

By: Peter Oakford, Deputy Leader and Cabinet Member for Finance and Traded Services
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To: County Council – 21 March 2019

Subject: **TREASURY MANAGEMENT 6 MONTH REVIEW 2018-19**

Classification: Unrestricted

Summary: To present a review of Treasury Management Activity 2018-19 to date

FOR DECISION

INTRODUCTION

1. This report covers Treasury Management activity for the 6 months to 30 September 2018 and developments in the period since up to the date of this report.
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 therefore ensures this council is embracing Best Practice in accordance with CIPFA's recommendations.
3. The Council's Treasury Management Strategy for 2018-19 was approved by full Council on 20 February 2018.
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.

GOVERNANCE

5. The Corporate Director Finance is responsible for the Council's treasury management operations and day to day responsibility is delegated to the Head of Finance (Policy, Planning & Strategy) / Head of Finance (Operations) and Treasury and Investments Manager. The detailed responsibilities are set out in the Council's Treasury Management Practices.
6. The Treasury Management Advisory Group (TMAG) which is a sub-committee of Cabinet has been established to work with the Officers on treasury management. The group consists of the Cabinet Member for Finance and Traded Services, Deputy Cabinet Member for Finance and Traded Services, Chairman Policy and Resources Cabinet Committee, Chairman Superannuation Fund Committee, Liberal Democrat Finance spokesman and a Labour Group Representative. The agreed terms of reference are "The Treasury Management Advisory Group will

be responsible for advising the Cabinet and Corporate Director Finance on treasury management policy within KCC's overarching Treasury Management Strategy". TMAG meets the requirement in the CIPFA TM Code for a member body focussing specifically on treasury management. TMAG meets half yearly and members of the group receive detailed information on a weekly and monthly basis.

7. Council will agree the Treasury Management Strategy and receives annual and half yearly reports on treasury management activity. Governance and Audit Committee receives annual and half-yearly reports and makes recommendations to County Council. It also receives quarterly updates.

EXTERNAL CONTEXT

Economic Background

8. The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, has continued to be a major influence on the Council's treasury management activity in 2018/19.
9. UK Consumer Price Inflation (CPI) remained steady during the period with October up 2.4% year/year, slightly below the consensus forecast and broadly in line with the Bank of England's November Inflation Report.
10. The most recent labour market data for October 2018 showed the unemployment rate edged up slightly from a low of 4.0%, its lowest on record, to 4.1% while the employment rate of 75.7% was the joint highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.3% as wages continue to rise steadily and provide some pressure on general inflation. Adjusted for inflation, real wages grew by 1.0%, a level still likely to have little affect on consumer spending.
11. The rise in quarterly GDP growth to 0.6% in the September quarter from 0.4% in the previous quarter was due to weather-related factors boosting overall household consumption and construction activity over the summer following the weather-related weakness in the March quarter. At 1.5%, annual GDP growth continues to remain below trend.
12. Following the Bank of England's decision to increase the Bank Rate to 0.75% in August, no changes to monetary policy have been made since. The Monetary Policy Committee continues to reiterate that any further increases will be at a gradual pace and limited in extent.
13. While US growth has slowed over 2018, the economy continues to perform robustly. The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the current 2%-2.25% in September. Concerns over trade wars continue to drag on economic activity.

Credit outlook

14. The big four UK banking groups have now divided their retail and investment banking divisions into separate legal entities under ringfencing legislation. Credit rating agencies have adjusted the ratings of some of these banks with the ringfenced banks generally being better rated than their non-ringfenced counterparts.
15. The Bank of England has released its latest report on bank stress testing, illustrating that all entities included in the analysis were deemed to have passed the test once the levels of capital and potential mitigating actions presumed to be taken by management were factored in. The BoE did not require any bank to raise additional capital.

LOCAL CONTEXT

16. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. 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.

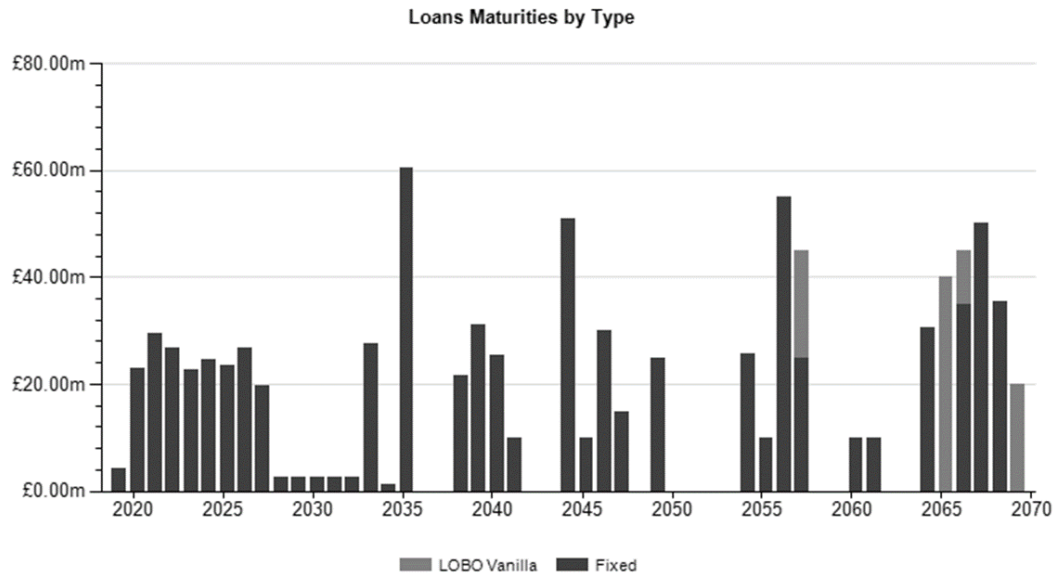
BORROWING STRATEGY

17. At 30 November 2018 the Council had total debt outstanding of £911.3m, a reduction of £31.33m from the balance as at 31 March 2018. Outstanding loans at 30 November are summarised in the table below.

Borrowing Position

| | 30/3/2018 Balance £m | 2018/19 Movement £m | 30/11/2018 Balance £m | Average Rate % | Years to final maturity |
|-------------------------|-------------------------|---------------------------|--------------------------|-------------------|-------------------------------|
| Public Works Loan Board | 472.28 | 21.00 | 493.28 | 5.03% | 16.99 |
| Banks (LOBO) | 150.00 | -60.00 | 90.00 | 4.15% | 45.21 |
| Banks (Fixed Term) | 320.32 | 7.67 | 327.99 | 3.97% | 35.85 |
| | 942.60 | -31.33 | 911.27 | 4.56% | 26.56 |

18. The maturity profile of KCC's outstanding debt is as follows:



19. 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.
20. In keeping with these objectives no new borrowing was undertaken other than as part of the restructure of the LOBO portfolio and in respect of the Council's replacement streetlighting project. £19m of existing loans were allowed to mature without replacement.
21. With short-term interest rates remaining much lower than long-term rates, KCC has considered it to be more cost effective in the near term to use internal resources or borrowed short term loans instead. The Council's strategy has enabled it to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.
22. 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 at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the period.
23. During the period an assessment by Arlingclose (the council's advisors) of KCC's LOBO portfolio identified restructuring opportunities with RBS likely to achieve substantial value from a negotiated settlement with the bank. The risks and benefits including restructuring savings were assessed and in October the Council successfully negotiated the prepayment of its 3 RBS loans with a principal value of £60m as follows:

Prepaid RBS LOBO loans

| Start date | End date | Yrs to mty | Principal | Coupon | Disc rate | Premium | Redemption Amount |
|------------|----------|--------------|-------------|-------------|-----------|-------------|-------------------|
| | | | £m | % | % | £m | £m |
| 10/8/11 | 10/8/57 | 38.85 | 25.0 | 3.83 | 2.95 | 5.1 | 30.1 |
| 10/8/11 | 10/5/58 | 40.0 | 25.0 | 3.83 | 2.94 | 5.2 | 30.2 |
| 30/1/09 | 30/1/69 | 50.33 | 10.0 | 3.95 | 2.90 | 12.8 | 12.8 |
| | | 41.19 | 60.0 | 3.85 | | 13.1 | 73.1 |

24. Taking account of advice from Arlingclose the prepayment was financed using a combination of a £40m 15-year EIP (Equal Instalment of Principal) loan from the PWLB at 2.21%, and cash balances. As a result of this change the Council was able to reduce the average interest rate payable on its borrowing and reduce its long-term debt exposure.
25. This funding arrangement using cash balances was deemed to represent the best balance between risk and reward. The combination of lower interest rate payments on debt partially offset by loss of investment income/cost of short-term borrowing is expected to deliver a net revenue saving of £400k to £500k per annum.

INVESTMENT ACTIVITY

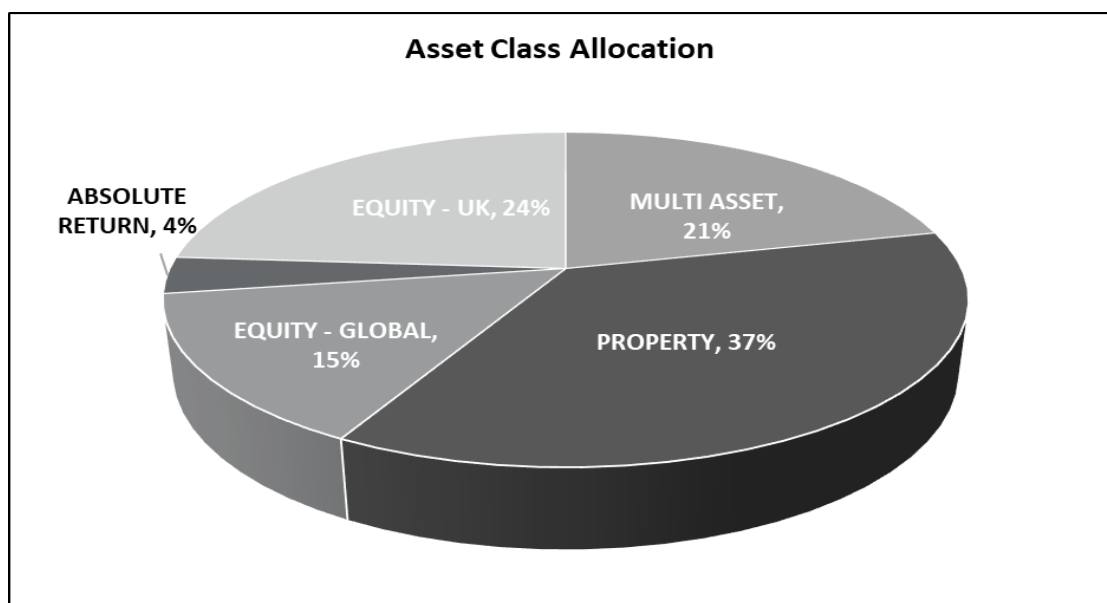
26. The Council holds significant invested funds representing income received in advance of expenditure plus balances and reserves held. During the period the Council's investment balance ranged between £274m and £434m due to timing differences. The investment position is shown below.

Investment Position

| | 31.3.18 Balance £m | 2018 Movement £m | 30.11.18 Balance £m | 30.11.18 Rate of Return % | Days to maturity | Average Credit Rating |
|--------------------------------|--------------------------|------------------------|---------------------------|------------------------------------|---------------------|-----------------------------|
| Money Market Fund | 79.8 | 23.6 | 103.4 | 0.63 | 1 | A+ |
| Fixed Deposit | 17.1 | 8.2 | 25.3 | 0.84 | 180 | AA- |
| T Bill | | 10.0 | 10.0 | 0.73 | 179 | AA |
| Covered Bond | 64.5 | 14.8 | 79.3 | 1.02 | 930 | AAA |
| Icelandic Recoveries o/s | 0.4 | 0.0 | 0.4 | | | |
| Equity | 2.1 | 0.0 | 2.1 | | | |
| Internally managed cash | 163.9 | 56.6 | 220.5 | 0.82 | 368 | AA |

| | | | | | | |
|----------------------------------|--------------|-------------|--------------|-------------|--|--|
| Strategic Pooled Funds | 113.8 | 26.9 | 138.3 | 4.02 | | |
| Cashplus / Short term Bond Funds | 20.0 | -20.0 | 0.0 | | | |
| External Investments | 133.8 | 4.5 | 138.3 | 4.02 | | |
| Total | 297.7 | 61.1 | 358.8 | 2.18 | | |

27. 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.
28. In furtherance of these objectives and given the increasing risk and low returns from short-term unsecured bank investments the Council has continued to diversify into more secure and/or higher yielding asset classes as set out in its Treasury Management Strategy Statement for 2018-19.
29. The Council's £138.3m of externally managed pooled funds generated an average total return of 2.18%, comprising a 4.02% income return which is used to support services in year, and -1.57% of capital losses. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives is regularly reviewed. In light of their performance and the Council's latest cash flow forecasts, investment in these funds has been increased with a further £10m invested in a Kames Capital multi asset fund in early December.
30. A breakdown of the external investments by asset class is as follows



31. A detailed schedule of KCC's investments as at 30 November 2018 is attached in Appendix 1. This schedule is circulated to members of the Treasury Management Advisory Group (TMAG) every Friday.
32. The Ministry of Housing, Communities and Local Government (MHCLG) consulted in July on statutory overrides relating to the introduction of the IFRS 9 Financial Instruments accounting standard. KCC responded arguing that the adoption of IFRS 9 as proposed could add unwarranted volatility in the General Fund, and hence impact unnecessarily upon Council Tax or service expenditure. The MHCLG then announced in November that it has accepted the arguments made and decided to introduce a statutory override that while requiring IFRS 9 to be adopted in full, requires fair value movements in pooled investment funds to be taken to a separate reserve instead of the General Fund. MHCLG has also committed to keep the override in place for at least five years and to review this in to March 2023. The override will apply to all collective investment schemes, and not just to pooled property funds as suggested in the consultation.

FORECAST OUTTURN

33. It is anticipated that there will be an underspend against the net debt costs budget for the year of £0.6m as a result of higher dividends and interest receipts and the net impact of debt restructuring. Average cash balances during the year are forecast to be £351m earning an average return of 2.2%. The forecast average rate of debt interest payable in 2018-19, taking account of the cost of the premium paid on the restructure, is 4.7%, based on an average debt portfolio of £927m.

COMPLIANCE

30. The Corporate Director Finance reports that the treasury management activities undertaken during the period complied with the Council's Prudential Indicators for 2018-19 set as part of the Council's Treasury Management Strategy. Details can be found in Appendix 2.

RECOMMENDATION

31. Members are asked to consider and comment on the report.

Alison Mings
Treasury and Investments Manager
Ext: 03000 416488
29 January 2019

Investments as at 30 November 2018

1. Internally Managed Investments

1.1 Term deposits, Call accounts and Money Market Funds

| Instrument Type | Counterparty | Principal Amount | Interest Rate | End Date |
|-------------------------------|--|-------------------|---------------|------------|
| Fixed Deposit | Thurrock Borough Council | £10,000,000 | 0.90% | 31/05/2019 |
| Fixed Deposit | Thurrock Borough Council | £10,000,000 | 0.95% | 30/08/2019 |
| Fixed Deposit | Debt Management Account Deposit Facility | £5,350,000 | 0.50% | 03/12/2018 |
| Treasury Bill | DMO | £9,963,533 | 0.73% | 28/05/2019 |
| Total UK Bank Deposits | | 35,313,533 | | |

| | | | | |
|---|--|---------------------|------------------|-----|
| Money Market Fund | Aberdeen Sterling Liquidity Fund | £14,962,953 | 0.42% (variable) | n/a |
| Money Market Fund | Deutsche Managed Sterling Fund | £14,991,935 | 0.73% (variable) | n/a |
| Money Market Fund | Federated (PR) Short-term GBP Prime Fund | £14,997,736 | 0.50% (variable) | n/a |
| Money Market Fund | HSBC Global Liquidity Fund | £14,991,497 | 0.84% (variable) | n/a |
| Money Market Fund | Insight Liquidity Funds PLC | £13,535,199 | 0.68% (variable) | n/a |
| Money Market Fund | LGIM Sterling Liquidity Fund | £14,992,189 | 0.73% (variable) | n/a |
| Money Market Fund | SSgA GBP Liquidity Fund | £14,957,206 | 0.67% (variable) | n/a |
| Total Money Market Funds | | £103,428,714 | | |
| Equity and Loan Notes | Kent PFI (Holdings) Ltd | £2,135,741 | | n/a |
| Icelandic Recoveries outstanding | Heritable Bank Ltd | £366,905 | | n/a |

1.2 Bond Portfolio

| Bond Type | Issuer | Adjusted Principal | Coupon Rate | Maturity Date |
|----------------------------|------------------------------------|--------------------|-------------|---------------|
| Fixed Rate Covered Bond | Bank of Montreal | £5,006,029 | 1.06% | 17/04/23 |
| Fixed Rate Covered Bond | Bank of Nova Scotia | £4,990,619 | 0.88% | 14/09/21 |
| Fixed Rate Covered Bond | Canadian Imperial Bank of Commerce | £5,039,704 | 0.98% | 10/01/22 |
| Fixed Rate Covered Bond | Coventry Building Society | £3,003,110 | 1.03% | 17/03/20 |
| Fixed Rate Covered Bond | Leeds Building Society | £5,579,421 | 0.63% | 17/12/18 |
| Fixed Rate Covered Bond | Leeds Building Society | £2,043,411 | 2.03% | 17/12/18 |
| Floating Rate Covered Bond | Leeds Building Society | £1,514,308 | 1.19% | 17/12/18 |
| Floating Rate Covered Bond | Leeds Building Society | £5,000,000 | 1.20% | 01/10/19 |
| Floating Rate Covered Bond | Lloyds | £2,503,295 | 1.02% | 27/03/23 |
| Floating Rate Covered Bond | Lloyds | £2,504,397 | 1.01% | 27/03/23 |
| Floating Rate Covered Bond | Lloyds | £1,401,029 | 1.00% | 18/07/19 |
| Floating Rate Covered Bond | Lloyds | £5,007,765 | 1.01% | 27/03/23 |

Appendix 1

| | | | | |
|----------------------------|-----------------------------|--------------------|-------|----------|
| Floating Rate Covered Bond | National Australia Bank | £3,001,889 | 1.10% | 10/11/21 |
| Floating Rate Covered Bond | Nationwide Building Society | £4,505,430 | 1.04% | 12/04/23 |
| Floating Rate Covered Bond | Nationwide Building Society | £5,588,843 | 1.03% | 12/04/23 |
| Floating Rate Covered Bond | Santander UK | £3,397,332 | 0.65% | 14/04/21 |
| Floating Rate Covered Bond | Santander UK | £5,010,484 | 0.97% | 05/05/20 |
| Floating Rate Covered Bond | Santander UK | £5,003,472 | 1.10% | 16/11/22 |
| Floating Rate Covered Bond | Santander UK | £3,752,534 | 1.01% | 13/04/21 |
| Floating Rate Covered Bond | Toronto-Dominion Bank | £5,450,707 | 1.26% | 01/02/19 |
| Total Bonds | | £79,303,779 | | |

| | |
|---|---------------------|
| Total Internally managed investments | £220,548,672 |
|---|---------------------|

2. Externally Managed Investments

| Investment Fund / Equity | | Market Value at 30 November 2018 £ | 12 months return to 30 November 2018 | |
|---|-----------------|---|---|-------------|
| Fund Name | Asset Class | | Income % | Total % |
| CCLA - Diversified Income Fund | Multi asset | 4,979,931 | 0.79 | 0.39 |
| CCLA – LAMIT Property Fund | Property | 50,546,043 | 3.91 | 4.31 |
| Fidelity Multi Asset Income Fund | Multi asset | 24,505,940 | 3.31 | -0.33 |
| M&G Global Dividend Fund | Equity - global | 10,580,732 | 2.98 | 5.60 |
| Pyrford Global Total Return Sterling Fund | Absolute return | 4,906,058 | 2.31 | 0.10 |
| Schroder Income Maximiser Fund | Equity - UK | 23,607,427 | 6.70 | 3.17 |
| Threadneedle Global Equity Income Fund | Equity - global | 9,789,200 | 3.53 | 0.62 |
| Threadneedle UK Equity Income Fund | Equity - UK | 9,400,149 | 3.85 | 0.09 |
| Total External Investments | | 138,315,480 | 4.02 | 2.45 |

3. Total Investments

| | |
|--------------------------|---------------------|
| Total Investments | £358,864,152 |
|--------------------------|---------------------|

2018-19 Monitoring of Prudential Indicators as at 30 November 2018

1. Estimate of capital expenditure (excluding PFI)

| | |
|---------------------------|-----------|
| Actuals 2017-18 | £188.249m |
| Original estimate 2018-19 | £295.449m |
| Revised estimate 2018-19 | £205.906m |

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

| | 2017-18 | 2018-19 | 2018-19 |
|--|-----------|----------------------|-------------------------------|
| | Actual | Original Estimate | Forecast as at 30.11.18 |
| | £m | £m | £m |
| Capital Financing requirement | 1,322.493 | 1,373.692 | 1,296.719 |
| Annual increase/reduction in underlying need to borrow | -39.901 | 45.406 | -25.774 |

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

| | |
|---------------------------|--------|
| Actuals 2017-18 | 12.96% |
| Original estimate 2018-19 | 12.01% |
| Forecast 2018-19 | 11.86% |

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 2018-19

(a) Operational boundary for debt relating to KCC assets and activities

| | Prudential Indicator | Position as at 30.11.18 |
|-----------------------------|----------------------|-------------------------|
| | £m | £m |
| Borrowing | 1,003 | 875 |
| Other Long-Term Liabilities | 271 | 263 |
| | <hr/> 1,274 | <hr/> 1,138 |

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

| | Prudential Indicator | Position as at 30.11.18 |
|-----------------------------|----------------------|-------------------------|
| | £m | £m |
| Borrowing | 1,038 | 911 |
| Other Long-Term Liabilities | 271 | 263 |
| | <hr/> 1,309 | <hr/> 1,174 |

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. The revised limits for 2018-19 are:

| | Authorised limit for debt relating to KCC assets and activities | Position as at 30.11.18 | Authorised limit for total debt managed by KCC | Position as at 30.11.18 |
|-----------------------------|---|-------------------------|--|-------------------------|
| | £m | £m | £m | £m |
| Borrowing | 1,043 | 875 | 1,078 | 911 |
| Other long-term liabilities | 271 | 263 | 271 | 263 |
| | <hr/> 1,314 | <hr/> 1,138 | <hr/> 1,349 | <hr/> 1,174 |

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 Strategy Statement. Compliance has been tested and validated by our independent professional treasury advisors.

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

The Council has determined the following upper limits for 2018-19

| | |
|------------------------------|------|
| Fixed interest rate exposure | 100% |
| Variable rate exposure | 50% |

These limits have been complied with in 2018-19.

8. Upper limits for maturity structure of borrowings

| | Upper limit | Lower limit | Position as at 30.11.18 |
|--------------------------------|----------------|----------------|----------------------------|
| | % | % | % |
| Under 12 months | 10 | 0 | 0.47 |
| 12 months and within 24 months | 10 | 0 | 2.52 |
| 24 months and within 5 years | 15 | 0 | 8.83 |
| 5 years and within 10 years | 15 | 0 | 10.96 |
| 10 years and within 20 years | 20 | 5 | 13.94 |
| 20 years and within 30 years | 25 | 5 | 19.09 |
| 30 years and within 40 years | 25 | 10 | 17.67 |
| 40 years and longer | 30 | 10 | 26.52 |

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

| | |
|-----------|-------|
| Indicator | £250m |
| Actual | £218m |