AUDIT COMMITTEE

26 NOVEMBER 2013

TREASURY MANAGEMENT STRATEGY MID-YEAR REVIEW REPORT 2013/2014

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Summary

On the 21 February 2013, Full Council approved the 2013/14 Treasury Management Strategy. As part of that strategy and in line with the Chartered Institute of Public Finance Accountancy's (CIPFA) code of Practice for Treasury Management, there should be a review of that strategy at least half yearly. This report is the mid year review of the Treasury Management Strategy 2013/14.

1. Budget and Policy Framework

1.1 Business Support Overview and Scrutiny is responsible for the scrutiny of the Council's Treasury Management, Investment Strategy and Minimum Revenue Provision Policy Statement along with Treasury Management Practices and associated Schedules.

1.2 There needs to be, as a minimum, a mid year review of treasury management strategy and performance. This is intended to highlight any areas of concern that have arisen since the original strategy was approved.

1.3 This report is scheduled for consideration by Cabinet on 17 December 2013 and Council on 23 January 2014. The Business Support Overview and Scrutiny Committee should also consider Mid Year report. On this occasion however the Overview and Scrutiny Committee have requested that the Audit Committee consider this report on their behalf, to relieve pressure on the Overview and Scrutiny Committee's work programme. The submission of this report to the Audit Committee is consistent with the Committee's role in considering the annual Treasury Outturn report.

2. Background

2.1 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensures this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering maximising investment return.

2.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer-term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer-term cash may involve arranging long or short-term loans, or using long-term cash flow surpluses, and on occasion, debt previously incurred may be restructured to meet Council risk or cost objectives.

2.3 As a consequence treasury management is defined 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. "

2.4 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) was adopted by this Council on 24 January 2013.

2.5 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 full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a **Mid-year Review Report** and an Annual Report (stewardship 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: Business Support Overview and Scrutiny Committee.

2.6 This mid year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first six months of 2013/14
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- A review of the Council's investment portfolio for 2013/14
- A review of the Council's borrowing strategy for 2013//14
- A review of any debt rescheduling undertaken during 2013/14
- A review of compliance with Treasury and Prudential Limits for 2013/14.

3 Economic update

3.1 Economic performance to date

3.1.1 During 2013/14 economic indicators suggested that the economy is recovering, albeit from a low level. After avoiding recession in the first quarter (Q1) of 2013, with a 0.3% quarterly expansion the economy grew 0.7% in Q2. There have been signs of renewed vigour in household spending in the summer, with a further pick-up in retail sales, mortgages, house prices and new car registrations.

3.1.2 The strengthening in economic growth appears to have supported the labour market, with employment rising at a modest pace and strong enough to reduce the level of unemployment further. Pay growth also rebounded strongly in April, though this was mostly driven by high earners delaying bonuses until after April's cut in the top rate of income tax. Excluding bonuses, earnings rose by just 1.0% year on year, well below the rate of inflation at 2.7% in August, causing continuing pressure on household's disposable income.

3.1.3 The Bank of England extended its Funding for Lending Scheme (FLS) into 2015 and sharpened the incentives for banks to extend more business funding, particularly to small and medium size enterprises. To date, the mortgage market still appears to have been the biggest beneficiary from the scheme, with mortgage interest rates falling further to new lows. Together with the Government's Help to Buy scheme, which provides equity loans to credit-constrained borrowers, this is helping to boost demand in the housing market. Mortgage approvals by high street banks have risen as have house prices, although they are still well down from the boom years pre 2008.

3.1.4 Turning to the fiscal situation, the public borrowing figures continued to be distorted by a number of one-off factors. On an underlying basis, borrowing in Q2 started to come down, but only slowly, as Government expenditure cuts took effect and economic growth started to show through in a small increase in tax receipts. The 2013 Spending Review, covering only 2015/16, made no changes to the headline Government spending plan, and monetary policy was unchanged in advance of the new Bank of England Governor, Mark Carney, arriving. Bank Rate remained at 0.5% and quantitative easing also stayed at £375bn. In August, the Monetary Policy Committee (MPC) provided forward guidance that Bank Rate is unlikely to change until unemployment first falls to 7%, which was not expected until mid 2016. However, 7% is only a point at which the MPC will review Bank Rate, not necessarily take action to change it. The three month to July average rate was 7.7%.

3.1.5 CPI inflation (MPC target of 2.0%), fell marginally from a peak of 2.9% in June to 2.7% in August. The Bank of England expects inflation to fall back to 2.0% in 2015.

3.1.6 Financial markets sold off sharply following comments from Ben Bernanke (the Fed chairman) in June that suggested the Fed. may 'taper' its asset purchases earlier than anticipated. The resulting rise in US Treasury yields was replicated in the UK. Equity prices fell initially too, as Fed. purchases of bonds has served to underpin investor moves into equities out of low yielding bonds. However, as the market moves to realign its expectations, bond yields and equities are likely to rise further in expectation of a continuing economic recovery.

3.1.7 Increases in payroll figures have shown further improvement, helping to pull the unemployment rate down from a high of 8.1% to 7.3%, and continuing house price rises have helped more households to escape from negative equity. In September, the Fed. surprised financial markets by not starting tapering as it felt the run of economic data in recent months had been too weak to warrant taking early action. Bond yields fell sharply as a result, though it still only remains a matter of time until tapering does start.

3.1.8 Tensions in the Eurozone eased over the second quarter, but there remained a number of triggers for a renewed flare-up. Economic survey data improved consistently over the first half of the year, pointing to a return to growth in Q2, so ending six quarters of Eurozone recession.

3.2 Outlook for the next six months of 2013/14

3.2.1 Economic forecasting remains difficult with so many external influences weighing on the UK. Volatility in bond yields is likely during 2013/14 as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, and safer bonds. Downside risks to UK gilt yields and Public Works Loan Board (PWLB) rates (risks of gilt yields or PWLB rates being less than expected) include:

- A return to weak economic growth in the US, UK and China causing major disappointment to investor and market expectations
- The potential for a significant increase in negative reactions of populaces in Eurozone countries against austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- The Italian political situation is frail and unstable: the coalition government fell on 29 September.
- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Weak growth or recession in the UK’s main trading partners - the EU and US, depressing economic recovery in the UK.
- Geopolitical risks e.g. Syria, Iran, North Korea, which could trigger safe haven flows back into bonds.

3.2.2 Upside risks to UK gilt yields and PWLB rates, (Risk of Gilts yields or PWLB rates being greater than expected), especially for longer term PWLB rates include: -

- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- Increased investor confidence that sustainable robust world economic growth is firmly expected, together with a reduction or end of Quantitative Easing QE operations in the US, causing a further flow of funds out of bonds into equities.
- A reversal of Sterling’s safe-haven status on a sustainable improvement in financial stresses in the Eurozone.

- In the longer term - a reversal of QE in the UK; this could initially be implemented by allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held.
- Further downgrading by credit rating agencies of the creditworthiness and credit rating of UK Government debt, consequent upon repeated failure to achieve fiscal correction targets and sustained recovery of economic growth, causing the ratio of total Government debt to GDP to rise to levels that provoke major concern.

3.2.3 The overall balance of risks to economic recovery in the UK is now weighted to the upside after five months of robust good news on the economy. However, only time will tell just how long this period of strong economic growth will last, and it remains exposed to vulnerabilities in a number of key areas. 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 of bond issuance in other major western countries. Near-term, there is some residual risk of further QE if there is a dip in strong growth or if the Monetary Policy Committee (MPC) were to decide to take action to combat the market's expectations of an early first increase in Bank Rate. If the MPC does takes action to do more QE in order to reverse the rapid increase in market rates, especially in gilt yields and interest rates up to 10 years, such action could cause gilt yields and PWLB rates over the next year or two to significantly undershoot the forecasts in the table below. The tension in the US over passing a Federal budget for the new financial year starting on 1 October and raising the debt ceiling in mid October could also see bond yields temporarily dip until agreement is reached between the opposing Republican and Democrat sides. Conversely, the eventual start of tapering by the Fed. will cause bond yields to rise.

3.3 Interest rate forecasts

	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%
5yr PWLB rate	2.50%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.20%	3.30%	3.50%	3.60%	3.70%
10yr PWLB rate	3.70%	3.70%	3.70%	3.70%	3.80%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%
25yr PWLB rate	4.40%	4.40%	4.40%	4.40%	4.50%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.10%	5.10%	5.20%
50yr PWLB rate	4.50%	4.40%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.20%	5.20%	5.30%

The above Interest rate forecasts have been provided by Capita Assets Services (formally known as Sector) the PWLB rates quoted are "certainty rates" rather than "standard rates".

3.3.1 Expectations for the first change in Bank Rate in the UK are now dependent on how to forecast when unemployment is likely to fall to 7%. Financial markets have taken a very contrary view to the MPC and have aggressively raised short-term interest rates and gilt yields due to their view that the strength of economic recovery is now so rapid that unemployment will fall much faster than the Bank of England forecasts. They therefore expect the first increase in Bank Rate to be in quarter 4 of 2014. There is much latitude to disagree with this view as the economic downturn since 2008 was remarkable for the way in which unemployment did not rise to anywhere near the extent likely, unlike in previous recessions. This meant that labour was retained, productivity fell and now, as the MPC expects, there is major potential for unemployment to fall only slowly as existing labour levels are worked more intensively and productivity rises back up again. The size of the work force is also expected to increase relatively rapidly and there are many currently self employed or part time employed workers who are seeking full time employment. Capita Asset Services take the view that the unemployment rate is not likely to come down as quickly as the financial markets are currently expecting and that the MPC view is more realistic. The prospects for any increase in Bank Rate before 2016 are therefore seen as being limited. However, some forecasters are forecasting that even the Bank of England forecast is too optimistic as to when the 7% level will be reached and so do not expect the first increase in Bank Rate until spring 2017.

4 Treasury Management Strategy Statement and Annual Investment Strategy update

4.1 The Treasury Management Strategy Statement (TMSS) for 2013/14 was approved by Council on 21 February 2013. There are no policy changes to the TMSS.

4.2 Limits to Borrowing Activity

4.2.1 The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowing less investments) will only be for a capital purpose. Net external borrowing should not, except in the short term, exceed the total of Capital Financing Requirement (CFR) in the preceding year plus the estimates of any additional CFR for 2013/14 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2013/14 Original Estimate £m	Current Position 30 Sept 2013 £m
Gross borrowing	162,324	172,325
Plus other long term liabilities*	3,123	3,123
Less investments	(64,957)	(69,002)
Net borrowing	100,490	106,446
CFR (year end position)	249,286	249,286

* Embedded Leases (on balance sheet)

4.2.2 On the 21 November 2013, £10 million PWLB loan was repaid, bringing the debt portfolio in line with the original estimate, and invested cash is likely to be in line with the original estimate producing a net borrowing figure of some £100 million – well within the CFR.

4.2.3 The Chief Finance Officer reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator for maintaining net borrowing to CFR.

4.2.4 A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit, which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in longer-term scenario. It is a forecast of maximum borrowing requirement with some capacity for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The council's authorised borrowing limit for 2013/14 is £435.915 million and it will not exceed this limit.

5 Investment Portfolio 2013/14

5.1 In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return, which is consistent with the Council's risk appetite. As set out in Section 3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. The continuing Euro zone sovereign debt crisis, and its potential impact on banks, prompts a low risk and short-term strategy. Given this risk adverse environment, investment returns are likely to remain low.

5.2 The investment portfolio yield for the first six months of the year for the in-house team is 1.08% (on an annual basis) and Investec is currently showing a loss of -0.13% (on an annual basis) net of fees or 0.04% gain gross of fees, however the outturn position for Investec is estimated to be 0.26% net of fees and the outturn position for the in-house team is currently estimated to be 1%.

5.3 The rates payable on investments have continued the trend of falling and it is anticipated this will continue.

5.4 A full list of in house investments held as at 30 September 2013 is shown below:

Investments	**Principal 30 Sept 2013 £**	**Interest %**
<u>Core Investments</u>		
Svenska Handelsbanken	10,000,000	0.70%
Nat West	20,000,000	1.58%
Lloyds TSB	5,000,000	1.90%
Total In house Core Investments	35,000,000	
Liquid Investments		
<u>Barclays FIBCA Account</u>	1,000,000	0.65%
Svenska Handelsbanken	10,000,000	0.75%
Total In house Liquid Investments	11,000,000	

5.5 The average balances, interest rate earned to 30 September 2013 and forecast average interest rate for 2013/14 comparing the performance of the externally managed fund to the In house team is shown below.

	Average Balance to 30 Sept 2013 **£**	**Average Interest Rate to 30 Sept 2013** **%**	Forecast **Average Interest Rate 2013/14** **%**
Externally Managed			
Investec (net of fees)	23,017,052	(0.13)%	0.26%
Managed In-House			
In-house Core Investments	32,907,609	1.42%	1.33%
In-house Liquid Investments	27,497,826	0.67%	0.68%
Total In-House		1.08%	1.00%

5.6 The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2013/14. However, on the 5 November a breach did occur, details of this breach are given in Section 8 of this report.

5.7 The Council's budgeted investment return for 2013/14 is £1.819 million, performance for the year to date shows that there will be a shortfall on this budget but that the overall budget for Finance and Interest should break even.

5.8 As shown in the table above, approximately £23 million of the Council's portfolio is externally managed by Investec Asset Management. The performance of that portfolio to 30 September 2013 has been very poor with a loss from 31 March 2013 of some 0.063%.

5.9 Officers have analysed the historical performance of both the In-house team and Investec Asset Management. In order to compare fairly the In-house performance has been split each year between "Core Funds" and "Cash Flow Funds" along with the total or aggregated Portfolio. Cash Flow Funds have to be kept highly liquid in order to be able to finance the day-to-day peaks and troughs in the Council's bank accounts. The Core Funds are funds that the In-house team has invested on a fixed term basis for 3 months or longer. Investec Asset Management returns and been shown Gross and Net of fees charged to Medway Council.

	In-House Team			Investec Asset Management		
Year	**Core Funds**	**Cash Flow Funds**	**Aggregated Portfolio**	**Gross of Fees**	**Net of Fees**	**Higher Performing Portfolio**
2013/14 (anticipated)	*1.33%*	*0.68%*	*1.00%*	*0.40%*	*0.26%*	*In-House*
2012/13	2.27%	0.95%	1.66%	1.06%	0.89%	In-House
2011/12	1.96%	0.95%	1.42%	1.77%	1.60%	In-House
2010/11	1.41%	0.86%	1.00%	1.17%	1.01%	In-House
2009/10	4.34%	0.82%	2.85%	1.25%	1.13%	In-House
2008/09	5.94%	4.32%	5.83%	6.89%	6.71%	Investec
2007/08	6.10%	5.85%	6.08%	5.81%	5.68%	In-House
2006/07	5.04%	4.95%	4.99%	4.35%	4.19%	In-House
2005/06	4.68%	4.69%	4.69%	4.75%	4.61%	In-House
2004/05	4.78%	4.61%	4.73%	4.86%	4.70%	In-House
2003/04	N/A	3.27%	3.27%	3.05%	2.92%	In-House

5.10 Within the above table we have compared the In-house Core Funds to the Investec Asset Management “Net of Fees” return, as these most closely reflect each others investment conditions, i.e. Investec Asset Management are not concerned about cash flow issues and equally if the Investec Asset Management portfolio were to be brought in house, the In-house team would not require additional resources to deal with the extra workload, therefore performance should be compared net of fees. Within the above table it can be seen that in 2003/04 the In-house team had no investments in excess of three months, officers have therefore for that year only compared the aggregated portfolio performance against Investec Asset Management.

5.11 As can be seen from the table above the In-house team outperformed Investec Asset Management in nine out of the last ten years

5.12 Over the past few years there has been a decrease in the quantity of Local authorities utilising the services of fund managers to manage authority portfolios. Capita Asset Services provide services to approximately 350 local authorities, of these only 25 utilise the services of fund managers (approximately 7%). Medway has continued to use the external fund manager both as mechanism for a more varied investment strategy and also as a benchmark for in-house performance. In the past performance comparison had been made on a cruder basis which failed to highlight the relative performance on ‘core’ funds.

5.13 Given the continued poor return being received from Investec it is recommended that Officers be instructed to agree with Investec Asset Management a controlled withdrawal of funds. Removing funds to the In-house team such that the risk of further losses is minimised.

5.14 Impacts of moving Investec Portfolio In-house, there are a number of issues that should be considered if Members agree that the authority should have a controlled withdrawal of funds from the Investec Asset Management portfolio.

5.14.1 The authorities' portfolio will be less diversified which increases the risk that it could be affected to a greater degree by future economic events. The authority will continue it's existing policy of always ensuring that any counterparties invested in are counterparties with sufficient creditworthiness to be investable.

5.14.2 With an increase in the In-house portfolio this may lead to difficulties for the In-house team to find suitable counterparties with whom to invest.

5.14.3 The total value of the aggregated limits on the commonly used counterparties within our current counterparty list totals £90 million. This therefore demonstrates the current size of investments that the In-house team can easily deal with on a day-to-day basis. The current counterparty list does also include other counterparties that are not currently used, such as Nationwide Building Society and the DMO (Debt Management Office). Nationwide BS have indicated that we could obtain returns in the region of 0.77% for 1 year money or 0.47% for 3 month money. The DMO traditionally pay very low rates but of course they are extremely safe. By utilising Nationwide BS we would increase our aggregated limit to £110 million.

5.14.4 The authorities cashflow shows that between the time of writing this report and the end of the financial year the maximum invested on any one day is likely to be approximately £60 million, but if we had at that point moved 100% of the Investec portfolio into the In-house arrangement then we would have an investment need of some £83 million. This is within the current £90 million investment capability but leaves very little headroom for variances. However, by utilising counterparties such as Nationwide BS we would be comfortably within our limits.

5.14.5 If any change is required in the Treasury Strategy or limits this can be considered within the 2014/15 Treasury Strategy report.

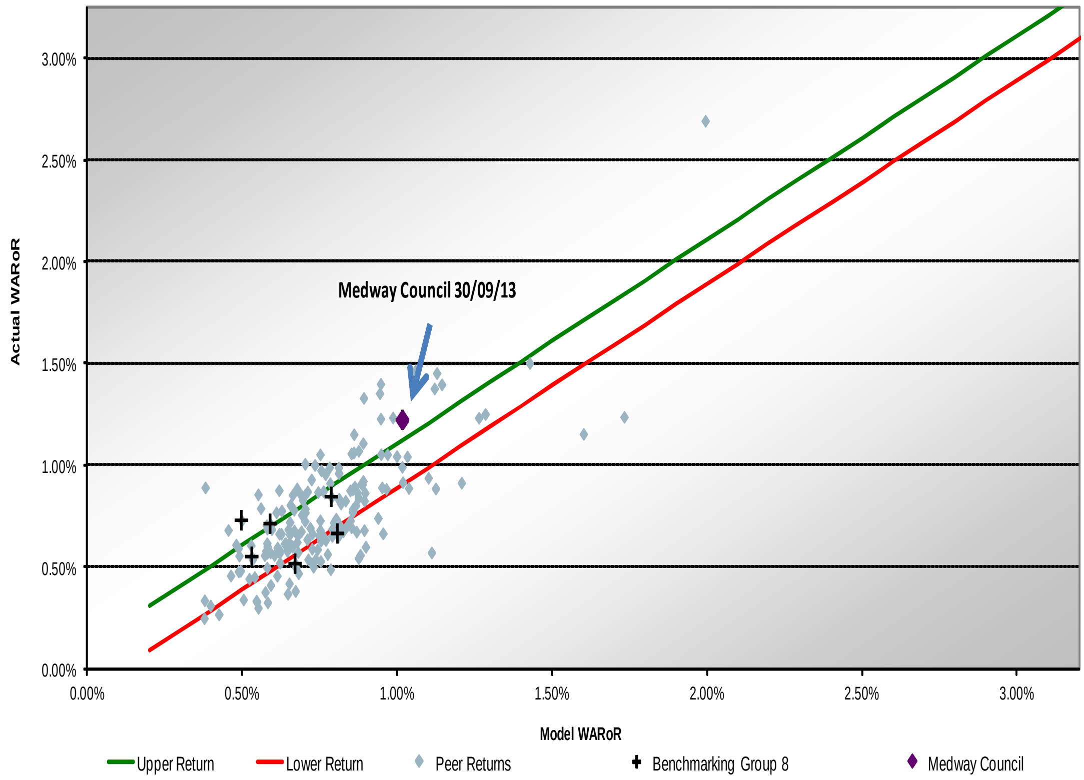
5.15 Investment Counterparty Criteria

5.15.1 The current investment counterparty criteria selection approved in the Treasury Strategy is meeting the requirement of the treasury management function.

5.16 Benchmarking

5.16.1 The in-house Treasury team, contribute to both the CIPFA and Capita Asset Services benchmarking clubs. The CIPFA benchmarking is reported annually with the Treasury outturn report, whereas, the Capita Asset Services benchmarking does report quarterly. Shown below is a graph showing Medway's performance against all 182 members of the Capita Asset Services benchmarking club.

Population Returns against Model Return's September 2013



5.16.2 The "x" axis of the graph shows the "Model Weighted Average Rate of Return", this is easiest interpreted as the level of return we should expect for the level of risk that we are taking with our investment portfolio. This is then plotted against the "Actual Weighted Average Rate of Return" on the "y" scale, running diagonally upwards across the graph are two parallel lines, if a Council performance falls between these lines then they are deemed to be receiving a return as would be expected for their level of risk, below these two lines and performance is considered below that expected and above then the return being received is above that expected. As can be seen Medway's return is "above" that expected for our level of risk.

5.16.3 In assessing the risk inherent in an Investment Portfolio for the benchmarking, three factors are taken into account,

1) The number of days to maturity of an investment. With a larger the number of days left to maturity the greater the risk that an adverse event could occur
2) The total number of days that the investment was originally invested for, again the longer an authority is comfortable to invest for the greater the risk it is willing to take.
3) The creditworthiness of the counterparties that the authority invests with.

5.17.4 The table below shows some detail from the benchmarking data comparing Medway in-house performance against all participants of the benchmarking group; Unitaries; and local councils.

Comparison of risk and returns

	Model Weighted Average Rate of Return	Risks			Weighted Average Rate of Return
		Weighted Average Maturity (Days)	Weighted Average Total Time (Days)	Weighted Average Credit Risk	
Medway	1.02%	40	206	3.50	1.22%
Average English Unitaries (14)		64	123	3.31	0.75%
Average Total Population (182)		85	173	3.21	0.77%
Average Local Benchmarking Group		64	123	3.31	0.75%
Brighton & Hove CC	0.67%	23	50	3.70	0.52%
Maidstone BC	0.50%	78	90	2.50	0.73%
Sevenoaks DC	0.81%	55	123	4.20	0.67%
Shepway DC	0.59%	156	205	2.80	0.71%
Thanet DC	0.53%	17	45	2.30	0.55%
Tonbridge & Malling BC	0.79%	82	142	4.20	0.85%

5.18 When the benchmarking performance for March 2013 was considered with the Treasury Outturn report the question was raised as to why one particular authority had achieved a very similar rate of return as ourselves but at a much lower “model return”, this has been investigated and that particular authority does have considerable resources and as such was able to invest part of it’s portfolio for periods between one and ten years. As the counterparty were local authorities, the risk rating was low, however, as the investments were up to ten years the authority enjoyed returns of between 2.43 – 3.37%.

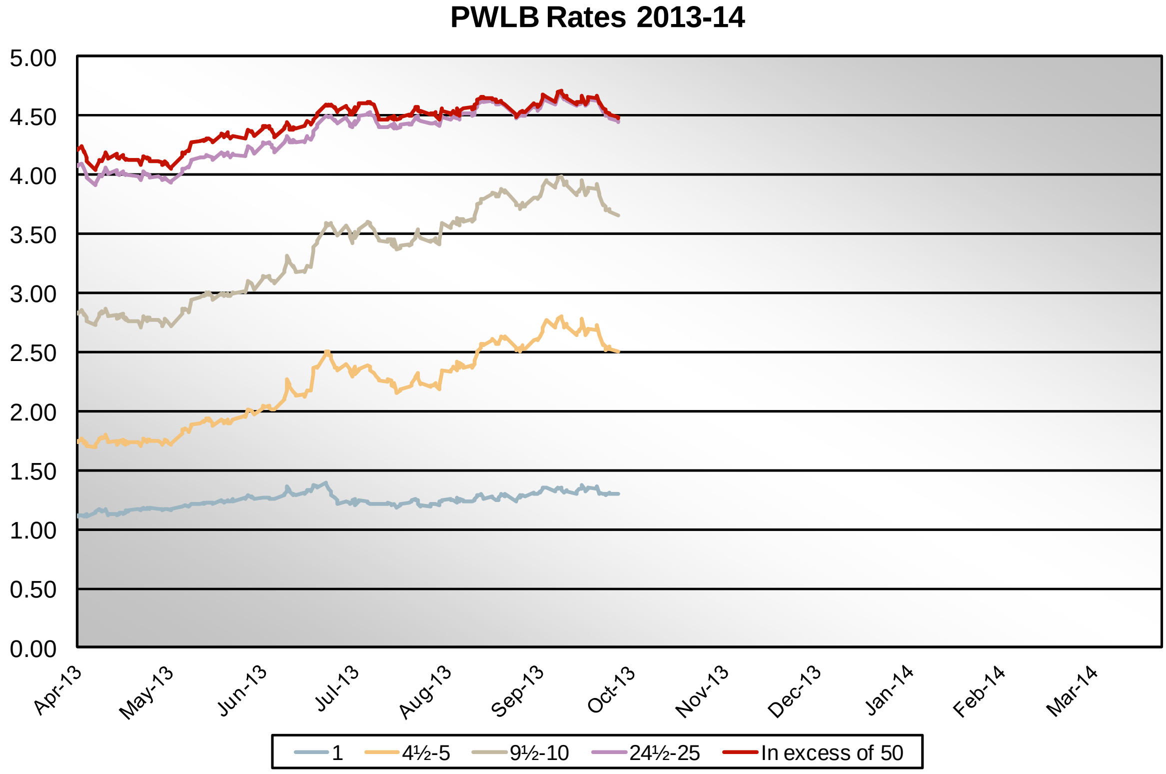
6 Borrowing

6.1 The Council’s capital financing requirement (CFR) for 2013/14 is £249.286 million. The CFR denotes the Council’s underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the 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. The table in section 4.2.1 shows the Council has external borrowings of £172.325 million against a CFR of £249.286 million.

6.2 The current borrowing strategy is to repay debt rather than enter into new borrowing as a consequence of the relationship between investment and borrowing interest rates. Using invested funds to repay debt also has the benefit of mitigating counterparty risk. This policy has been adhered to for the first six months of this financial year. However, as specified within the strategy, in the event that it was deemed advantageous to borrow then we will evaluate the economic and market factors to form a view on future interest rates so as to determine the manner and timing of decisions to borrow.

6.3 As outlined below, the general trend has been an increase in interest rates during the six months, across all maturity bands.

The graph and table below show the movement in PWLB rates for the first six months of the year to 30.9.13:



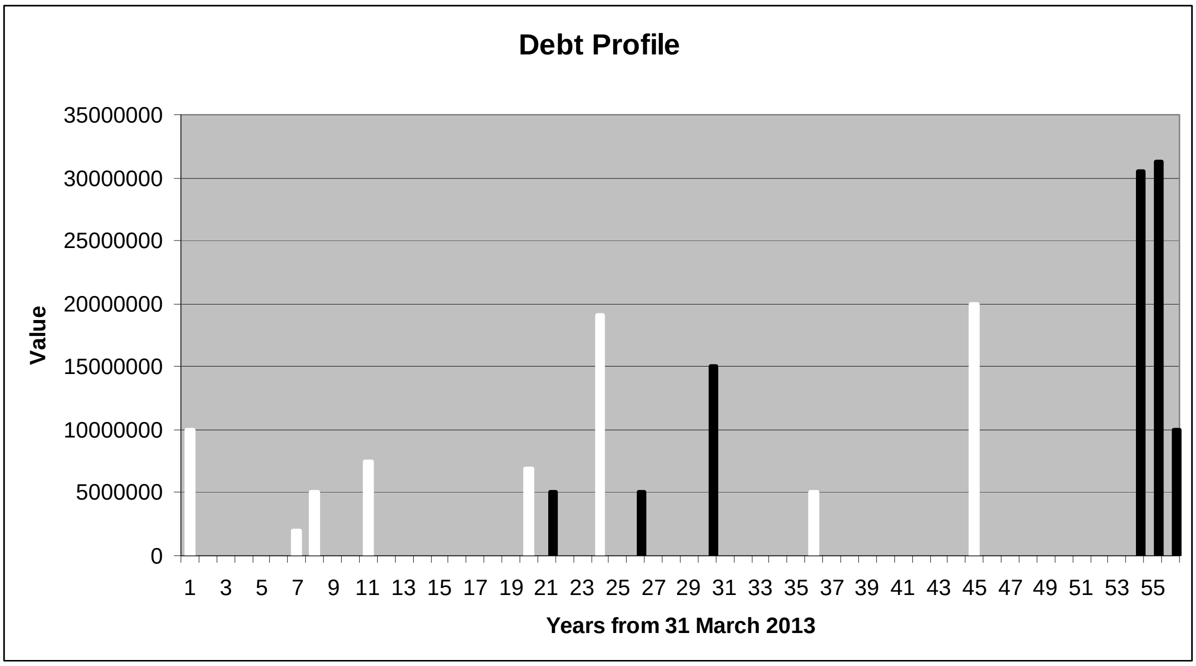
6.4 It is anticipated that no external borrowing will be undertaken during this financial year, unless it is found to be advantageous as mentioned in paragraph 6.2.

6.5 One of the important risks that is inherent within Treasury management is “Interest rate risk”. This risk is high where a large proportion of an organisation’s borrowing portfolio reach termination point at the same time. The organisation has then to re-finance a large proportion of their portfolio at a set point of time whereby they run the risk that interest rates may not be beneficial to the organisation.

6.6 In order to protect against this risk it is prudent to spread repayment dates over a number of years thereby reducing the risk of a large proportion of the portfolio being affected by adverse interest rates.

6.7 The graph below shows the debt portfolio repayment profile as at 1 April 2013. It can be seen that the debt repayments are reasonably spread over the forthcoming decades, thereby reducing any impact of interest rate risk.

6.8 It is worth noting that the white shaded repayments are PWLB debt and black are LOBO's (Lender Option Borrower Option). All debts are being shown as repayable at term, although the LOBO's have a variety of "call" periods of between 6 months and every 5 years. The risk of a call occurring is currently low and therefore these have been shown as running full term.



7 Debt Rescheduling

7.1 Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. During the first six months of the year, no debt rescheduling was undertaken and it is not envisaged that any will occur before the end of the financial year. However, officers and the council's financial advisers 'Capita Asset Services' will continue to monitor the situation and opportunities will be carefully considered.

8 Compliance with Treasury and Prudential Limits

8.1 It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits". Council's approved Treasury and Prudential Indicators (affordability limits) are outlined in the approved TMSS.

8.2 During the financial year to date the Council has operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices, with the exception of the following breach.

8.2.1 The Treasury Management Strategy agreed by Council on 21 February states in relation to counterparty limits that "in-house team £20 million limit per counterparty and £25 million for counterparties with a Sector duration rating of 12 months or above". In practice counterparties to be included within the In-house counterparty list and their associated limits are then agreed with the

Chief Finance Officer and Portfolio Holder of Finance and may be subject to more stringent criteria.

8.2.2 Svenska Handlesbanken is included within our counterparty list and has a Sector duration rating of up to 12 months, therefore, according to the Treasury Strategy, we could have a counterparty limit of £25m, however the limit has been set by the CFO and Portfolio Holder at £20m, £5m below the strategy limit.

8.2.3 On the 5 November 2013 the total invested with Svenska Handlesbanken was £21.1m, but this was rectified on the 6 November. On the 6 November as a result of this breach procedures were reviewed and in future the spreadsheet recording proposed transactions will now highlight in red if a transaction would result in a breach occurring, the transactions can therefore be amended prior to bank transfers being processed. This technical breach of the more stringent internal level did not result in any adverse impact on the Council portfolio.

9 Risk management

9.1 Risk and the management thereof is a feature throughout the strategy and in detail within the Treasury Management Practices 1 within the Treasury strategy. The risks associated with moving the Investec Portfolio to the In-house team is explored in section 5 of the report.

10 Financial and legal implications

10.1 The finance and legal implications are highlighted throughout this report. The Council has delegated responsibility for the execution and administration of treasury management decisions to the Chief Finance Officer, who will act in accordance with the Council's policy statement and Treasury Management Practices.

11 Recommendations

11.1 Members are requested to consider this report, note its contents and pass comments of this report onto Cabinet.

11.2 Recommend to Cabinet that the Chief Finance Officer commence discussions with Investec Asset Management to enable the movement of the portfolio managed by Investec Asset Management to the in-house team.

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Background papers

Treasury Strategy 2013/14 Report to Council 21 February 2013
http://democracy.medway.gov.uk/ieListDocuments.aspx?CId=122&MId=2580&Ver=4

Investec report September 2013