

By: John Simmonds, Cabinet Member for Finance
Andy Wood, Corporate Director of Finance

To: Governance and Audit Committee – 19 July 2017

Subject: **TREASURY MANAGEMENT ANNUAL REVIEW 2016-17**

Classification: Unrestricted

Summary: To report a summary of Treasury Management activities in 2016-17

FOR DECISION

INTRODUCTION

1. The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires that Authorities report on the performance of the treasury management function at least twice yearly (mid-year and at year end). At KCC half yearly reports are made to Council and quarterly updates are provided to the Governance and Audit Committee.
2. The Council's Treasury Management Strategy for 2016-17 was approved by full Council on 11 February 2016.
3. The Council has both borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. This report covers treasury activity and the associated monitoring and control of risk during 2016-17:
 - a) Reports on the implications of treasury decisions and transactions;
 - b) Gives details of the outturn position on treasury management transactions in 2016-17;
 - c) Confirms compliance with its Treasury Management Strategy, Treasury Management Practices and Prudential Indicators.
4. When this report is agreed by this Committee it will go forward to full Council.

EXTERNAL CONTEXT

5. Politically, 2016/17 was an eventful twelve month period during which the UK voted to leave the European Union, had a change of Prime Minister, and Donald Trump was elected the 45th President of the USA. Uncertainty over the outcome of the US presidential election, the UK's future relationship with the EU and the slowdown witnessed in the Chinese economy in early 2016 all resulted in significant market volatility during the year. Article 50 of the Lisbon Treaty, which sets in motion the 2-year exit period from the EU, was triggered on 29th March 2017.

6. UK inflation had been subdued in the first half of 2016 as a consequence of weak global price pressures, past movements in sterling and restrained domestic price growth. However the sharp fall in the Sterling exchange rate following the referendum had an impact on import prices which, together with rising energy prices, resulted in CPI rising from 0.3% year/year in April 2016 to 2.3% year/year in March 2017 and is forecast to rise further during 2017/18.
7. Following the referendum outcome in June 2016 the Prime Minister, David Cameron, resigned. He was replaced by Theresa May in July 2016. The new prime minister made several significant cabinet changes, including the Chancellor of the Exchequer. The new Chancellor made his first Autumn Statement in November 2016 which included lower economic growth forecasts and a revision of the government's fiscal target; budget surplus deferred until the next parliament and a new target for the net budget deficit of no more than 2% of GDP by the end of the current parliament. This represented a significant change and added an additional £122bn of government borrowing between 2016/17 and 2020/21.
8. The referendum's outcome prompted the Bank of England's decision in August to reduce the base rate to 0.25%, to make further gilt and corporate bond purchases (Quantitative Easing), and to provide cheap funding for banks (Term Funding Scheme) in order to maintain the supply of credit to the economy. These post Brexit vote actions were made to pre-empt a slowdown in the economy but subsequently GDP grew better than expected. The reduction in the base rate has led to further reductions in the rates offered by banks for deposits and available from money market funds.
9. After an initial sharp drop in the second quarter of 2016 equity markets rallied and the FTSE-100 index rose 18% over the year. The Council had some exposure to equity markets, through its investments in the Pyrford Fund and in the first quarter of 2017 in the Fidelity multi asset fund.
9. After the initial Brexit reaction UK Commercial Property values have continued the recovery trend however returns are now being driven by income returns and KCC has exposure to this market through its investment in the CCLA LAMIT Property Fund and the Fidelity fund.

LOCAL CONTEXT

10. At 31 March 2017 the Council had net borrowing of £682.8m arising from its revenue and capital income and expenditure, an increase on 2016 of £7.0m. The Council's current strategy is to maintain borrowing and investments below their underlying levels, known as internal borrowing, in order to reduce risk and keep interest costs low.

BORROWING ACTIVITY

11. At 31 March 2017 KCC held £965.5m of loans, a decrease of £14.1m on 31 March 2016.
12. The Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and

achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

13. During 2016-17 PWLB loans totalling £32.0m were repaid while a further £17.9m was drawn of the loans agreed specifically to fund improvements to Kent's street lighting under the government's energy efficiency loans programme. At 31 March 2017 the total borrowed for this purpose was £19.4m.
14. The benefits of internal borrowing are monitored regularly against the potential for incurring additional costs and the Council's Treasury Advisor, Arlingclose has assisted it with this 'cost of carry' and breakeven analysis. The Council's strategy enabled it to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.
15. In June 2016 Barclays Bank advised the Council of their decision to cancel all the embedded options within their standard Lender's Option Borrower's Option (LOBO) loans. This converted the Barclays LOBOs, totalling £281.8m, into fixed rate loans. None of the other lenders exercised their options during the year.
16. The Council is now holding £160m of LOBO loans where the lender has the option to propose an increase in the interest rate at set dates, following which KCC has the option to either accept the new rate or to repay the loan at no additional cost. £70m of these LOBOs have options in 2017-18.
17. The year-end borrowing position and the year-on-year change are shown in the table below
18. Borrowing Position

	01/04/2016 Balance £m	2016/17 Movement £m	31/3/2017 Balance £m	Average Rate %	Average Life (yrs)
Public Works Loan Board	536.3	-32	504.3	5.7	17
Banks (LOBO)	441.8	-281.8	160.0	4.0	44.3
Banks (Fixed Term)	1.5	299.7	301.2	4.2	42.6
Total borrowing	979.6	-14.1	965.5	5.0	18.9

INVESTMENT ACTIVITY

19. KCC holds significant invested funds, representing income received in advance of expenditure plus balances and reserves. During 2016-17 the Council's average investment balance was £330m. The year-end investment position and the year-on-year change are shown in the table below.

Investment Position

Investment Counterparty	01/04/2016 Balance £m	2016/17 Movement £m	31/03/2017 Balance £m	Average Rate % / Average Life (yrs)
Banks and building societies	119.0	-50.4	68.6	0.85% / 0.4
Marketable instruments (Covered Bonds)	88.4	5.0	93.4	1.16% / 1.4
Money Market Funds	59.7	-12.4	47.3	0.33% / overnight
Icelandic recoveries outstanding	0.5	0.0	0.5	
Icelandic deposits held in Escrow (incl interest)	3.3	1.2	4.5	
Total Internally Managed Investments	270.9	-56.6	214.3	0.72% / 1.0
Pooled property fund	25.7	-0.3	25.4	4.57% pa
Pooled absolute return fund	5.1	0.0	5.1	9.13% pa
Pooled multi asset fund		25.8	25.8	1.30% pa
Cashplus / short bond fund		10.0	10.0	
Equity	2.1		2.1	
Total Externally Managed Investments	32.9	35.5	68.4	4.30% pa
Total investments	303.8	-21.1	282.7	1.62% pa

20. Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.
21. The Council's objective has been maintained by following KCC's counterparty policy as set out in its Treasury Management Strategy Statement for 2016-17.
22. Counterparty credit quality was assessed and monitored with reference to credit ratings (KCC's minimum long-term counterparty rating is A- across rating agencies Fitch, S&P and Moody's); for financial institutions analysis of funding structure and susceptibility to bail-in, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.
23. KCC has also used secured investments products in particular covered bonds that provide collateral in the event that the counterparty cannot meet its obligations for repayment.

COUNTERPARTY UPDATE

24. Fitch and Standard & Poor's downgraded the UK's sovereign rating to AA. Fitch, S&P and Moody's have a negative outlook on the UK. Moody's has a negative outlook on those banks and building societies that it perceives to be exposed to a more challenging operating environment arising from the 'leave' outcome.
25. None of the banks on the Authority's lending list failed the stress tests conducted by the European Banking Authority in July and by the Bank of England in November, although Royal Bank of Scotland was one of the weaker banks in both tests. The Council's treasury advisor Arlingclose regularly monitors the banks to determine whether there would be a bail-in of senior investors, such as local authority unsecured investments, in a stressed scenario.
26. During 2016-17 KCC continued to make use of money market funds to support short term liquidity requirements and reduced further the proportion of surplus cash invested in unsecured bank deposits. The total amount invested in covered bonds fell slightly due to maturities while that invested in pooled investment funds increased. KCC also invested in a cashplus fund.
27. At the end of March 2017 some 57% of KCC's cash was invested in covered bonds, investment funds and equity which are not subject to bail in risk.

FINANCIAL OUTTURN

28. The Council's total investment income for the year, including dividends received on the investment funds and equity, was £7.2m, 2.12% on funds held. The above benchmark return primarily reflects:
 - a) Internally managed deposits made at an average of 0.77% compared to the average 7 day LIBID rate during 2016-17 of 0.20%. The higher return in particular reflects the investment in a diversified covered bond portfolio which earned £1.85m during 2016-17; and
 - b) The Council maintained its investment in the CCLA Property Fund, Pyrford Absolute Return Fund and Kent PFI (Holdings) Ltd, and invested £25m in the Fidelity Multi asset Fund in December 2016. Total income received in the year from these investments was £2.76m.
 - c) Interest earned and unrealised exchange gains on the ISK held in Escrow accounts with Icelandic banks totalling £1.2m.
 - d) Dividends received on the equity held in Kent PFI Holding Co Ltd of £468,000
29. Of the original deposits (principal and interest) totalling £51.99m with Icelandic Banks in 2008 only £372,000 remains outstanding from Heritable. £4.5m was

held as ISK in escrow accounts with two banks in Iceland and this was paid to KCC in June 2017 following the temporary lifting of capital controls. The total amount recovered by KCC now totals £52.6m

30. Investments as at 31 March 2017 are shown in Appendix 2.

COMPLIANCE WITH PRUDENTIAL INDICATORS

31. The Council confirms that it has complied with its Prudential Indicators for 2016-17, which were set as part of the Council's Treasury Management Strategy Statement. Details can be found in Appendix 1.

TREASURY ADVISOR

32. Following a full tendering process for treasury advisory services Arlingclose were reappointed for a 3 year period from 1 August 2016.

RECOMMENDATION

33. Members are asked to agree the report and recommend that it is submitted to County Council.

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2016-17 Prudential Indicators**1. Estimate of Capital Expenditure (excluding PFI)**

	£m
Actuals 2015-16	234.911
Original estimate 2016-17	299.658
Actuals 2016-17	238.519

2. Estimate of capital financing requirement (underlying need to borrow for a capital purpose)

	2015-16 Actual £m	2016-17 Original Estimate £m	2016-17 Actual as at 31 March £m
Capital Financing Requirement	1,348.259	1,335.724	1,362.394
Annual increase/(decrease) in underlying need to borrow	-34.597	-17.266	14.135

In the light of current commitments and planned expenditure, forecast net borrowing by the Council will not exceed the Capital Financing Requirement.

3. Estimate of ratio of financing costs to net revenue stream

Actual 2015-16	13.90%
Original estimate 2016-17	13.71%
Actual 2016-17	13.41%

4. Operational Boundary for External Debt

The operational boundary for debt is determined having regard to actual levels of debt, borrowing anticipated in the capital plan, the requirements of treasury strategy and prudent requirements in relation to day to day cash flow management. The operational boundary for debt will not be exceeded in 2016-17

Operational boundary for debt relating to KCC assets and activities

	Prudential Indicator £m	Position as at 31 March 2017 Actual £m
Borrowing	975	927

Other Long Term Liabilities	248	271
Total	1,223	1,198

Operational boundary for total debt managed by KCC including that relating to Medway Council etc (pre Local Government Reorganisation)

	Prudential Indicator £m	Position as at 31 March 2017 £m
Borrowing	1,015	966
Other Long Term Liabilities	248	271
Total	1,263	1,237

5. Authorised Limit for external debt

The authorised limit includes additional allowance, over and above the operational boundary to provide for unusual cash movements. It is a statutory limit set and revised by the Council.

Authorised limit for debt relating to KCC assets and activities

	Prudential Indicator £m	Position as at 31 March 2017 £m
Borrowing	1,015	927
Other long term liabilities	258	271
Total	1,263	1,198

Authorised limit for total debt managed by KCC including that relating to Medway Council etc (pre Local Government Reorganisation)

	Prudential Indicator £m	Position as at 31 March 2017 £m
Borrowing	1,055	966
Other long term liabilities	248	271
Total	1,303	1,273

The additional allowance over and above the operational boundary has not needed to be utilised and external debt has and will be maintained well within the authorised limit.

6. Compliance with CIPFA Code of Practice for Treasury Management in the Public Services

The Council has adopted the Code of Practice on Treasury Management and has adopted a Treasury Management Policy Statement. Compliance has been tested and validated by our independent professional treasury advisers.

7. Upper limits of fixed interest rate and variable rate exposures

The Council has determined the following upper limits for 2016-17

Fixed interest rate exposure	100%
Variable rate exposure	40%

These limits have been complied with in 2016-17.

8. Upper limits for maturity structure of borrowings

	Upper limit	Lower limit	As at 31 March 2017
	%	%	%
Under 12 months	10	0	3.51
12 months and within 24 months	10	0	2.35
24 months and within 5 years	15	0	6.64
5 years and within 10 years	15	0	10.30
10 years and within 20 years	20	5	9.18
20 years and within 30 years	20	5	20.19
30 years and within 40 years	25	10	16.64
40 years and within 50 years	30	10	24.41
50 years and within 60 years	30	10	6.78

9. Upper limit for principal sums invested for periods longer than 364 days

Prudential Indicator	Actual
£m	£m
230	163.4

Appendix 2

Investments as at 31 March 2017

1. Internally Managed Investments

1.1 Term deposits, Call accounts and Money Market Funds

Instrument Type	Counterparty	Principal Amount	End Date	Interest Rate
Fixed Deposit	Lloyds Bank	£5,000,000	21/08/2017	1.00%
Fixed Deposit	Lloyds Bank	£5,000,000	29/09/2017	1.00%
Fixed Deposit	Lloyds Bank	£5,000,000	24/07/2017	1.05%
Fixed Deposit	Lloyds Bank	£5,000,000	08/08/2017	1.00%
Fixed Deposit	Lloyds Bank	£5,000,000	08/02/2018	0.90%
Fixed Deposit	Lloyds Bank	£5,000,000	05/09/2017	1.00%
	Total Lloyds Group	£30,000,000		
180 Day Call Notice Account	Santander UK	£25,000,000	n/a	0.90%
	Total Santander	£25,000,000		
Total UK Bank Deposits		£55,000,000		
Fixed Deposit	Nationwide Building Society	£3,600,000	19/04/2017	0.42%
Fixed Deposit	Nationwide Building Society	£10,000,000	24/04/2017	0.43%
	Total UK Building Society Deposits	£13,600,000		
Money Market Fund	Aberdeen Sterling Liquidity Fund	£9,991,290	n/a	0.23% (variable)
Money Market Fund	Deutsche Managed Sterling Fund	£4,727	n/a	0.21% (variable)
Money Market Fund	Federated (PR) Short-term GBP Prime Fund	£9,978,939	n/a	0.22% (variable)
Money Market Fund	HSBC Global Liquidity Fund	£8,289,048	n/a	0.22% (variable)
Money Market Fund	Insight Sterling Liquidity Fund	£9,548	n/a	0.21% (variable)
Money Market Fund	LGIM Liquidity Fund	£9,114,106	n/a	0.33% (variable)
Money Market Fund	SSgA GBP Liquidity Fund	£6,138	n/a	0.23% (variable)
Money Market Fund	Standard Life Sterling Liquidity Fund	£9,957,400	n/a	0.26% (variable)
	Total Money Market Funds	£47,351,196		

Instrument Type	Principal Amount
Total Icelandic Recoveries outstanding	£506,554
Total ISK held in Escrow (est GBP)	£4,482,933
Net Icelandic Recoveries outstanding	£4,989,487

1.2 Bond Portfolio

Bond Type	Issuer	Adjusted Principal	Net Yield	Maturity Date
Floating Rate Covered Bond	Abbey National Treasury	£2,408,488	0.64%	05/04/2017
Floating Rate Covered Bond	Abbey National Treasury	£1,359,997	0.58%	05/04/2017
Floating Rate Covered Bond	Abbey National Treasury	£3,002,032	0.52%	29/05/2018
Fixed Rate Covered Bond	Bank Of Nova Scotia	£4,984,225	0.88%	14/09/2021
Floating Rate Covered Bond	Barclays Bank	£5,001,542	0.47%	15/09/2017
Floating Rate Covered Bond	Barclays Bank	£3,000,985	0.47%	15/09/2017
Floating Rate Covered Bond	Barclays Bank	£5,001,520	0.52%	12/02/2018
Floating Rate Covered Bond	Barclays Bank	£2,396,603	0.70%	12/02/2018
Fixed Rate Covered Bond	Coventry Building Society	£3,157,053	1.93%	19/04/2018
Fixed Rate Covered Bond	Coventry Building Society	£5,282,513	1.73%	19/04/2018
Fixed Rate Covered Bond	Coventry Building Society	£2,121,260	1.52%	19/04/2018
Floating Rate Covered Bond	Coventry Building Society	£3,006,231	0.57%	17/03/2020
Floating Rate Covered Bond	Leeds Building Society	£2,501,236	0.58%	09/02/2018
Floating Rate Covered Bond	Leeds Building Society	£2,501,255	0.58%	09/02/2018
Fixed Rate Covered Bond	Leeds Building Society	£2,085,960	2.03%	17/12/2018
Fixed Rate Covered Bond	Leeds Building Society	£1,558,096	1.19%	17/12/2018
Fixed Rate Covered Bond	Leeds Building Society	£5,771,641	0.63%	17/12/2018
Floating Rate Covered Bond	Leeds Building Society	£5,000,000	0.77%	01/10/2019
Floating Rate Covered Bond	Lloyds	£3,901,156	0.52%	19/01/2018
Floating Rate Covered Bond	Lloyds	£1,403,435	0.56%	18/07/2019
Fixed Rate Covered Bond	National Australia Bank	£3,003,113	1.10%	10/11/2021
Floating Rate Covered Bond	Nationwide Building Society	£1,899,999	0.56%	17/07/2017
Floating Rate Covered Bond	Nationwide Building Society	£1,000,245	0.51%	17/07/2017
Floating Rate Covered Bond	Nationwide Building Society	£2,100,617	0.50%	17/07/2017
Floating Rate Covered Bond	Nationwide Building Society	£3,429,266	0.53%	27/04/2018

Floating Rate Covered Bond	Nationwide Building Society	£2,147,740	0.64%	27/04/2018
Fixed Rate Covered Bond	Santander UK PLC	£3,615,957	0.65%	14/04/2021
Floating Rate Covered Bond	Toronto Dominion	£5,455,852	0.78%	01/02/2019
Fixed Rate Covered Bond	Yorkshire Building Society	£2,107,752	1.98%	12/04/2018
Fixed Rate Covered Bond	Yorkshire Building Society	£3,187,918	1.55%	12/04/2018
	Total Bonds	£93,393,687		

Total Internally managed investments	£214,334,369
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2. Externally Managed Investments

Investment Fund / Equity	Market Value at 31 March 2017	12 months return to 31 March 2017	
		Income	Total
CCLA LAMIT Property Fund	£25,339,954	4.57%	3.01%
Pyrford Global Total Return Fund	£5,111,978	9.13%	8.91%
Fidelity Multi Asset Income Fund	£25,772,296	1.30%	4.39%
Aberdeen Ultra Short Duration Sterling Fund	£10,031,944	-	0.27%
Kent PFI (Holdings) Ltd	£2,135,741		

Total External Investments	£68,391,913
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3. Total Investments

Total Investments	£282,726,282
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