

By: John Simmonds, Cabinet Member for Finance
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To: Governance and Audit Committee – 24 April 2017

Subject: **TREASURY MANAGEMENT UPDATE**

Classification: Unrestricted

Summary: To report a summary of Treasury Management activity

FOR ASSURANCE

INTRODUCTION

1. This report covers Treasury Management activity and developments in 2017 - 18 up to the date of this report.

BACKGROUND

2. 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). This report provides an additional quarterly update.
3. The Council's Treasury Management Strategy for 2017-18 was approved by full Council on 9 February 2017
4. 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.

MONTHLY PERFORMANCE REPORT

5. The Treasury and Investments Manager produces a monthly report for members of the Treasury Management Advisory Group and a copy of the February 2018 report is attached in Appendix 1.

EXTERNAL CONTEXT

6. The significant economic event was the increase in the Bank Rate in November by 0.25% to 0.50%, making it the first increase by the Bank of England's Monetary Policy Committee (MPC) to rates since July 2007. The vote to increase the Bank Rate reflected the MPC's growing concern that rising inflation had finally outweighed the risks to growth and largely to meet expectations the Bank itself created.
7. The FTSE 100 rose, reaching yet another record high of 7,777 in early January 2018 before falling back in recent weeks to 7,056 at the end of March. Money market rates increased: 1-month, 3-month and 12-month London Interbank Bid Rate (LIBID) rates have risen to 0.39%, 0.59% and 0.88% in the period to the end of March 2018

8. The Consumer Price Inflation (CPI) index rose to 3.01% by the end of November, its highest since March 2012, as companies passed on the higher costs stemming from the lower level of sterling. It has subsequently fallen a little to 2.7% in February. CPIH (a new measure which includes owner occupier housing costs) shows a similar trend peaking at 2.8% between September and November 2017 before falling a little to 2.5% in February.
9. The impact on KCC's counterparties and investments of the uncertain economic environment is being carefully monitored by officers and the Council's treasury advisors.

REGULATORY UPDATES

Implementation of the Markets in Financial Instruments Derivative (MiFID II)

10. Following the introduction of MiFID II from 3 January 2018, local authorities were able to "opt up" to professional client status, providing that they met certain criteria including having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority having at least a year's relevant professional experience. The Council has met the conditions to opt up to professional status and has done so in order to maintain its MiFID II status prior to January 2018. The Council will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

CIPFA Consultation on Prudential and Treasury Management Codes

11. CIPFA published the two revised codes in late December 2017 for implementation in 2018/19. Changes to the Prudential Code include the requirement for a new Capital Strategy report and changes to prudential indicators. Changes to the Treasury Management Code include non-treasury investments such as commercial investments in property being included in the definition of "investments".

New Ministry of Housing, Communities and Local Government (MHCLG) Investment Guidance and Minimum Revenue Provision (MRP) Guidance

12. In February 2018 MHCLG published revised guidance on Local Authority Investments and MRP following a consultation in 2017. The intention is that these changes come into force for the 2018/19 financial year.
13. Investments now include all the financial assets of the authority as well as non-financial assets held for the primary purpose of generating income including investment properties and loans. The guidance also covers the issues of security and liquidity of investments as well as more detailed risk assessment.
14. The new guidance on MRP includes an updated definition of MRP provision and guidance on asset lives but does not propose changes to the methods of calculation.

BORROWING STRATEGY

15. At 28 February 2018 the Council had total debt outstanding of £939.11m a reduction of £26.39m from the balance as at 31 March 2017. The following table shows the movement by lender.

| | 31/3/2017 Balance £m | 2017/18 Movement £m | 28/02/2018 Balance £m | Weighted Average Rate % | Value waited Average Life (yrs) |
|---|----------------------------|---------------------------|-----------------------------|-------------------------------|--|
| Public Works Loan Board | 504.3 | -31.02 | 473.28 | 5.44% | 17.21 |
| Banks (LOBO) | 160 | -10.00 | 150.00 | 4.03% | 44.29 |
| Banks and other institutions (Fixed Term) | 301.2 | 14.63 | 315.83 | 4.12% | 37.78 |
| Total Borrowing | 965.5 | -26.39 | 939.11 | 4.77% | 28.45 |

16. 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
17. 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 has enabled it to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.
18. KCC continues to hold LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. The total value of these loans fell to £150m at the end of August as the result of RBS' decision to waive its options on a £10m loan agreed in December 2009, converting it into a fixed rate loan and assigning it to Phoenix Life Assurance Ltd.
19. By the end of February the Council had received £24.13m of the total £40m funding agreed for the County's street lighting replacement project and received a further £4.3m by the end of March 2018. Of the total borrowed to date some £22m has been an interest free loan provided by Salix Ltd.
20. As a result of the new borrowing and repayment of maturing loans, the average interest rate payable on the Council's debt portfolio reduced to 4.77%.
21. Affordability and the "cost of carry" remain important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates remain lower than long-term rates, the Council has determined it is more cost effective in the short-term to use internal resources instead.
22. The benefits of internal borrowing are monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term

borrowing rates are forecast to rise. The Council's Treasury Advisor, Arlingclose, assists it with this 'cost of carry' and breakeven analysis.

INVESTMENT ACTIVITY

23. The Council's average investment balances to date have amounted to £309m, representing income received in advance of expenditure plus balances and reserves held.
24. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles.
25. Security of capital has remained the Council's main investment objective. Given the increasing risk and continued low returns from short-term unsecured bank investments, the Council's aim has been to further diversify into more secure and/or higher yielding asset classes as set out in its Treasury Management Strategy Statement for 2017-18. During August and September 2017 the Council moved £55m from bank deposits into pooled investment funds
26. Internally managed investments have achieved an average return of 0.74% over the 9 month period.

Statement of investments

27. A statement of investments as at 29 March 2018 is attached in Appendix 2. This statement is circulated to members of the Treasury Management Advisory Group every Friday.

Icelandic Deposits

28. As a result of the repatriation of monies held in escrow accounts in Iceland in June 2017 KCC has recovered £52.6m, some £600k higher than the total of the original deposits. £372k remains outstanding from Heritable Bank.

RECOMMENDATION

29. Members are asked to note this report for assurance.

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Treasury and Investments Manager
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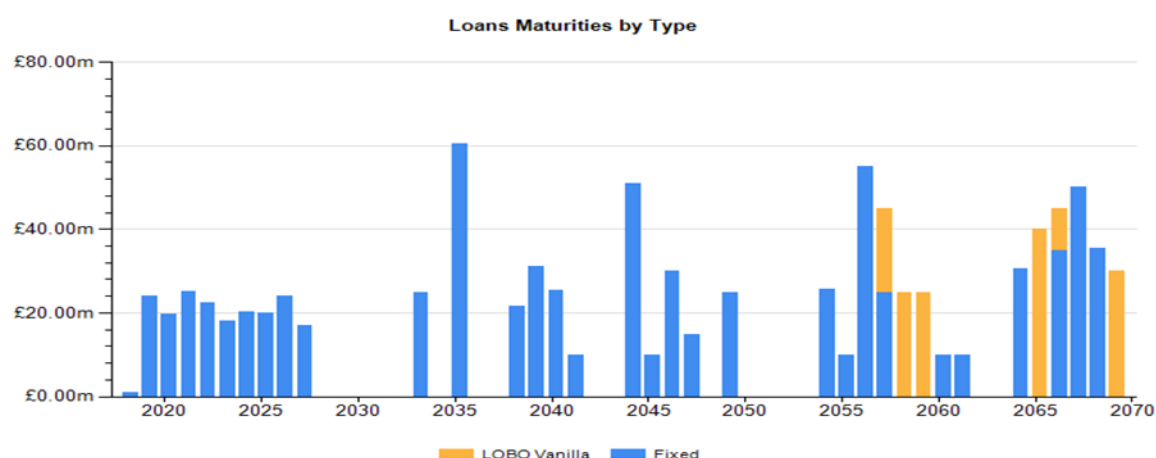
Treasury Management Report for the month of February 2018

1. Borrowing

- 1.1 The total amount of debt outstanding at the end of February was £939.1m following the repayment in the month of £25m of PWLB maturing loans and a £10m short term loan, and receipt of a new £2.2m loan in respect of the Council's streetlighting project. The following table shows the current borrowing analysed by lender.

| | 28/02/2018 Balance £m | Average Rate % | Value weighted Average Life (yrs) |
|---|-----------------------------|----------------|--------------------------------------|
| Public Works Loan Board | 473.28 | 5.44% | 17.21 |
| Banks (LOBO) | 150.00 | 4.03% | 44.29 |
| Banks and other lenders (Fixed Term) | 315.83 | 4.12% | 37.78 |
| Total borrowing | 939.11 | 4.77% | 28.45 |

- 1.2 The maturity profile of KCC's outstanding debt is as follows:



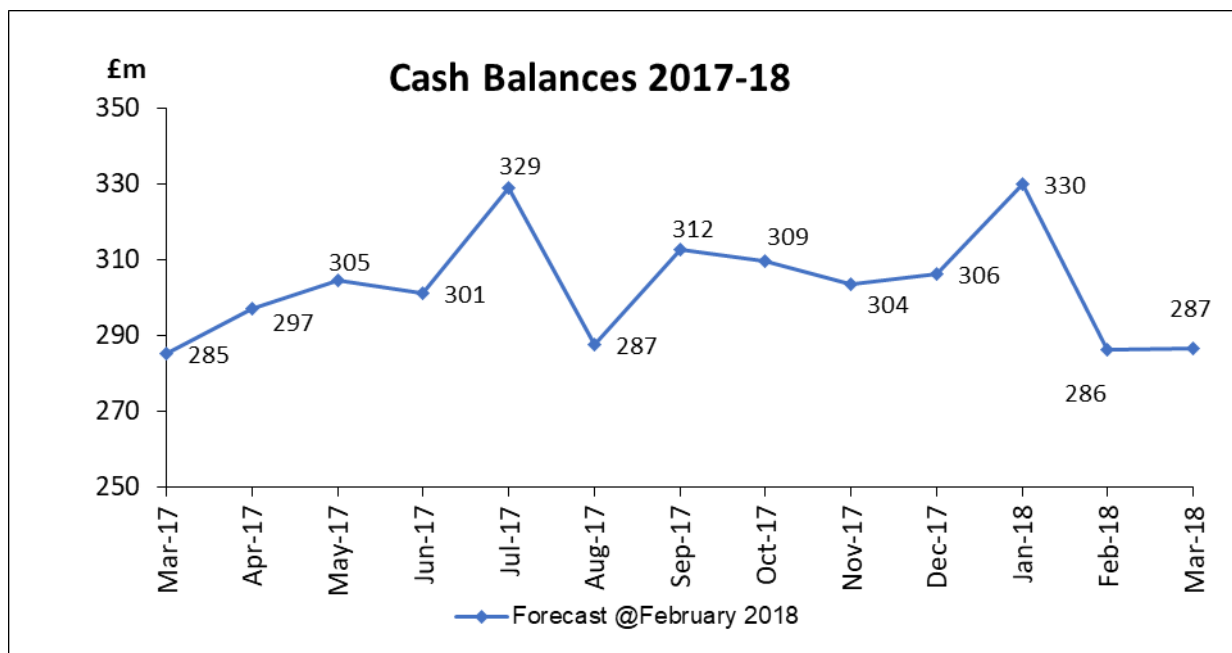
- 1.3 The Council's strategy continues to be to fund its capital expenditure from internal resources as well as consider borrowing at advantageous points in interest rate cycles.

Total long-term debt managed by KCC includes £35.54 pre-LGR debt managed by KCC on behalf of Medway Council. Also included is pre-1990 debt managed on behalf of Further Education Funding Council (£0.29m), Magistrates Courts (£0.28m).

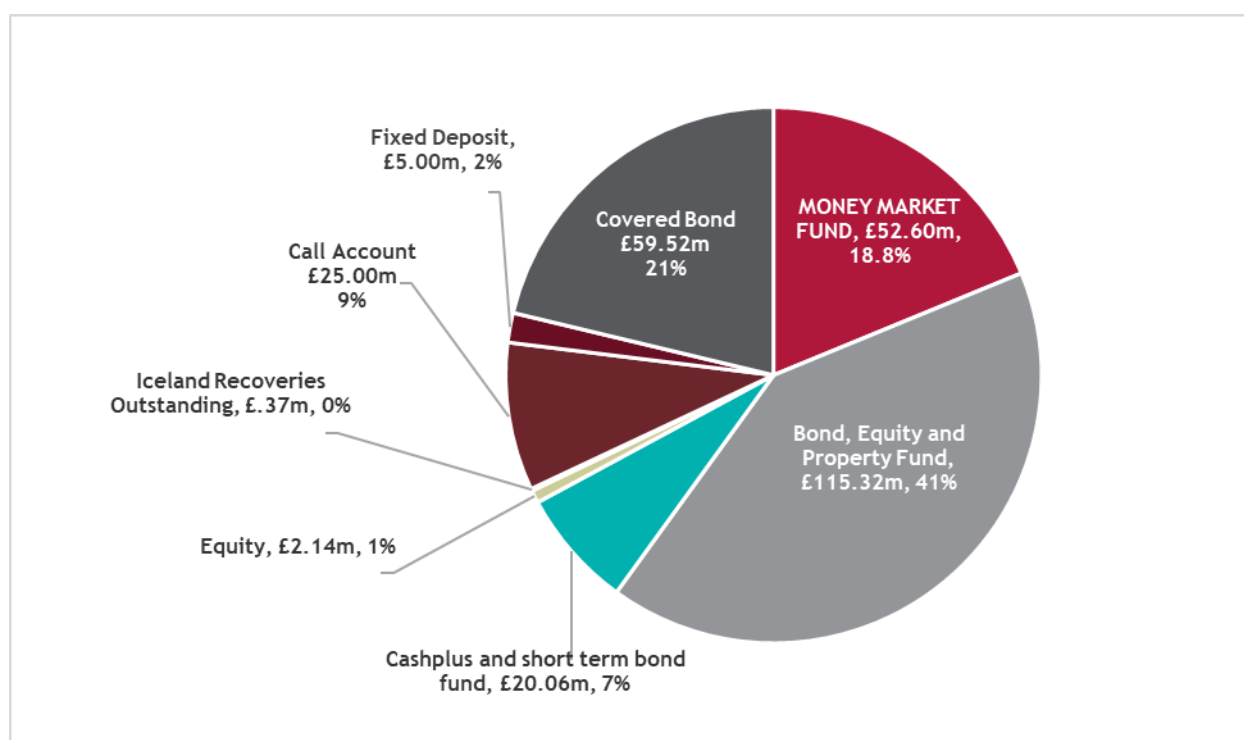
2. Investments

2.1 Cash Balances

During February the value of cash under management fell to £286m. Future cashflows are forecast as follows:

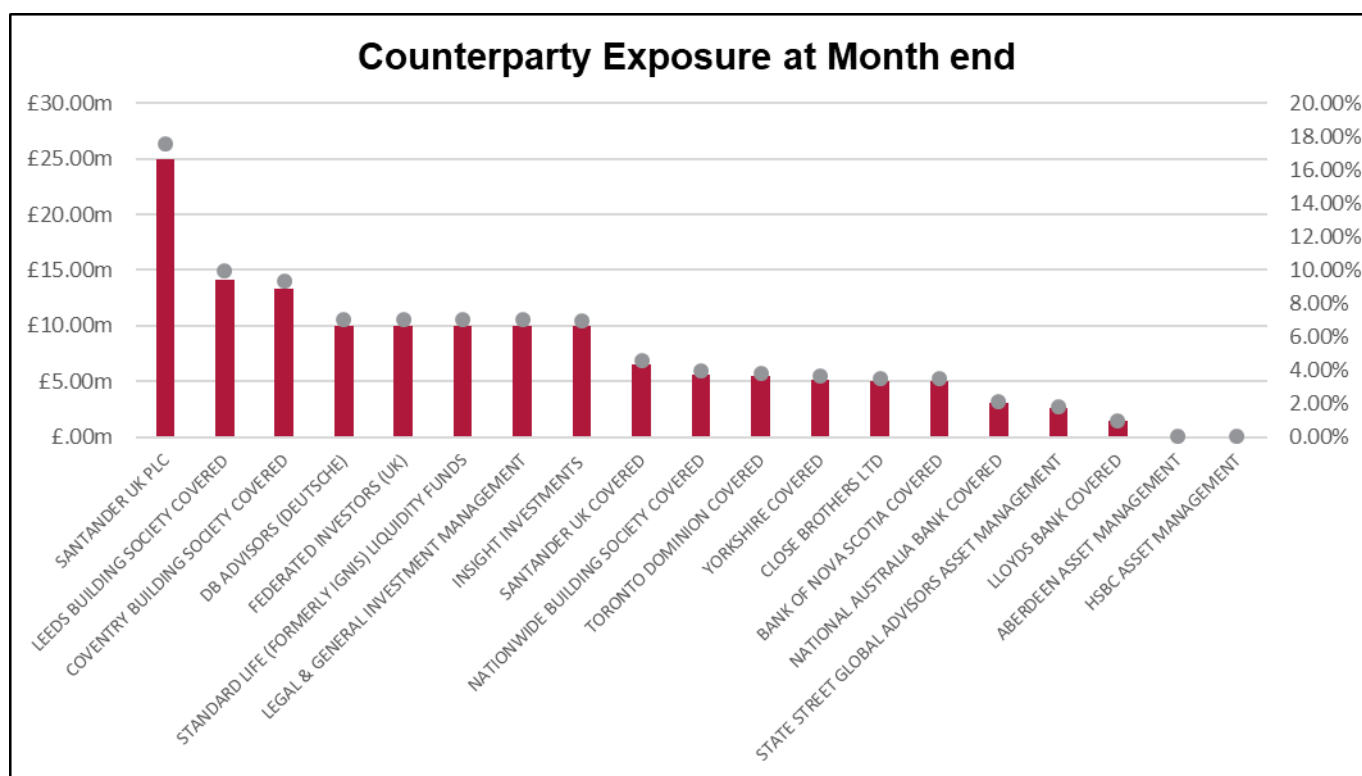
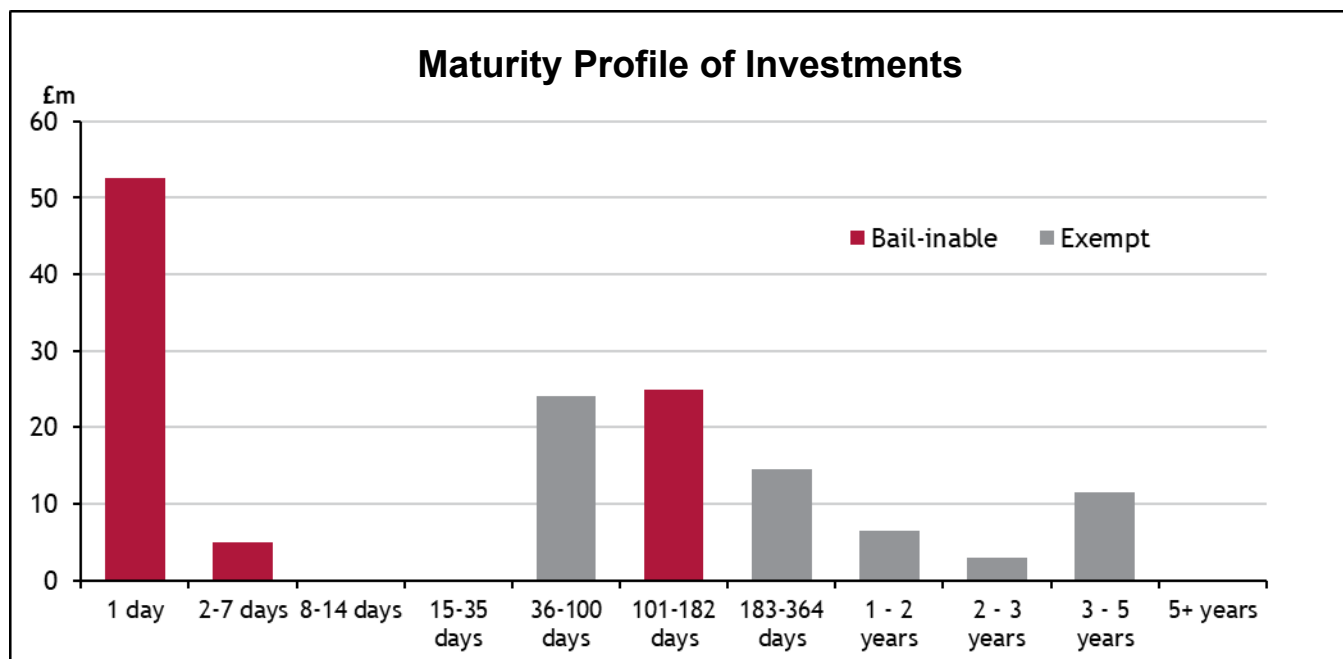


2.1 Type of investment at month end



2.2 Internally managed cash

- 2.2.1 The rate of return on investments held at month end of 0.74% vs the target return 7-day LIBID of 0.3603%.
- 2.2.2 The maturity profile of KCC's investments and counterparty exposure are shown in the following charts.



2.3.3 Credit Score matrix

The Council's credit scores are detailed in the following table.

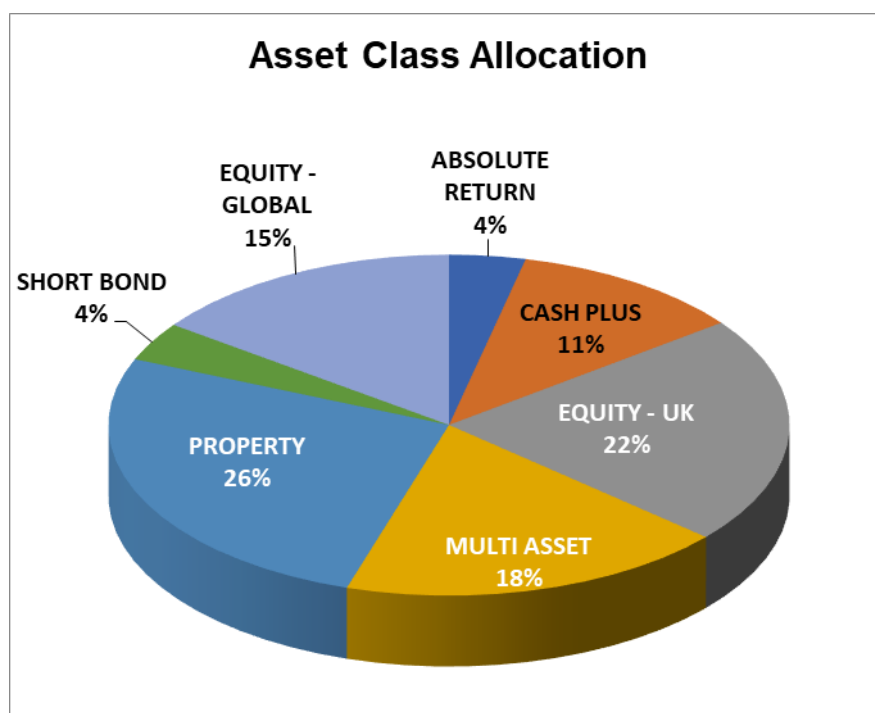
| | Credit Rating | Credit Risk Score |
|------------------------|---------------|-------------------|
| Value Weighted Average | AA | 3.24 |
| Time Weighted Average | AA+ | 1.64 |

3. Externally managed Investments

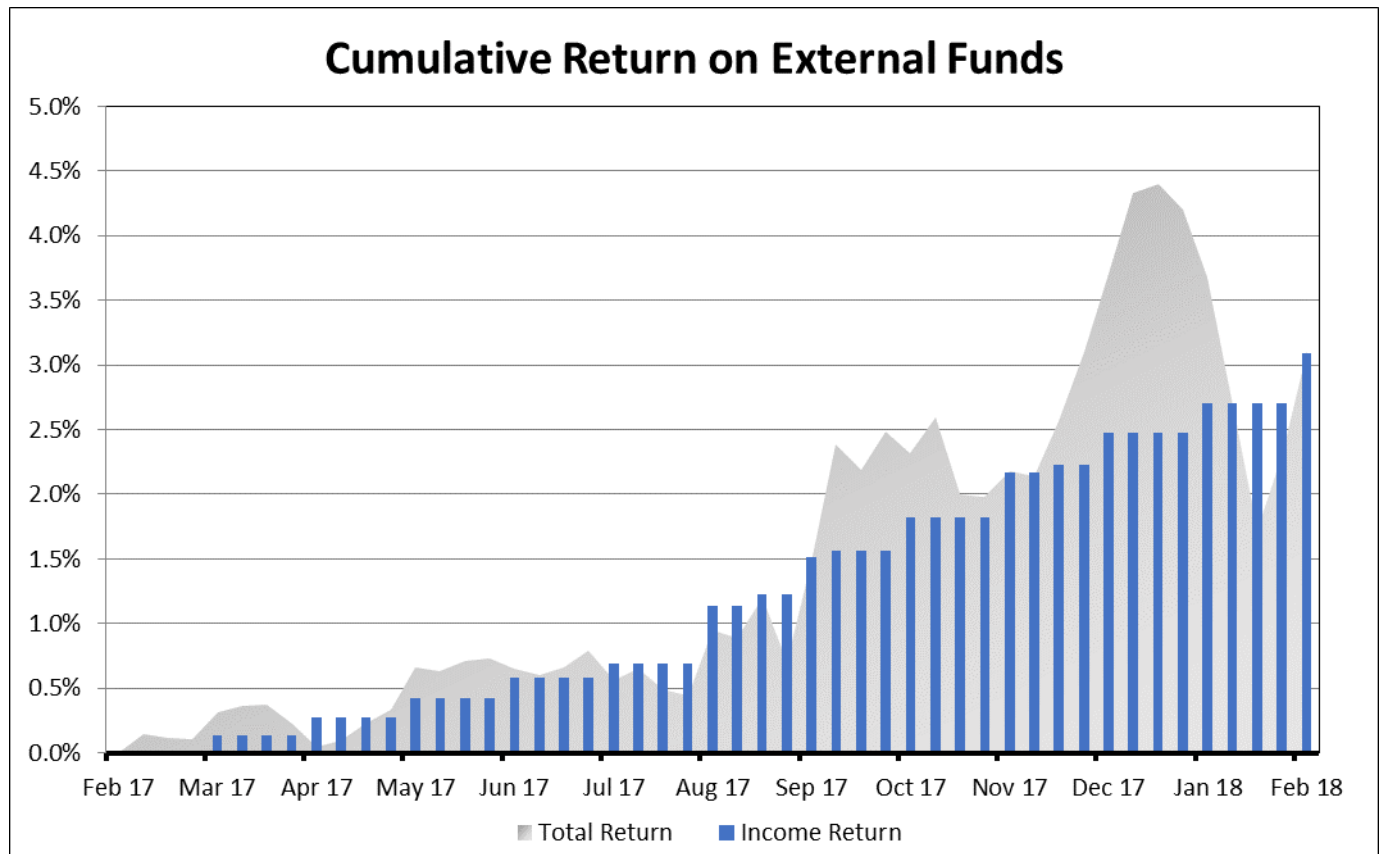
3.1 At the end of February 48% of total investments were held in externally managed funds as per the table below.

| | Book cost (£000) | Market Value at 28 February 2018 (£000) | 12 months return to 28 February 2018 | |
|--|---------------------|---|---|--------------|
| | | | Income | Total |
| CCLA Property Fund | 35,000 | 35,973 | 4.33% | 6.34% |
| Pyrford Global Total Return Sterling Fund | 5,000 | 4,906 | 2.16% | -1.30% |
| Fidelity Multi Asset Income Fund | 25,000 | 25,032 | 3.74% | 1.01% |
| Schroder Income Maximiser Fund | 20,000 | 20,197 | 4.94% | 6.95% |
| M&G Global Dividend Fund | 10,000 | 10,390 | 2.49% | 6.32% |
| Threadneedle Global Equity Income Fund | 10,000 | 9,935 | 1.41% | 0.76% |
| Threadneedle UK Equity Income Fund | 10,000 | 9,441 | 1.93% | -3.66% |
| Cashplus / Short Term Bond Funds | 20,000 | 20,057 | 0.23% | 0.39% |
| Bond, Equity and Property Funds | 135,000 | 135,931 | 3.09% | 3.11% |

3.2 A breakdown of the external investments by asset class is as follows



3.3 The following chart tracks the returns earned over the 12 months to end February 2018.



Alison Mings
Treasury and Investments Manager
16 March 2018

Investments as at 29 March 2018

1. Internally Managed Investments

1.1 Term deposits and Money Market Funds

| Instrument Type | Counterparty | Principal Amount | Interest Rate | Maturity Date |
|---|---|--------------------|--------------------|---------------|
| Fixed Deposit | Close Brothers | £5,000,000 | 0.80% | 05/09/18 |
| Fixed Deposit | North Wales Police and Crime Commissioner | £5,000,000 | 0.95% | 23/05/18 |
| Fixed Deposit | Redditch Borough Council | £4,000,000 | 0.95% | 29/05/18 |
| Fixed Deposit | DMADF | £600,000 | 0.25% | 16/04/18 |
| Fixed Deposit | DMADF | £2,450,000 | 0.25% | 03/04/18 |
| Total UK Bank Deposits | | £17,050,000 | | |
| Money Market Fund | Aberdeen Sterling Liquidity Fund | £9,982,827 | 0.4204% (variable) | n/a |
| Money Market Fund | Deutsche Managed Sterling Fund | £9,993,729 | 0.4428% (variable) | n/a |
| Money Market Fund | Federated (PR) Short-term GBP Prime Fund | £9,985,998 | 0.50% (variable) | n/a |
| Money Market Fund | HSBC Global Liquidity Fund | £9,976,594 | 0.3329% (variable) | n/a |
| Money Market Fund | Insight Sterling Liquidity Fund | £9,922,941 | 0.3908% (variable) | n/a |
| Money Market Fund | LGIM Liquidity Fund | £9,981,589 | 0.4269% (variable) | n/a |
| Money Market Fund | SSgA GBP Liquidity Fund | £9,991,217 | 0.3918% (variable) | n/a |
| Money Market Fund | Standard Life Sterling Liquidity Fund | £9,984,853 | 0.6399% (variable) | n/a |
| Total Money Market Funds | | £79,819,748 | | |
| Equity and Loan Notes | Kent PFI (Holdings) Ltd | £2,135,393 | | |
| Icelandic Recoveries outstanding | Heritable Bank Ltd | £366,905 | | |

1.2 Bond Portfolio

| Bond Type | Issuer | Adjusted Principal | Coupon Rate | Maturity Date |
|----------------------------|---------------------------|--------------------|-------------|---------------|
| Fixed Rate Covered Bond | Bank Of Nova Scotia | £4,987,436 | 0.88% | 14/09/2021 |
| Fixed Rate Covered Bond | Coventry Building Society | £3,079,278 | 1.93% | 19/04/2018 |
| Fixed Rate Covered Bond | Coventry Building Society | £5,142,465 | 1.73% | 19/04/2018 |
| Fixed Rate Covered Bond | Coventry Building Society | £2,061,088 | 1.52% | 19/04/2018 |
| Floating Rate Covered Bond | Coventry Building Society | £3,004,144 | 0.56% | 17/03/2020 |
| Fixed Rate Covered Bond | Leeds Building Society | £5,579,421 | 0.63% | 17/12/2018 |
| Fixed Rate Covered Bond | Leeds Building Society | £2,043,411 | 2.03% | 17/12/2018 |
| Fixed Rate Covered Bond | Leeds Building Society | £1,514,308 | 1.19% | 17/12/2018 |
| Floating Rate Covered Bond | Leeds Building Society | £5,000,000 | 0.74% | 01/10/2019 |
| Floating Rate Covered Bond | Lloyds - Bonds | £1,402,406 | 0.58% | 18/07/2019 |

| | | | | |
|----------------------------|-----------------------------|--------------------|-------|------------|
| Floating Rate Covered Bond | Lloyds - Bonds | £2,503,664 | 0.90% | 27/03/2023 |
| Floating Rate Covered Bond | Lloyds - Bonds | £2,504,890 | 0.89% | 27/03/2023 |
| Fixed Rate Covered Bond | National Australia Bank | £3,002,504 | 1.10% | 10/11/2021 |
| Floating Rate Covered Bond | Nationwide Building Society | £2,149,563 | 0.82% | 27/04/2018 |
| Floating Rate Covered Bond | Nationwide Building Society | £3,428,245 | 0.70% | 27/04/2018 |
| Fixed Rate Covered Bond | Santander UK | £3,528,063 | 0.65% | 14/04/2021 |
| Floating Rate Covered Bond | Santander UK | £3,000,402 | 0.75% | 29/05/2018 |
| Floating Rate Covered Bond | Toronto-Dominion Bank | £5,452,902 | 0.95% | 01/02/2019 |
| Fixed Rate Covered Bond | Yorkshire Building Society | £3,094,680 | 1.55% | 12/04/2018 |
| Fixed Rate Covered Bond | Yorkshire Building Society | £2,054,403 | 1.98% | 12/04/2018 |
| Total Bonds | | £64,533,273 | | . |

| | |
|---|---------------------|
| Total Internally managed investments | £163,905,319 |
|---|---------------------|

2. Externally Managed Investments

| | |
|--|---------------------|
| Total External Investments per appendix 1 | £135,930,952 |
|--|---------------------|

3. Total Investments

| | |
|--------------------------|---------------------|
| Total Investments | £299,836,271 |
|--------------------------|---------------------|