costs with minimal risk.

    - Balancing the volatility profile (i.e. the ratio of fixed to variable rate debt) of the debt portfolio.

    - Amending the profile of maturing debt to reduce any inherent refinancing risks.

20. In September 2009, the PWLB issued a Consultation document entitled ‘PWLB Fixed Rates’, where the PWLB is reviewing the frequency of rate setting (currently daily) and could move to a live pricing basis. The deadline for the consultation period is 8 January 2010. The likely outcome of this is a reduction in the extent of the margins between premature repayment and new borrowing rates, particularly for longer maturities. The strategy will need to be updated for the outcomes of the consultation.

21. Any rescheduling activity will be undertaken within the Council's treasury management policy and strategy. The Council will agree in advance with our treasury advisers the strategy and framework within which debt will be repaid/rescheduled if opportunities arise. Thereafter the Council's debt portfolio will be monitored against equivalent interest rates and available refinancing options on a regular basis. As opportunities arise, they will be identified by the treasury advisers.

22. All rescheduling activity will comply with the accounting requirements of the local authority SORP and regulatory requirements of the Capital Finance and Accounting Regulations (SI 2007 No 573 as amended by SI 2008/414).

INVESTMENT STRATEGY

23. **Principles**

(1) In accordance with the CLG Investment Guidance the Council's main policy principles for cash deposits will be Security and then Liquidity. In the past income from investments has provided key support in the Council's budget but Yield will remain subsidiary to the other principles.

(2) The Council will fully comply with the CIPFA TM Code.

(3) The CLG Investment Guidance distinguishes between:

- Specified Investments
  - Sterling denominated
  - Maximum duration of one year
  - Meets "high" credit criteria
  - Cannot be defined as capital expenditure

- Non-Specified Investments
  - Investments not meeting the criteria above.

(4) On 13 October 2009 Cabinet agreed a report on Treasury Investments, the investments agreed all meet the criteria of Specified Investments.

(5) Officers will continue to work with our treasury advisers to appraise investment options. Any changes to the approach set out will be subject to report to Cabinet for decision following detailed consideration by the Treasury Advisory Group.

(6) The global financial meltdown has led to a dramatic reduction in investment returns. The whole strategy is based upon a prime focus on security and liquidity.

(7) To date some £5.3m has been returned from the collapsed Icelandic banks, in line with expectations. During 2010 further action is expected to clarify the recovery of the remaining monies. On the basis of KCC's work with the relevant bodies and legal advice, confidence remains high that most of the funds will be recovered.

24. **Types of Investment**

The Council's current policy only allows for the use of Cash deposits.

25. **Criteria for Counterparty Selection**

The current criteria for the selection of counterparties are:

- Access to the UK Government Credit Guarantee Scheme
- Credit rating and other relevant financial information e.g. credit default swaps, share price.
- Country exposure e.g. Sovereign support mechanisms, GDP, net debt as a percentage of GDP.
- Exposure to other parts of the same banking group.
- Reputational issues.

26. **Counterparties**

The selected counterparties are:

- Debt Management Office
- Abbey National
- Barclays
- HSBC
- Lloyds Banking Group
- Royal Bank of Scotland

27. **Counterparty Limits**

£450m for DMO and £40m for the other counterparties. This allows for all deposits to be moved into the DMO if necessary within the terms of this strategy.

28. **Duration of Deposits**

Duration is currently limited to 6 months. Given the likelihood of rates rising this seems to be a reasonable approach at this point

29. **Strategy Options**

The changes to the counterparty strategy made by Cabinet in October 2009 reflected the risk appetite at this time. Within this paper it is appropriate to present a range of other options which could be adopted over a period of time and which have been discussed with the Treasury Advisory Group.

(1) Counterparties

This can be seen in a number of incremental steps:

- Nationwide - they have access to the Government Credit Guarantee Scheme on the basis of being of systemic importance to the UK economy. They meet all our current criteria.

- Clydesdale - owned by National Australia Bank and currently recommended by Arlingclose for deposits up to 1 month.

- Overseas banks - Arlingclose are evaluating a range of Overseas Banks as appropriate counterparties. Key issues are not only the financial standing of the banks but the strength of their domestic economies and the importance of these banks to the functioning of the domestic economy.

(2) Types of Investment

Officers will undertake research on Money Market Funds and the use of External Managers.

(3) Counterparty Limits

The limits for the 5 bank counterparties has been set at £40m - our previous highest limit. With reduced Pension Fund money and KCC balances being run down by deferring borrowing there is no case for increasing the limit. With less Cash there may be a case for reducing the limits in future.

(4) Duration of Deposits

The current 6 month limit for deposits reflects the likelihood of rates increasing and our caution about the stability of the world banking sector. Consideration could be given to extending deposits to 12 months with the strongest counterparties. This would make it more likely that HSBC would accept deposits, whilst we are at our limit with the other 4 we have no money with HSBC.

(5) Decision Making

TAG recommends to Cabinet that Nationwide be added to our counter party list but with a limit of £20m.

TREASURY ADVISERS

30. With support from Legal Services a new requirement document and terms and conditions has been prepared and an EU tender process will be undertaken. The appointment will be made by the Director of Finance in consultation with Treasury Advisory Group.

TRAINING

31. TAG has had a dedicated training session with Arlingclose and a treasury management training session provided by KCC Officers which all members were invited to was given on 4 November. The Director of Finance will provide training to individuals or collective groups.

RECOMMENDATIONS

32. Members are asked to:

(1) Agree the strategy.

(2) Agree to add Nationwide to the counterparty list with a maximum limit of £20m.

Nick Vickers
Head of Financial Services