# 7(iv)

**THE ROYAL BOROUGH OF KENSINGTON AND CHELSEA**

**AUDIT COMMITTEE – 21 SEPTEMBER 2011**

**MEETING OF THE COUNCIL - 12 OCTOBER 2011**

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

# ANNUAL TREASURY REPORT 2010/11

In accordance with the Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management, the Council's treasury management practices require this report to be made to the Cabinet Member for Finance and Information Technology and to the Audit Committee. The latter is the body identified as being responsible for the scrutiny of treasury management. The report must be submitted by 30 September each year. The report must also be presented to the full Council for information.

**FOR INFORMATION**

## 1. Introduction

1.1 This report presents the Council's Annual Treasury Report for 2010/11 in accordance with the Council's treasury management practices.

## 2. Background

2.1 Introduction

2.1.1 The Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management 2009 requires the following:

- Creation and maintenance of a treasury management policy statement which sets out the policies and objectives of the Council's treasury management activities. This was reported to the Cabinet in July 2010;
- Creation and maintenance of treasury management practices which set out the manner in which the Council will seek to achieve those policies and objectives;

- Receipt by the full Council of an annual treasury management strategy report for the year ahead and a mid-year review of the strategy;
- Receipt by the Cabinet Member for Finance and Information Technology, the Audit Committee and full Council of an annual review of the previous year;
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and the execution and administration of treasury management decisions; and
- Delegation by the Council of the role of scrutinising of treasury management strategy and policy to a specific named body, which for this Council is the Audit Committee.

2.1.2 Treasury management in this context is defined 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."[1]

2.1.3 This annual treasury report covers:
- the treasury position as at 31 March 2011;
- the borrowing strategy for 2010/11;
- the borrowing outturn for 2010/11;
- compliance with treasury limits and prudential indicators;
- investment strategy for 2010/11; and
- investment outturn for 2010/11.

## 2.2 Current Treasury Position

2.2.1 The Council's debt and investment position at the beginning and end of the year was as follows:

| £ million | **31 March 2010 Principal** | **Rate/ Return at 31 March 2010** | **31 March 2011 Principal** | **Rate/ Return at 31 March 2011** |
|---|---|---|---|---|
| Fixed Rate Funding | | | | |
| - Public Works Loan Board | 192.529 | 7.26% | 182.345 | 7.14% |
| - Special | 0.002 | 0.50% | 0.002 | 0.50% |
| **Total Debt** | **192.531** | **7.26%** | **182.347** | **7.14%** |
| | | | | |
| Investments | | | | |

[1] Treasury Management Policy Statement adopted by Cabinet – 22nd July 2010

| | | | | |
|---|---|---|---|---|
| - In House | 155.861 | 0.54% | 155.001 | 0.47% |
| - Investec | 40.045 | 0.46% | 40.333 | 0.73% |
| **Total Investments** | **195.906** | **0.53%** | **195.334** | **0.52%** |

2.2.2 The table below shows the allocation of interest paid and received during the year:

| Fund | Interest Paid | | Interest Received | | Net £m |
|---|---|---|---|---|---|
| | **Apportionment %** | **Amount £m** | **Apportionment %** | **Amount £m** | |
| Gen Fund | 14 | 1.98 | 88 | 0.97 | (1.01) |
| HRA | 86 | 12.00 | 8 | 0.09 | (11.91) |
| Other* | | | 4 | 0.03 | 0.03 |
| **Total** | **100** | **13.98** | **100** | **1.09** | **(12.89)** |

*Other includes Section 106, London Residuary Body etc.

2.3 The Strategy for 2010/11

2.3.1 The treasury strategy for 2010/11, approved by the Council on 3 March 2010, was based on the expectation that base rate, whilst remaining low, would rise gradually from the fourth quarter of 2010 with similar gradual rises in medium and longer term fixed interest rates over 2010/11. Continued uncertainty in the aftermath of the 2008 financial crisis led to a continuation of a cautious approach for investments with low counterparty risk the main consideration, resulting in relatively low returns compared to borrowing rates.

2.3.2 Due to the level of cash balances held by the Council (£196 million at 31 March 2010), it was anticipated that there would not be any need to borrow during 2010/11. However interest rates would be monitored and if any opportunity to borrow at historically low rates occurred, this would be considered with 4 per cent regarded as the trigger for reviewing the borrowing position.

2.4 Outturn for 2010/11

2.4.1 In 2010/11, rather than focusing on individual institutions, market fears moved on to sovereign debt issues, particularly in the peripheral Euro zone countries. First Greece (May), then Ireland (December), were forced to accept assistance from a combined EU / IMF rescue package. Subsequently fears steadily grew about

Portugal, although it managed to put off accepting assistance until after the year end. These worries caused international investors to seek safe havens in investing in non-Euro zone government bonds.

2.4.2 UK growth proved mixed over the year. The first half of the year saw the economy outperform expectations, although it showed a negative return in the final quarter of 2010. The year finished with expectations for UK economic growth being lowered over the short to medium term. The Japanese earthquake and tsunami in March and the crisis in North Africa, particularly Libya, caused an increase in world oil prices, which combined to dampen international economic growth prospects.

2.4.3 The new coalition Government announced spending cuts in the October Comprehensive Spending Review.

2.4.4 Gilt yields fell for much of the first half of the year as financial markets drew considerable reassurance from the Government's debt reduction plans, especially in the light of Euro zone sovereign debt concerns. Speculation regarding the possibility of further quantitative easing also helped to push yields to historic lows. However, this positive performance was mostly reversed in the closing months of 2010 as sentiment changed due to sharply rising inflation.

2.4.5 Local authorities found their potential borrowing costs increased following the unexpected change of policy on Public Works Loan Board (PWLB) lending arrangements in October 2010. This resulted in an increase in new borrowing rates of 0.75 – 0.85 per cent, without an associated increase in early redemption rates. This made new borrowing more expensive and repayment even less attractive.

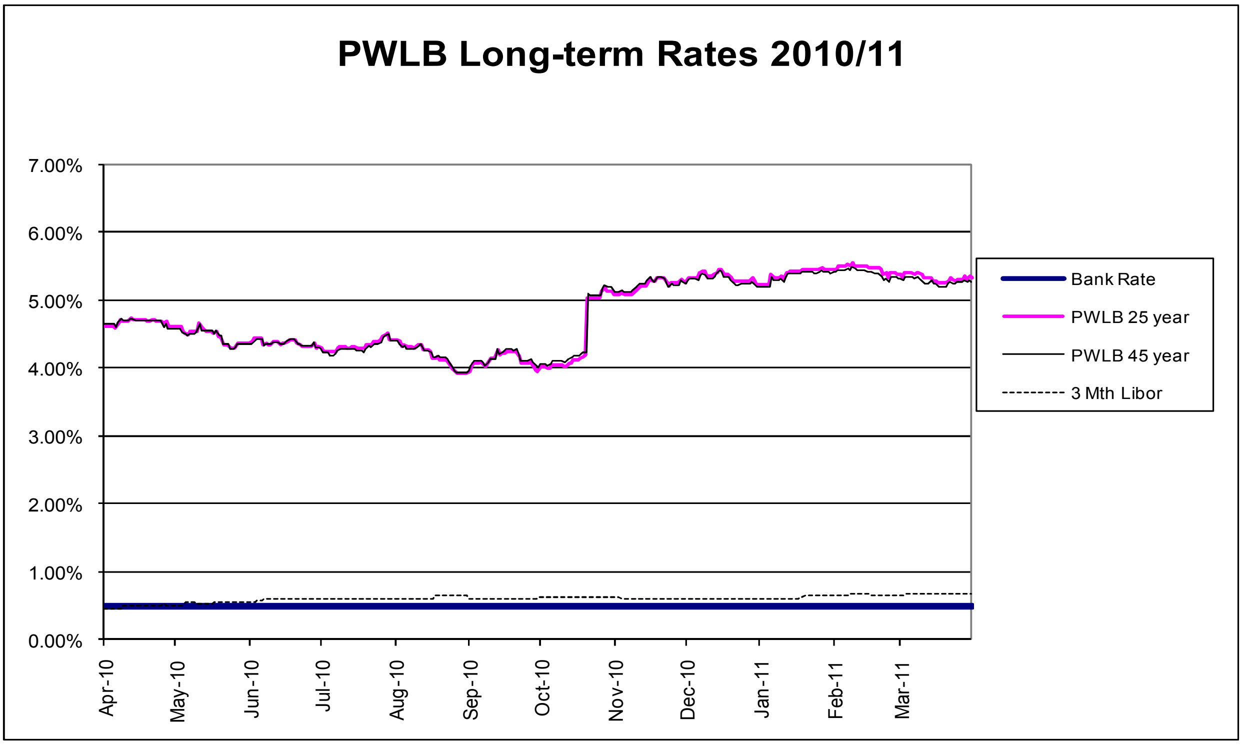
2.4.6 Deposit rates picked up modestly in the second half of the year as rising inflationary concerns, and strong first half growth, fed through to prospects of an earlier start to increases in Bank Rate. However, in March 2011, slowing actual growth, together with weak growth prospects, saw consensus expectations of the first UK rate rise move back from May to August 2011 despite high inflation.

2.4.7 Risk premiums were also a factor in raising money market deposit rates beyond three months. Although market sentiment has improved, continued Euro zone concerns, and the significant funding issues still faced by many financial institutions, mean that investors remain cautious of longer-term commitment.

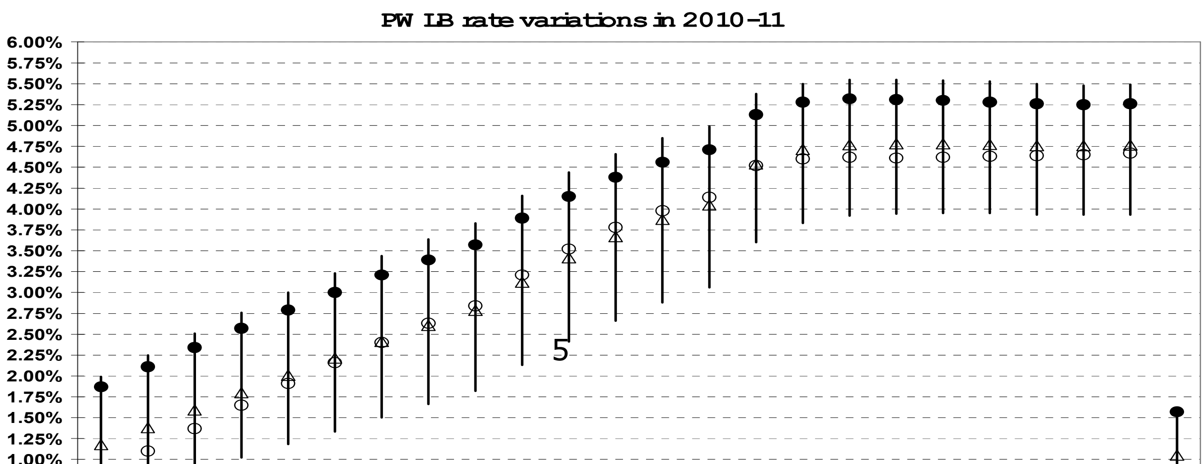
2.5 Treasury Borrowing

2.5.1 No new borrowing was undertaken during the year. PWLB debt maturing during the year, which was not refinanced, totalled £10.184 million, with an average nominal interest rate of 9.41 per cent. This resulted in a reduction in average interest rates from 7.26 per cent to 7.14 per cent.

2.5.2 The following graph shows the levels of Bank Rate, three month London Interbank Offer Rate (LIBOR), PWLB 25 and 45 year rates during the year. The sharp increase in PWLB rates in mid October reflects the change in policy increasing the margin over the corresponding gilt that the Board used when setting borrowing rates for local authorities:




2.5.2 The graph below shows the range (high and low points) for PWLB rates for each maturity period during the year, and individual rates at the start and end of the financial year. The 50 year+ rate is not available for borrowing but is quoted for repayment / rescheduling calculations for outstanding loans with longer than 50 years to maturity.



2.6 Compliance with Treasury Limits

2.6.1 During the financial year the Council operated within the treasury limits set out in the Council's Treasury Policy Statement and Treasury Strategy Statement. The outturn for Treasury Management Prudential Indicators is shown in **appendix A**.

2.7 Investment Strategy for 2010/11

2.7.1 Continuing the gradual movement of deposits away from the Debt Management Office (DMO) the total amount that could be placed in certain UK financial institutions (HSBC, Barclays, Royal Bank of Scotland, Lloyds Group, Santander UK and Nationwide) was increased from 25 per cent to 33 per cent with effect from 1 April 2010.

2.7.2 Further consideration was given to the position in November 2010 when the limit was increased to 50 per cent.

2.7.3 By 31 March 2011 the portfolio was invested accordingly:

a) £40.3 million with Investec, the Council's external cash fund manager. This represents the initial investment of £40 million plus capitalised income.

b) Around £40 million held in a UK gilt (5.25 per cent 7th June 2012) invested on 9 December 2010, which will yield the equivalent of 0.83 per cent per annum. This has been invested on a 'buy to hold' basis, i.e. not for trading but to achieve the fixed yield

c) Approximately £76 million was invested in house in short term deposits with the agreed UK financial institutions.

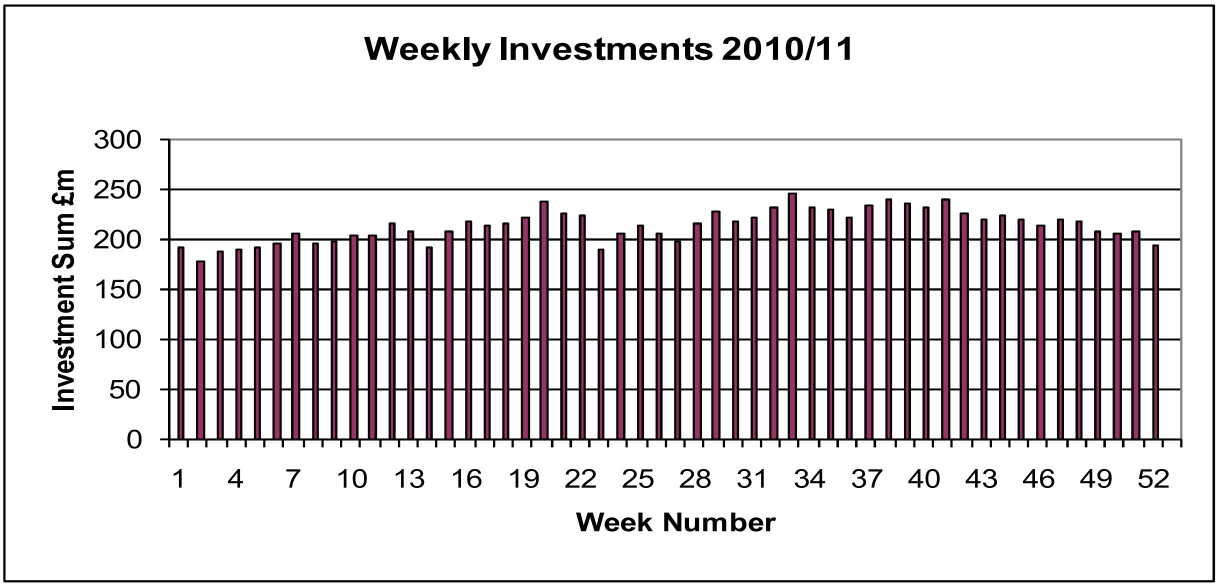
d) The remainder continues to be invested in the Debt Management Office.

2.7.4 The external fund manager's investments and the 'buy to hold' gilt are held in segregated custody accounts at Citibank. Investigations were undertaken by officers to ensure the holding is fully recoverable by the Council should the custodian be subject to insolvency or administration proceedings.

2.8 Investment Outturn for 2010/11

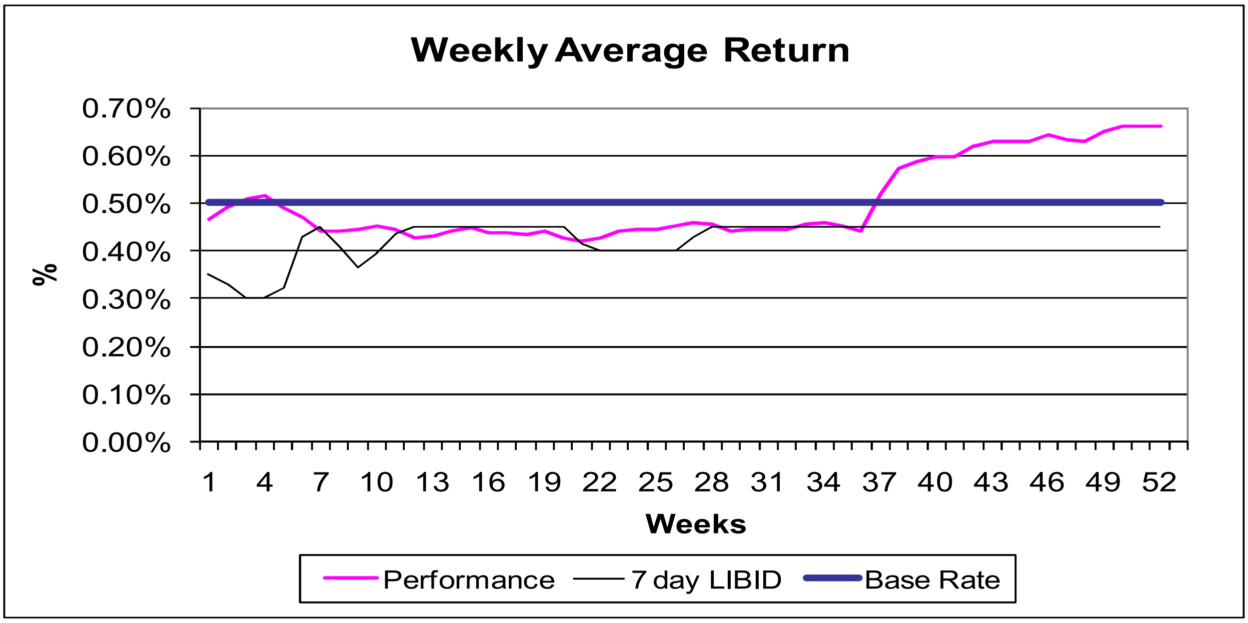
2.8.1 The investments outstanding at 31 March 2011 amounted to £195.334 million: £155.944 million was invested in short-term deposits and the remainder in the 'buy to hold' gilt maturing in June 2012. This compares with £195.906 million short-term investments at 1 April 2010.

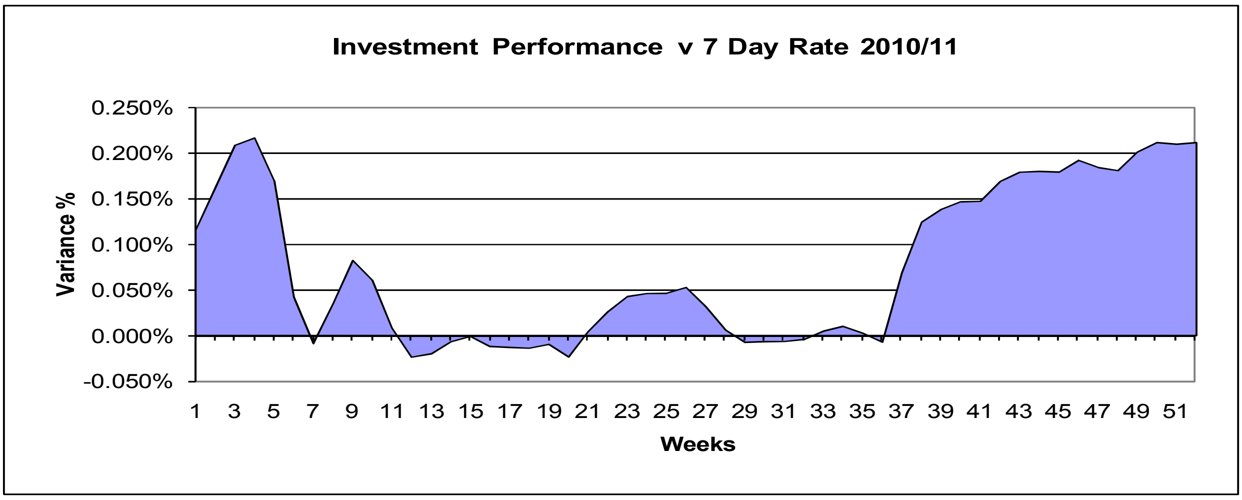
2.8.2 The investments outstanding each week during the year are shown in the following diagram inclusive of funds with external managers:




2.8.3 Internally Managed Cash

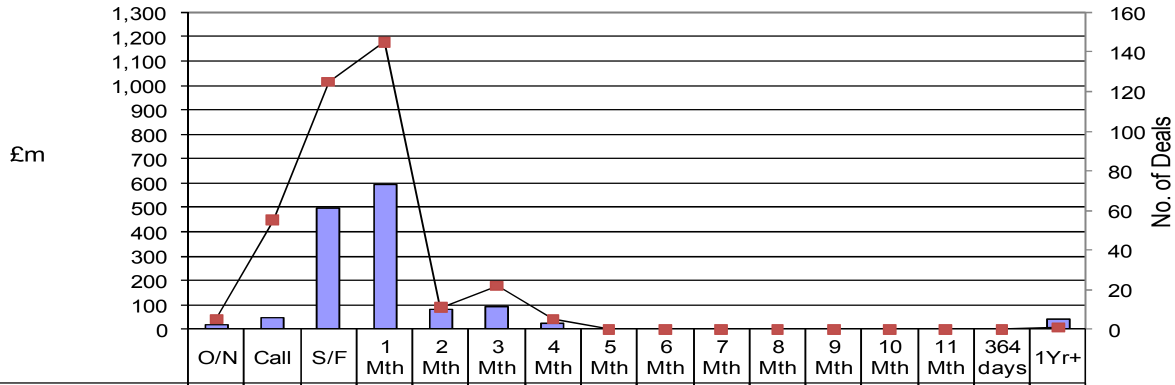
The average return achieved on investments managed internally for the year was 0.51 per cent compared to the average 7-day money market rate (uncompounded) of 0.43 per cent. Interest rates remained low throughout the year, the Council follows a low risk strategy and does not seek potential higher returns which would increase counterparty risk. The following graphs show the weekly average return on investments held compared with market rates and the variance from the 7 day LIBID rate:



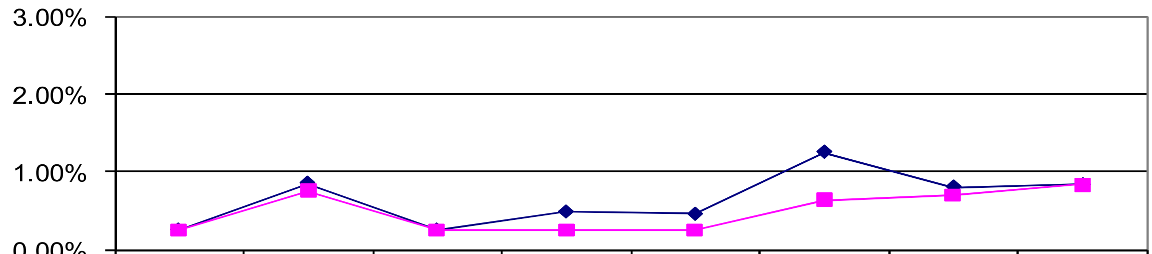

2.8.4 The following graphs show the short term deposits that were placed on money markets during the year, the range of interest rates achieved on the deposits and the maturity profile of in-house investments at the beginning and end of the year:

## Investments Made by Period



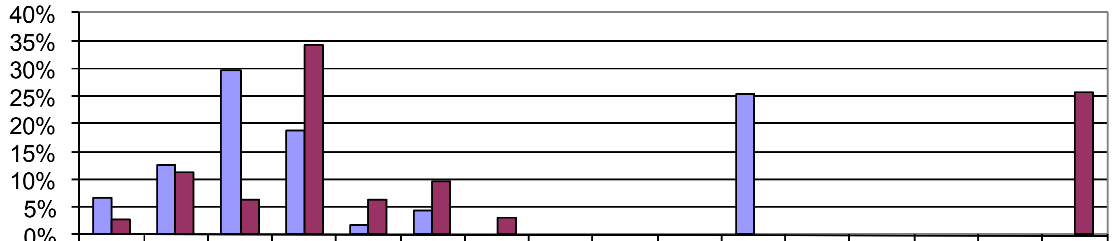

| | O/N | Call | S/F | 1 Mth | 2 Mth | 3 Mth | 4 Mth | 5 Mth | 6 Mth | 7 Mth | 8 Mth | 9 Mth | 10 Mth | 11 Mth | 364 days | 1Yr+ |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total Value £m | 20 | 44 | 499 | 595 | 79 | 95 | 25 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 40 |
| No. of Deals | 5 | 55 | 125 | 145 | 11 | 22 | 5 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1 |

## Interest Rate High /Low on New Investments




| | O/N | Call | S/F | 1 Mth | 2 Mth | 3 Mth | 4 Mth | 1Yr+ |
|---|---|---|---|---|---|---|---|---|
| High | 0.25% | 0.85% | 0.25% | 0.48% | 0.45% | 1.25% | 0.80% | 0.83% |
| Low | 0.25% | 0.75% | 0.25% | 0.25% | 0.25% | 0.63% | 0.70% | 0.83% |

## Investment Maturity Profile




| | O/N | Call | S/F | 1 Mth | 2 Mth | 3 Mth | 4 Mth | 5 Mth | 6 Mth | 7 Mth | 8 Mth | 9 Mth | 10 Mth | 11 Mth | 364 days | 1Yr+ |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 31-Mar-10 | 7% | 13% | 30% | 19% | 2% | 4% | 0% | 0% | 0% | 0% | 25% | 0% | 0% | 0% | 0% | 0% |
| 31-Mar-11 | 3% | 11% | 6% | 34% | 6% | 10% | 3% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 26% |

The graph reflects a slight increase in the duration of investments made during the year. The investment with over one year to maturity represents the direct investment in gilts. The DMO interest rates remained at 0.25 per cent for the year. Call accounts have continued to operate at a margin above Bank Rate and Lloyds Group offer enhanced rates on limited deposits in the three, six and twelve month periods.

2.8.5 **Appendix B** shows the volume and value of investments made with approved counterparties. These are summarised as follows:

| Counterparty Group | Per cent based on Value | Per cent based on Volume |
|---|---|---|
| DMO | 87 | 77 |
| UK Gilt | 3 | 0 |
| UK Banks | 10 | 21 |
| UK Building Society | 3 | 2 |

These figures reflect the decision to continue using alternative UK Government holdings and to move some of the Council's deposits from the DMO to the agreed UK financial institutions

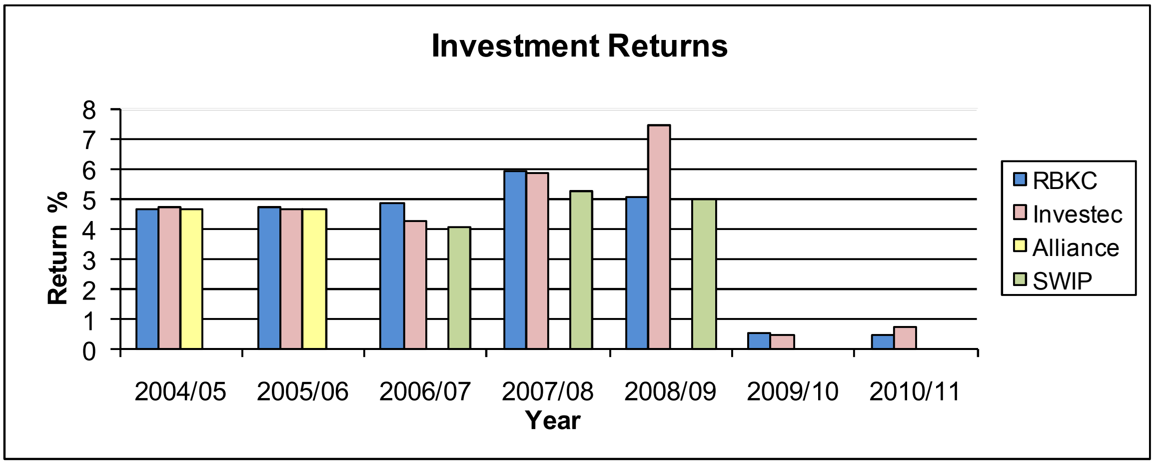
The credit ratings shown in the appendix are those in force at the end of the financial year and the limits shown are calculated using these ratings and the limits agreed in the 2010/11 Strategy.

2.8.6 External Fund Managers

The Council has allocated a limit of £80 million to the funds that can be placed in total with external cash fund managers. At 31 March £40.3 million was invested via Investec, which represents the initial placing of £40 million plus capitalised income. The portfolio is restricted to investments in term deposits and Certificates of Deposit with six named UK banks/building societies (i.e. HSBC, Barclays, RBS, Lloyds Group, Santander UK and Nationwide) plus UK gilts, Treasury Bills, and European Investment Bank bonds. Investment in the guaranteed institutions by the external manager is within the overall limit for that sector including internally invested funds

The return on this portfolio for 2010/11 is 0.73 per cent compared with the benchmark (7 day LIBID compounded) of 0.52 per cent. Since inception (January 2010) the fund has returned 0.68 per cent and the benchmark 0.51 per cent.

2.8.7 The following graph shows the relative investment returns for internally and externally managed cash for the past six years.




2.8.9 No institutions in which investments were made had any difficulty in repaying investments and interest in full during the year.

**FOR INFORMATION**

Nicholas Holgate
**Executive Director for Finance, Information Systems and Property**

**APPENDIX A**

## RBKC – TREASURY MANAGEMENT PRUDENTIAL INDICATORS 2010/11

| Indicator | Approved Limit | Actual Debt | No. of days Limit Exceeded |
|---|---|---|---|
| Authorised Limit[1] | £286.9m | | None |
| Operational Boundary[2] | £219.2m | £182.3m | None |
| **Interest Rate Exposure** | **Lower Limit** | **Upper Limit** | **Actual at 31 Mar 2011** |
| Fixed Rate Debt | £111m | £222m | £182.3m |
| Variable Rate Debt | £0m | £111m | £0m |
| **Maturity Structure of Borrowing** | **Lower Limit** | **Upper Limit** | **Actual at 31 Mar 2010** |
| Under 12 Months | 0% | 10% | 7% |
| 12 Mths to within 24 Mths | 0% | 10% | 3% |
| 24 Mths to within 5 years | 5% | 20% | 12% |
| 5 years to within 10 years | 10% | 50% | 21% |
| Over 10 years | 30% | 85% | 56% |

[1] The Authorised Limit is the maximum requirement for borrowing taking into account maturing debt, capital programme financing requirements and the ability to borrow in advance of need for up to two years ahead.

[2] The Operational Boundary is the expected normal upper requirement for borrowing in the year.

## RBKC – AUTHORISED INVESTMENTS – ACTUAL USAGE 2010/11 APPENDIX B

| | Credit Rating as at 31st March 2011 (see below for definitions) | | | Limit | Peak Exposure £M | Year End Exposure £M | No. of Deals | Turnover £m |
|---|---|---|---|---|---|---|---|---|
| | Long Term | Short Term | Support | | | | | |
| **UK GOVERNMENT** | | | | | | | | |
| Debt Management Account Deposit Facility | AAA | N/A | N/A | 100% | 129.93 | 39.95 | 283 | 1,179.00 |
| Gilt – Buy to Hold | AAA | N/A | N/A | 100% | 39.99 | 39.39 | 1 | 39.99 |
| | | | | | | | | |
| **UK GOVERNMENT TOTAL** | | | | | | **79.34** | **284** | **1,218.99** |
| | | | | | | | | |
| **UK BANKS** | | | | | | | | |
| Barclays Bank | AA- | F1+ | 1 | £25m | 20.00 | 20.00 | 6 | 30.00 |
| HSBC Bank | AA | F1+ | 1 | £25m | 0 | 0 | 0 | 0 |
| Lloyds Group (Including Bank of Scotland) | AA- | F1+ | 1 | £25m | 19.56 | 19.56 | 31 | 68.17 |
| Royal Bank of Scotland | AA- | F1+ | 1 | £25m | 19.89 | 16.51 | 25 | 29.02 |
| Santander UK (formally Abbey) | AA- | F1+ | 1 | £25m | 13.71 | 0.02 | 15 | 10.32 |
| | | | | | | | | |
| **UK BANKS TOTAL** | | | | | | **56.09** | **77** | **137.51** |
| | | | | | | | | |
| **UK BUILDING SOCIETIES** | | | | | | | | |
| Nationwide | AA- | F1+ | 1 | £25m | 20 | 19.58 | 8 | 39.58 |
| | | | | | | | | |
| **UK BUILDING SOCIETIES TOTAL** | | | | | | **19.58** | **8** | **39.58** |
| | | | | | | | | |
| **TOTAL INVESTED** | | | | | | **155.01** | **369** | **1,396.08** |

## CREDIT RATING DEFINITIONS:

| Fitch | Moody's | S&P | Definition |
|---|---|---|---|
| **Long Term** | | | |
| AAA | Aaa | AAA | Highest credit quality. 'AAA' ratings denote the lowest expectation of credit risk. They are assigned only in case of exceptionally strong capacity for payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events. |
| AA+<br>AA<br>AA- | Aa1<br>Aa2<br>Aa3 | AA+<br>AA<br>AA- | Very high credit quality. 'AA' ratings denote expectations of very low credit risk. They indicate very strong capacity for payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events. |
| A+<br>A<br>A- | A1<br>A2<br>A3 | A+<br>A<br>A- | High credit quality. 'A' ratings denote expectations of low credit risk. The capacity for payments of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings. |
| BBB | Baa | BBB | Good credit quality. 'BBB' ratings indicate that there are currently expectations of low credit risk. The capacity for payment of financial commitments is considered adequate but adverse changes in circumstances and economic conditions are more likely to impair this capacity. This is the lowest investment grade category. |
| **Short Term** | | | |
| F1+<br>F1 | P1<br>P1 | A1+<br>A1 | Highest credit quality. Indicates the strongest capacity for timely payment of financial commitments; may have an added "+" to denote any exceptionally strong credit feature. |
| F2 | P2 | A2 | Good credit quality. A satisfactory capacity for timely payment of financial commitments, but the margin of safety is not as great as in the case of the higher ratings. |

| | | | |
|---|---|---|---|
| F3 | P3 | A3 | Fair credit quality. The capacity for timely payment of financial commitments is adequate; however, near term adverse changes could result in a reduction to non investment grade. |
| **Support** | | | |
| 1 | n/a | n/a | A bank for which there is an extremely high probability of external support. The potential provider of support is very highly rated in its own right and has a very high propensity to support the bank in question. This probability of support indicates a minimum long-term rating floor of 'A-'. |
| 2 | n/a | n/a | A bank for which there is a high probability of external support. The potential provider of support is highly rated in its own right and has a high propensity to provide support to the bank in question. This probability of support indicates a minimum long-term rating floor of 'BBB-'. |
| 3 | n/a | n/a | A bank for which there is a moderate probability of support because of uncertainties about the ability or propensity of the potential provider of support to do so. This probability of support indicates a minimum long-term rating floor of 'BB-'. |