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ROYAL BOROUGH OF KENSINGTON AND CHELSEA

MEETING OF THE COUNCIL - 8 DECEMBER 2010

ITEM 6 - SUBMISSIONS FROM THE CABINET

REPORT BY THE EXECUTIVE DIRECTOR FOR FINANCE, INFORMATION SYSTEMS AND PROPERTY

ANNUAL TREASURY STRATEGY MID-YEAR REVIEW 2010/11

This report forms part of the monitoring of the treasury function as recommended in the Chartered Institute of Public Finance and Accountancy's (CIPFA) Treasury Management Code of Practice. It reviews the implementation of the Strategy to date and allows for any changes to be made dependent on market conditions. The full Council is required to approve the review and any changes to the Strategy

FOR DECISION

Summary

The report seeks to make some minor changes to the approved investments allowed under the Council's strategy. The aim is to improve yield whilst containing risk.

1 Introduction

1.1 Treasury management is defined by the CIPFA Code of Practice as 'The management of the local authority'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.'

1.2 The CIPFA Code of Practice on Treasury Management (revised November 2009) was adopted by this Council on 13 October 2010.

The primary requirements of the Code are as follows:

1 Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

2 Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

3 Receipt by the full council of an annual Treasury Management Strategy Statement, including the Annual Investment Strategy, for the year ahead, a Mid-year Review Report (this report) and an Annual Report covering activities during the previous year.

4 Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

5 Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Audit Committee.

1.3 This mid-year report has been prepared in compliance with the Code of Practice, and covers the following:

- An economic update for the first six months of 2010/11
- A review of the Annual Treasury Strategy
- A review of the Council's investment portfolio for 2010/11
- A review of the Council's borrowing strategy for 2010/11
- A review of compliance with Prudential Code indicators for 2010/11

2 Economic Update

2.1 The sovereign debt crisis peaked in May 2010. It was prompted, in the first place, by major concerns over the size of the Greek government's total debt and annual deficit. However, any default or write down of Greek debt would have eroded confidence in other countries' public finances, in particular, Portugal, Spain and Ireland. This crisis culminated in the EU and IMF putting together a €750 billion support package in mid May

2.2 Growth in the US, UK and the Euro zone in the second quarter of 2010 was driven by strong growth in the construction sector catching up from inclement weather earlier in the year and is unlikely to be repeated; general expectations are for more modest figures for the remainder of 2010.

2.3 Following the general election in May 2010, the coalition government has put in place a deficit reduction plan for the next five years.

2.4 **Economic Growth** – Gross Domestic Product (GDP) growth is likely to have peaked at 1.2 per cent in quarter 2 of 2010.

Unemployment – the trend of falling unemployment (on the benefit claimant count) has now been replaced since July with small increases.

Inflation and Bank Rate – The Consumer Prices Index (CPI) has remained high so far during 2010. It reached 3.7 per cent in April and has fallen back to 3.1 per cent in August. The Retail Prices Index (RPI) remains high, at 4.7 per cent in August. Although inflation has remained above the Monetary Policy Committee's (MPC) two per cent target, the MPC is confident that inflation will fall back under the target over the next two years. The last quarterly Inflation Report in August showed a significant probability of undershoot after the end of 2011.

The Bank of England undertook a programme of quantitative easing with a total of £200 billion by November 2009; it may or may not choose to add to this.

AAA rating – prior to the general election, credit rating agencies had been issuing repeated warnings that, unless there was a major fiscal contraction, the United Kingdom AAA sovereign rating was at significant risk of being downgraded. Sterling was also under major pressure during the first half of the year. However, after the Chancellor's budget on 22 June, sterling has strengthened against the United States dollar and confidence has returned that the UK will retain its AAA rating. In addition, international investors now view UK government gilts as being a safe haven from European Union government debt. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and rates offered by the Public Works Loans Board (PWLB).

2.5 It is currently difficult to have confidence as to how strong the UK economic recovery may be, and there are a range of views in the market. There are uncertainties in all forecasts due to the major difficulties of forecasting the following areas:

- the speed of economic recovery in the US and EU;
- the degree to which government austerity programmes will dampen economic growth;
- the speed of rebalancing of the UK economy towards exporting and substituting for imports;
- changes in the consumer savings ratio;
- the potential for more quantitative easing, and the timing of this in both the UK and US;
- the speed of recovery of banks' profitability and balance sheet imbalances; and

- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economy

2.6 The overall balance of risks is weighted to the downside and there is some risk of a double dip recession and deleveraging. This in turn could lead to a downward spiral of falling demand, falling jobs and falling prices, although this is currently viewed as being a small risk.

2.7 The longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries.

2.8 Tables 1 to 3 below show the latest market forecasts from the Council's treasury advisor; Capital Economics (an independent forecasting consultancy); and UBS.

Sector Treasury Services (the Council's advisor) interest rate forecast 28 August 2010
Table 1

	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
Bank rate	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.50%	3.00%	3.25%
5yr PWLB rate	2.20%	2.20%	2.20%	2.40%	2.60%	2.80%	3.00%	3.30%	3.60%	3.80%	4.10%	4.40%
10yr PWLB rate	3.30%	3.30%	3.30%	3.40%	3.70%	3.90%	4.00%	4.30%	4.40%	4.60%	4.60%	4.90%
25yr PWLB rate	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.70%	4.70%	4.80%	5.00%	5.00%	5.00%
50yr PWLB rate	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.70%	4.70%	4.80%	5.00%	5.00%	5.00%

Capital Economics interest rate forecast – 13 September 2010
Table 2

	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%
5yr PWLB rate	1.65%	1.65%	1.65%	1.65%	1.65%	1.65%	1.65%
10yr PWLB rate	2.90%	2.90%	2.90%	2.90%	2.90%	2.90%	2.90%
25yr PWLB rate	3.90%	3.85%	3.85%	3.85%	3.85%	3.85%	3.85%
50yr PWLB rate	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%

UBS Interest rate forecast (for quarter ends) – 4 October 2010
Table 3

	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Bank rate	0.50%	0.50%	0.50%	0.75%	1.00%
10yr PWLB rate	3.15%	3.25%	3.45%	3.65%	3.75%
25yr PWLB rate	4.25%	4.25%	4.25%	4.35%	4.45%
50yr PWLB rate	4.35%	4.45%	4.45%	4.55%	4.65%

2.9 Expectations in the Strategy were for Bank Rate to increase steadily during the year with a forecast to rise to 1.5 per cent by the fourth quarter of 2010/11. It was then expected to continue to rise reaching 3.5 per cent by the end of 2011/12 and 4.5 per cent by the end of 2012/13. As can be seen, these expectations have changed with the first rise put back to the second quarter of 2011/12 and a peak of only 3.25 per cent by the end of 2012/13.

3 Annual Treasury Strategy Update

Investments

3.1 The Annual Treasury Strategy for 2010/11 was approved by the Council on 3 March 2010. The Council's Annual Investment Strategy which forms part of this document sets out the Council's policy for giving priority to the security and liquidity of its investments, rather than yield. The Council's agreed policy objective is the **prudent investment of treasury balances**. The Council's investment priorities are to **achieve the optimum returns on investments subject to a very high level of security of capital and a level of liquidity in its investments**, appropriate to the Council's projected need for funds over time. The risk appetite of this Council is low in order to give priority to security of its investments.

3.2 In the current economic climate it is considered appropriate to keep investments short term and only invest with highly rated institutions, taking into account sovereign credit ratings and the creditworthiness service provided by the Council's treasury advisor.

3.3 Investments during the first six months of the year have been entirely in line with the strategy.

3.4 Following discussions with the then Cabinet Member for Finance and Property in February 2010, the operational limits on these investments have been:

- No more than 33 per cent of total investments to be placed in the six agreed UK guaranteed institutions (HSBC, Barclays, RBS, Lloyds Group, Santander UK and Nationwide) with no more than £25 million in any one institution.
- A maximum of 12 months' final maturity of deposits in these institutions.
- An extension to the duration limits used by the external cash fund manager on investments in gilts and multilateral

development bank bonds to an average of three years and a maximum final maturity of five years.

3.5 During the current uncertainty with regard to the European debt crisis funds have been withdrawn from Santander UK even though the bank is regulated by the FSA, which should limit the amount that could be repatriated if the Spanish parent considered it necessary.

3.6 Even though there is still uncertainty in the financial and banking market, both globally and in the UK, it is considered that the strategy agreed on 3 March 2010 is still fit for purpose in the current economic climate. However it is proposed to make a minor change to the approved investment limits to enhance yield whilst preserving security, namely to increase the maximum duration of in-house 'buy to hold' gilts from one year to two years.

3.7 **Appendix 1** shows the current investment instruments that are allowed under the strategy and the proposed change.

3.8 The investment portfolio yield for the first six months of the year is 0.48 per cent against the benchmark (seven day rate) of 0.42 per cent an out-performance of six basis points. A full list of investments held as at 30 September 2010 is shown in **Appendix 2** and is summarised below

Investments	1 April 2010 £m	Average Rate of Return %
In-house	155.861	0.54
Investec	40.045	0.46
Total	195.906	0.53
	30 September 2010 £m	Average Rate of Return %
In-house	164.974	0.45
Investec	40.170	0.62
Total	205.144	0.48

3.9 The average level of funds available for investment in the first six months of 2010/11 was £206 million. The Council's budgeted investment return for the year is £1.3 million and performance for the year to date is £0.16 million below budget.

Borrowing

3.10 The Council's capital financing requirement (CFR) for 2010/11 is £221.962 million. The CFR denotes the Council's underlying need to borrow for capital purposes. The outstanding debt as at 30 September was £192.462 million. Where the CFR exceeds borrowing the Council may choose to cover the difference by borrowing either from the Public Works Loan Board (PWLB) or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions.

3.11 Borrowing rates have been at historically low levels during the first six months of the financial year as shown in the table below. However, as anticipated in the Strategy, the Council has undertaken no new borrowing due to the high level of cash holdings. It is anticipated that no borrowing will be undertaken during the financial year.

PWLB BORROWING RATES 2010/11 for 1 to 50 years

	1	2	3	4	5	10	25	50
1. 4.2010	0.81%	1.37%	1.91%	2.40%	2.84%	4.14%	4.62%	4.65%
30.9.2010	0.64%	0.91%	1.22%	1.55%	1.88%	3.14%	3.95%	4.01%
HIGH	0.93%	1.52%	2.07%	2.56%	2.99%	4.27%	4.73%	4.74%
LOW	0.60%	0.89%	1.20%	1.52%	1.84%	3.06%	3.92%	3.93%
spread	0.33%	0.63%	0.87%	1.04%	1.15%	1.21%	0.81%	0.81%
average	0.73%	1.15%	1.58%	1.99%	2.37%	3.65%	4.35%	4.35%
high date	26/04/2010	26/04/2010	26/04/2010	26/04/2010	26/04/2010	12/04/2010	12/04/2010	26/04/2010
low date	15/06/2010	24/08/2010	25/08/2010	31/08/2010	31/08/2010	31/08/2010	31/08/2010	31/08/2010

4 Compliance with Prudential Indicators

4.1 It is a statutory duty for the Council to determine and keep under review affordable borrowing limits. The Council’s approved Prudential Indicators are outlined in the approved Annual Treasury Strategy.

4.2 During the financial year to date the Council has operated within the Prudential Indicators set out in the Annual Treasury Strategy and in compliance with the Council’s Treasury Management Practices. The Prudential Indicators are shown in **Appendix 3**

5 Recommendation

5.1 Council is asked to **approve** the Annual Treasury Strategy 2010/11 Mid-year Review including the proposed change to investment limits outlined in paragraph 3.6 and **Appendix 1.**

Nicholas Holgate
Executive Director for Finance, Information Systems and Property

Background papers: CIPFA Code of Practice on Treasury Management for the Public Sector
CLG Guidance on Local Government Investments

Further background statistics on Treasury Management are included in section C of "Vital Finances" on the Council's Intranet (Plans and performance>Plans and strategies>Financial>Vital Finances) reported to the Cabinet in July 2009.

Contact officer: Paul Kidd, Corporate Services Tel: 020 7361 2316 E-mail: fis.dept@rbkc.gov.uk

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Appendix 1
Maximum Investment Amounts (changes highlighted in bold)

Investment Category *(assuming **£200 million** total portfolio)*	Long term Min Credit Rating	**2010/11 Approved Treasury Strategy (a)**	**2010/11 Mid-year review proposed Strategy changes (c)**
Deposits < 1 year			
Govt Guaranteed UK Banks & B.Soc (Total)			
Govt Guaranteed UK Banks & B.Soc (Indiv)	AA-		
Banks (Indiv) [1]	AAA AA+	£50m	
Banks (Indiv) [1]	AA	£25m	
Banks (Indiv) [1] (Lower limits apply for ratings down to A)	AA-	£25m	
Debt Mgt Office		£200m	
UK Local Authorities		£22.5m	
Deposits > 1 year			
Banks & B.Soc (Total) Indiv limits within above figs)	AA-	Nil	
Gilts / Treasury Bills			
Short dated UK gilts (max 1 year)		£200m	
Long dated UK gilts		Nil (internal) £80m (external mgrs) 3 year average max 5 yrs to maturity	**Up to two years maturity (internal)** £80m (External) 3 year average max 5 yrs to maturity
Multi-lateral Devt Bank Bonds		£22.5m (int+ext) 3 year average duration max 5 yrs to maturity	
Ext Fund Mgt (within above limits)			
External Fund Mgt Total		£80m max	
External Fund Mgt Total – Long term illiquid (within total)		£40m	

[1] Combined with a short term credit rating of F1+ and support rating of 1 (AAA and AA+) 1or 2 (AA) and 1, 2 or 3 (AA-). In addition non UK counter parties where the sovereign rating is AAA are further limited in total to £34m in any one country, sovereign rating AA+ limited in total to £22.5m in any one country.

Investment Category *(assuming **£200 million** total portfolio)*	Long term Min Credit Rating	**2010/11 Approved Treasury Strategy (a)**	**2010/11 Mid-year review proposed Strategy changes (c)**
Money Market Funds			
Money Market Funds	AAA MR1+	£200m	

Appendix 2

Investments Outstanding 30 September 2010 Analysed by Counterparty

Counterparty	Total Invested	Individual Investments	Maturity
DMO	87,360,000.00	3,640,000.00	01-Oct-10
		1,250,000.00	01-Oct-10
		6,100,000.00	04-Oct-10
		3,700,000.00	05-Oct-10
		5,000,000.00	06-Oct-10
		5,000,000.00	08-Oct-10
		4,100,000.00	11-Oct-10
		2,030,000.00	13-Oct-10
		2,570,000.00	12-Oct-10
		4,420,000.00	14-Oct-10
		3,000,000.00	18-Oct-10
		680,000.00	19-Oct-10
		11,170,000.00	19-Oct-10
		3,760,000.00	20-Oct-10
		6,000,000.00	21-Oct-10
		2,820,000.00	22-Oct-10
		3,330,000.00	25-Oct-10
		5,100,000.00	25-Oct-10
		1,960,000.00	26-Oct-10
		2,870,000.00	27-Oct-10
		1,680,000.00	28-Oct-10
		1,850,000.00	29-Oct-10
		5,330,000.00	01-Nov-10
SANTANDER UK	15,138.77	15,138.77	Call
BARCLAYS BANK	0.00		
HSBC	0.00		
LLOYDS GROUP	19,351,383.35	2,351,383.35	Call
(Lloyds TSB / BoS)		2,000,000.00	07-Oct-10
		5,000,000.00	27-Oct-10
		5,000,000.00	08-Dec-10
		5,000,000.00	16-Dec-10
ROYAL BANK OF SCOTLAND	18,352,135.84	18,352,135.84	Call
NATIONWIDE BUILDING SOC	0.00		
GOVERNMENT STOCK (buy to hold)			
Gilt 6.25% 25-Nov-10	39,895,046.05	39,895,046.05	25-Nov-10
Investec	40,169,739.91		
Certificates of Deposit			
Barclays		5,028,661.02	20-Jun-11
Nationwide		5,004,145.90	09-Sep-11
Lloyds		5,001,051.21	28-Sep-11
T Bills			
October		20,999,097.00	
November		3,998,216.00	
Cash		138,568.78	
	205,143,443.92	205,143,443.92	

Summary			
DMO	87,360,000.00	42.58%	
Banks/Building Societies	52,891,084.87	25.78%	
Government Securities	64,892,359.05	31.63%	
	205,143,443.92		

Appendix 3

Indicator	Approved Limit	Actual Debt	No. of days Limit Exceeded
Authorised Limit	£286.9m		None
Operational Boundary	£219.2m	£192.5m	None
Interest Rate Exposure	**Lower Limit**	**Upper Limit**	**Actual**
Fixed Rate Debt	£111m	£222m	£192.5m
Variable Rate Debt	£0	£111m	£0
Maturity Structure of Borrowing	**Lower Limit**	**Upper Limit**	**Actual**
Under 12 Months	0%	10%	5%
12 Mths to within 24 Mths	0%	10%	6%
24 Mths to within 5 years	5%	20%	11%
5 years to within 10 years	10%	50%	19%
Over 10 years	30%	85%	59%

Actual figures as at 30 September 2010