By:	Cabinet Member for Finance & Business Support Corporate Director of Finance & Procurement
To:	Cabinet – 25 January 2012
Subject:	**TREASURY STRATEGY**
Classification:	Unrestricted

Summary: To agree a Treasury Management Strategy for 2012-13 to be recommended to the Council.

FOR DECISION

INTRODUCTION

1. The Chartered Institute of Public Finance and Accountancy's Code of Practce for Treasury Management in Public Services and the Prudential Code require local authorities to determine the Treasury Management Strategy Statement and Prudential Indicators on an annual basis. Prudential Indicators are reported to Cabinet and Council as part of the Medium Term Plan.

2. CIPFA define Treasury Management as:

   "The management of the organisation's cashflows, 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. All treasury activity will comply with relevant statute, guidance and accounting standards.

KCC GOVERNANCE

4. The Corporate Director of Finance & Procurement is responsible for the Council's treasury management operations, day to day responsibility is delegated to the Head of Financial Services and Treasury and Investments Manager. The detailed responsibilities are set out in the Council's Treasury Management Practices.

5. A sub-committee of Cabinet has been established to work with the Officers on treasury management issues – the Treasury Advisory Group (TAG). The group consists of the Cabinet Member for Finance & Business Support, Deputy Cabinet Member for Finance & Business Support, Deputy Leader, Chairman Corporate Policy Overview and Scrutiny 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 Corporate Director of Finance & Procurement on treasury management policy within KCC's overarching Treasury Management Policy". TAG meets the requirement in the CIPFA Treasury Management 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 monthly basis.

6. Whilst Council will agree the overall Treasury Management Strategy all amendments to the strategy during the year will be agreed by Cabinet. The strategy needs to remain dynamic and reflect changing circumstances.

7. Governance & Audit Committee previously received an annual review in accordance with the requirements of the CIPFA Treasury Management Code-it now receives quarterly reports which goes beyond the mid-year review proposed by CIPFA.

8. A revised Treasury Management Policy Statement is attached in Appendix 1 to reflect new requirements of the CIPFA Code published in November 2011.

9. The Authority's banker is the National Westminster Bank. At the current time it does not meet our minimum credit requirement of A+ (or equivalent) long term. Despite the credit rating being below the Authority's minimum criteria it will continue to be used for short term liquidity and ongoing day to day business.

BORROWING REQUIREMENT AND STRATEGY

10. Borrowing

(1) The underlying need to borrow for capital purposes, as measured by the Capital Financing Requirement (CFR), together with balances and reserves, are the core drivers of treasury management activity.

(2) As at 31 December 2011 long term borrowing was £1,091m including £48m attributable to Medway Council.

11. Interest Rate Forecast

(1) The economic and interest rate forecast provided by the Authority's treasury management advisor, Arlingclose, is attached at Appendix 2. The Authority will reappraise its strategies from time to time in response to evolving economic, political and financial events.

(2) There are a number of interest rate issues which have a major impact on strategy decisions:

- Arlingclose in common with most forecasters now expect short term interest rates to stay at their low levels for longer – their central forecast is that the official Bank Rate will remain at 0.5% to the end of 2014. The implication of this is that rates we can obtain for deposits will stay low for longer.

- In October 2010 the Chancellor added around 1% to Public Works Loan Board across all duration periods. In late November 2010 50 year PWLB maturity loans had a rate of 5.25% compared with 4.07% in late November 2011. Whether through the effect of Quantative Easing or the flight from the Euro Zone long term borrowing rates do currently look relatively low. Long term rates have much more scope for volatility and increases than short term rates.

12. Borrowing Strategy

(1) Capital expenditure levels, market conditions and interest rates levels will be monitored to minimise borrowing costs over the medium to longer term and maintain stability. The differential between debt costs and returns on deposits, the so called "cost of carry", remains acute and this is expected to remain a feature in the short term. The Council has therefore been actively trying to reduce its cash holdings by deferring long term borrowing. The use of internal cash resources in lieu of borrowing is likely to continue to be the most cost effective way of financing capital expenditure.

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

- Affordability of new borrowing in light of the Council's overall finances.

- Maturity of existing debt.

- 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.

- Borrowing short term for cash flow reasons if necessary.

13. Borrowing Requirement

(1) In 2012/13 the Council has £77m of borrowing to refinance and new borrowing as set out elsewhere in the budget report.

(2) The Authority's debt portfolio can be restructured by prematurely repaying loans and refinancing them on similar or different terms to achieve a reduction in risk and/or savings in interest costs.

(3) The lower interest rate environment and changes in the rules regarding the premature repayment of PWLB loans has adversely affected the scope to undertake meaningful debt restructuring although occasional opportunities arise. The rationale for undertaking any debt rescheduling would be one or more of the following:

- Savings in risk adjusted interest costs.
- Rebalancing the interest rate structure of the debt portfolio.
- Changing the maturity profile of the debt portfolio.

(4) Borrowing and rescheduling activity will be reported to the Treasury Advisory Group and Governance & Audit Committee in the regular treasury management reports.

INVESTMENT STRATEGY

14. Principles

(1) In accordance with Investment Guidance issued by the CLG and best practice this Authority's primary objective in relation to the investment of public funds remains the security of capital. The liquidity or accessibility of the Authority's investments followed by the yields earned on investments is important but are secondary considerations.

(2) Credit markets remain in a state of distress as a result of the excessive and poor performing debt within the financial markets. In some instances, Greece and Italy being the most notable examples, the extent and implications of the debt it has built up have lead to a sovereign debt crisis and a banking crisis with the outcome still largely unknown. It is against this backdrop of uncertainty that the Authority's investment strategy is framed.

(3) Investments are categorised as "Specified" or "Non-Specified" within the investment guidance issued by the CLG.

- Specified investments are sterling denominated investments with a maximum maturity of one year. They also meet the "high credit quality" as determined by the Authority and are not deemed capital expenditure investments under Statute.

- Non-Specified investments are, effectively, everything else.

(4) 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

15. <u>Criteria for Counterparty Selection</u>

The criteria for the selection of counterparties are:

- A strong likelihood of Government intervention in the event of liquidity issues based on the systemic importance to the UK economy.
- Publicised credit ratings for institutions (excluding the DMO).
- Other financial information eg Credit Default Swaps, share price, corporate developments, news, articles, market sentiment, momentum.
- 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.

The Corporate Director of Finance & Procurement in consultation with the Cabinet Member for Finance & Business Support can suspend a counter party at any time.

16. <u>Current Counterparties</u>

The current approved counterparties are:

- Debt Management Office – Debt Management Account Deposit Facility or Treasury Bills.
- Barclays
- HSBC
- Lloyds Banking Group
- Royal Bank of Scotland

- Santander UK
- Nationwide
- Standard Chartered
- Clydesdale

The actual position is as follows:

- Santander UK have been suspended since April 2010 due to concerns over the relationship with Banco Santander.
- Clydesdale have never been used due to concerns over its parent National Australia Bank – and then due to credit downgrades.
- Standard Chartered will not take local authority deposits.
- RBS, Lloyds and Nationwide have all been suspended since October due to credit rating downgrade.
- Barclays was suspended in December.
- On Arlingclose's recommendation the maximum duration for deposits is 3 months.

17. Counterparty Proposals

(1) The permitted deposits will be:

- Call accounts.
- Term deposits
- Certificates of deposit

(2) TAG considered options at its meeting on 7 December based upon options provided by Arlingclose. The proposed changes to counterparties are as follows:

- Arlingclose are now recommending a minimum long term rating of A- or equivalent for UK banks. This is lower than the A+ minimum adopted in 2011/12 and is in response to downgrades in credit ratings to many institutions considered to be systematically important to the financial system.
- The basis of the reduction to A- for UK banks is:
  - The rating is reduced but so is the maximum duration of deposits.

- This is a return to the normal pre 2008 credit requirement.
- Only applying to banks which are systematically important.
- All the other risk metrics still apply.

- Applying the A- rating to UK banks would give a counterparty list of:
  - Barclays
  - HSBC
  - Santander UK
  - Bank of Scotland
  - Lloyds TSB
  - National Westminster
  - Nationwide
  - Royal Bank of Scotland
  - Standard Chartered

- TAG recommends that all these counter parties should be available to the Council – but parameters would be applied to their use in-particular in-relation to duration of deposits. A decision on whether to use a particular counterparty will be made by the Corporate Director of Finance & Procurement and the Cabinet Member for Finance & Business Support after consultation with TAG and these decisions will be reported to Governance & Audit Committee in the quarterly reports.

- Arlingclose have a range of overseas banks (5 Canadian, 4 Australian and 1 US Banks) which meet their counterparty requirements. TAG recommends that the Authority does not recommence the use of overseas banks. Any proposal to do so would need to be agreed by Cabinet at a later date.

18. Counterparty Limits

The Counterparty Limits proposed are:

- DMO £450m
- Banks/Building Societies £50m.

- A group limit of £75m would be applied for Nat West / RBS and Bank of Scotland / Lloyds could not have more than £75m each.

19. Duration of Deposits

    Arlingclose recommend a maximum duration currently of 3 months. It is recommended that the Corporate Director of Finance & Procurement in consultation with the Cabinet Member for Finance & Business Support is able to increase duration up to a maximum of 12 months in line with Arlingclose recommendations. To go beyond this would require a report to Cabinet.

ICELAND

20. On 28 October the Icelandic Supreme Court confirmed the 1 April District Court decision that UK local authority deposits did count as deposits under Icelandic law and we are therefore preferred creditors. This also applies in the cases concerning the UK Financial Services Compensation Scheme, the Dutch National bank (on behalf of retail depositers) and Dutch local authorities.

21. The position on the two banks is as follows:

    - Glitnir – KCC had £15m deposited with Glitnir and 100% of this will be recovered. Negotiations with the Winding Up Board to ensure prompt payment have commenced.

    - Landisbanki – KCC has £17m deposited with Landsbanki and 98% of this will be recovered. A first dividend of £5.5m has been paid.

22. The Heritable administration continues to proceed well and we are confident of a final return of at least 85%. To date 65p in the £ has been paid totalling £11.9m.

23. The www.kent.gov.uk website is regularly updated for news on developments in Iceland.

TREASURY ADVISERS

24. Since March 2011 Arlingclose have been the Council's sole treasury adviser.

TRAINING

25. Training is provided by Arlingclose and a treasury management training module is included in the Financial Management Training Programme for members and senior officers.

RECOMMENDATIONS

26. Members are asked to agree:

    (1) The Revised Treasury Management Policy Statement.

    (2) The approach proposed to Borrowing.

    (3) The proposals for counter parties and the delegations to the Corporate Director of Finance & Procurement and the Cabinet Member for Finance & Business Support.

Nick Vickers
Head of Financial Services

Appendix 1

TREASURY MANAGEMENT POLICY STATEMENT

1. INTRODUCTION AND BACKGROUND

1.1 The Council adopts the key recommendations of CIPFA's Treasury Management in the Public Services: Code of Practice (the Code), as described in Section 5 of the Code.

1.2 Accordingly, the Council 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 Council will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

1.3 The Council (i.e. full 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 TMPs.

1.4 The Council delegates responsibility for the implementation and monitoring of its treasury management policies and practices to Cabinet and for the execution and administration of treasury management decisions to the Corporate Director of Finance & Procurement, who will act in accordance with the organisation's policy statement and TMPs and CIPFA's Standard of Professional Practice on Treasury Management.

1.5 The Council nominates Treasury Advisory Group and Governance & Audit Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

2. POLICIES AND OBJECTIVES OF TREASURY MANAGEMENT ACTIVITIES

2.1 The Council defines its treasury management activities as:

"The management of the 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."

2.2 This Council 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, and any financial instruments entered into to manage these risks.

2.3 This Council 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 performance measurement techniques, within the context of effective risk management."

2.4 The Council's borrowing will be affordable, sustainable and prudent and consideration will be given to the management of interest rate risk and refinancing risk. The source from which the borrowing is taken and the type of borrowing should allow the Council transparency and control over its debt.

2.5 The Council's primary objective in relation to investments remains the security of capital. The liquidity or accessibility of the Authority's investments followed by the yield earned on investments remain important but are secondary considerations.

Appendix 2

Economic Interest Rate table

	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
Official Bank Rate													
Upside risk						0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk													
1-yr LIBID													
Upside risk	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	1.75	1.75	1.75	1.75	1.75	1.80	1.85	1.95	2.00	2.10	2.20	2.30	2.40
Downside risk	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25
5-yr gilt													
Upside risk	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	1.25	1.30	1.35	1.40	1.50	1.60	1.70	1.80	2.00	2.10	2.30	2.40	2.50
Downside risk	-0.25	-0.25	-0.25	-0.25	-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	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	2.20	2.30	2.40	2.45	2.50	2.55	2.60	2.70	2.75	2.80	2.85	2.90	3.00
Downside risk	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25
20-yr gilt													
Upside risk	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	3.00	3.05	3.05	3.10	3.20	3.25	3.30	3.35	3.40	3.45	3.50	3.60	3.75
Downside risk	-0.25	-0.25	-0.25	-0.25	-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	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	3.25	3.40	3.50	3.60	3.70	3.80	3.90	4.00	4.00	4.00	4.10	4.20	4.25
Downside risk	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25