From:	Peter Oakford, Deputy Leader and Cabinet Member for Finance, Traded and Corporate Services Zena Cooke, Corporate Director of Finance
To:	Governance and Audit Committee – 25 January 2022
Subject:	Treasury Management Update
Classification:	Unrestricted
Future Pathway of report	County Council

Summary:

This report provides a review of Treasury Management Activity up to the end of November 2021 and developments in 2021-22 up to the date of this report.

Recommendation:

Members are asked to endorse this report and recommend that it is submitted to Council.

FOR DECISION

1. Introduction

1.1 This report covers Treasury Management activity up to the end of November 2021 and developments in 2021-22 up to the date of this report.

1.2 If agreed by members this report will go on to Council.

1.3 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.

1.4 The Council's Treasury Management Strategy for 2021-22 was approved by full Council on 11 February 2021.

1.5 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. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy. This report covers treasury activity and the associated monitoring and control of risk.

2. External context

2.1 **Economic background:** The economic recovery from coronavirus pandemic has continued to be the dominant issue.

2.2 The Bank of England (BoE) held Bank Rate at 0.1% throughout the period and maintained its Quantitative Easing programme at £895 billion, unchanged since the November 2020 meeting. However at its meeting on 16 December Bank Rate was raised to 0.25% while the Quantitative Easing programme was unchanged.

2.3 First estimates for Q3 2021 suggest that GDP increased 1.3% on the previous quarter and is up 6.6% on the previous year but remains 2.1% below its pre pandemic level. Estimates for growth in Q4 2021 have been revised down as the pace of the global recovery has shown signs of slowing and there are concerns inflationary pressures may be more persistent.

2.4 UK Consumer Price Inflation (CPI) for November 2021 registered 5.1% year on year, up from 4.2% in the previous month reflecting higher transport, housing and household service costs. Core inflation, which excludes the more volatile components, also rose to 4.0% year on year from 3.4% in October. CPI is expected to remain at 5% throughout the winter, rising further in April 2022 largely reflecting the pass-through of current rises in wholesale gas and electricity prices.

2.5 Government initiatives supporting the economy came to an end on 30 September 2021 with the end of the furlough scheme. The most recent labour market data for the three months to October 2021 showed a quarterly increase in the employment rate to 75.5%, while the unemployment rate decreased to 4.2%.

2.6 In October, the headline 3-month average annual growth rates for wages were 4.9% for total pay and 4.3% for regular pay. In real terms, after adjusting for inflation, total pay growth was up by 1.7% while regular pay was up 1.0%. However pay growth is now being impacted by base effects compared to 12 months ago when earnings were first affected by the coronavirus pandemic. The change in pay growth has been affected by a changing composition of employee jobs, where we have seen a fall in the number and proportion of lower-paid employee jobs.

2.7 The European Central Bank maintained its base rate at 0% and deposit rate at -0.5% throughout the period.

2.8 Monetary and fiscal stimulus together with rising economic growth and the ongoing vaccine rollout programmes continued to support equity markets over most of the period, albeit with a bumpy ride towards the end. The Dow Jones hit another record high while the UK-focused FTSE 250 index continued making gains over pre-pandemic levels. The more internationally focused FTSE 100 saw more modest gains over the period and remains below its pre-crisis peak.

2.9 Inflation worries continued during the period. Declines in bond yields in the first quarter of the financial year suggested bond markets were expecting any general price increases to be less severe, or more transitory, that was previously thought. However, an increase in gas prices in the UK and EU, supply shortages and a dearth of HGV and lorry drivers with companies willing to pay more to secure their services, has caused problems for a range of industries and, in some instance, lead to higher prices.

2.10 The 5-year UK benchmark gilt yield began the financial year at 0.36% rising to 0.61% at the end of November. The 10-year gilt yield fluctuated during the period ending up at 0.81%, slightly below its level at the beginning of April. The 20-year yield declined over the 8 months from 1.31% to 0.98% at the end of November.

3. Local context

3.1 At 31 March 2021 the Council had borrowed £853.7m and invested £502.1m arising from its revenue and capital income and expenditure. 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. A summary of the Council's borrowing and investments are shown in the following table.

	31 Mar 2021 Actual £m
Loans CFR	1,033.4
External borrowing	-853.7
Internal borrowing	**179.7**
Less: Usable reserves	-533.7
Less: Working capital	-148.1
Net investments	**502.1**

3.1 Lower official interest rates have reduced the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The Council pursued its strategy of keeping borrowing and investments below their underlying levels, known as internal borrowing, in order to reduce risk and keep interest costs low. This strategy is regularly reviewed with the Council's treasury advisors.

3.2 The treasury management position on 30 November 2021 and the change over the eight months is shown in the following table.

	31 Mar 2021 Balance £m	**Movement £m**	**30 Nov 2021 Balance £m**	**30 Nov 2021 Rate %**
Long-term borrowing	853.7	-25.2	828.5	4.46
Total borrowing	**853.7**	**-25.2**	**828.5**	**4.46**
Long-term investments	261.8	+32.2	294.0	2.93
Short-term investments	105.4	+50.9	156.3	0.04
Cash and cash equivalents	135.0	-80.7	54.3	0.00
Total investments	**502.1**	**+2.4**	**504.5**	**1.76**
Net borrowing	**351.6**	**-27.6**	**324.0**	

4. Borrowing Update

4.1 **PWLB loans:** Local authorities can borrow from the PWLB provided they can confirm they are not planning to purchase 'investment assets primarily for yield' in the current or next two financial years, with confirmation of the purpose of capital expenditure from the Section 151 Officer. Acceptable use of PWLB borrowing includes service delivery, housing, regeneration, preventative action, refinancing and treasury management.

4.2 Changes to the CIPFA Prudential Code were published in December 2021 and they prohibit borrowing from any source for the primary purpose of commercial return.

4.3 Kent County Council is not planning to purchase any investment assets primarily for yield within the next three years and so is fully able to access the PWLB.

4.4 In August 2021 HM Treasury published further guidance on PWLB borrowing and details of the sanctions which can be imposed for inappropriate use of the PWLB loans. These can include a request to cancel projects, restrictions to accessing the PLWB and requests for information on further plans.

4.5 Changes were also announced to PWLB Terms and Conditions with effect from 8 September 2021 including the settlement time for a PWLB loan being extended from two working days (T+2) to five working days (T+5) in a move to protect the PWLB against negative interest rates. The minimum interest rate for PWLB loans has also been set at 0.01% and the interest charged on late repayments will be the higher of Bank of England Base Rate or 0.1%.

4.6 **Other lenders:** Local authorities now also have the option of borrowing from the Municipal Bonds Agency with the minimum loan size expected to be £25 million. The UK Infrastructure Bank launched in June 2021 has earmarked £4bn for lending to local authorities. and loans will be available for qualifying projects at lower rates than those available from the PWLB.

5 Borrowing Strategy during the period

5.1 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.

5.2 At 30 November 2021 the Council held £828.5m of loans as part of its strategy for funding previous capital programmes. In keeping with its objectives no new borrowing has been undertaken in 2021-22 and £25.2m of existing loans have been allowed to mature without replacement.

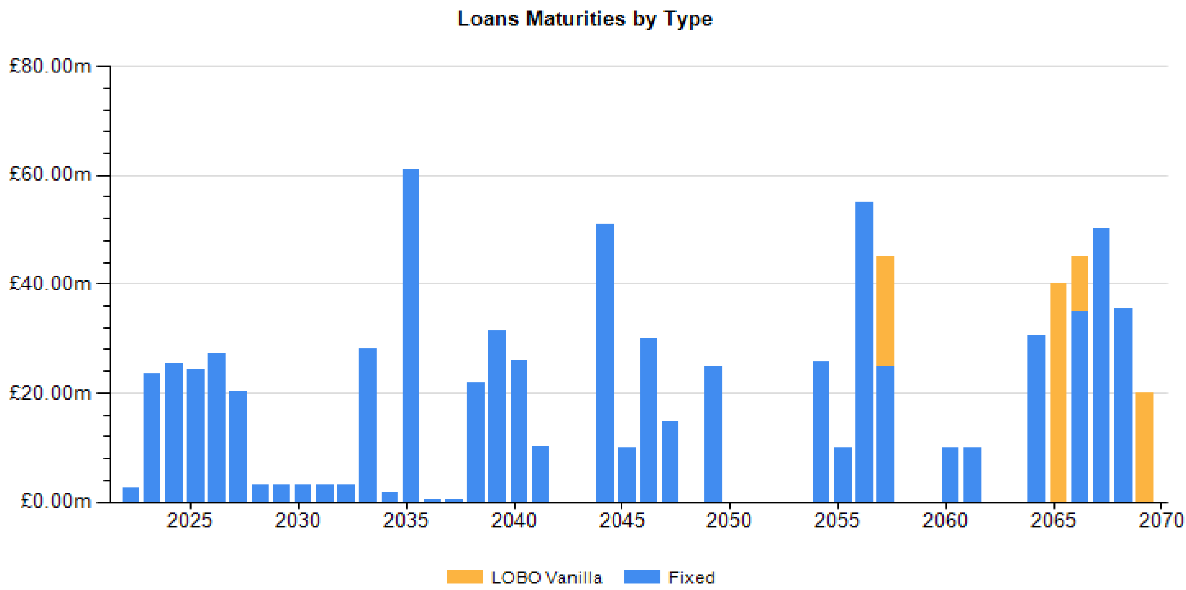
5.3 With short-term interest rates remaining much lower than long-term rates, the Council has considered it to be more cost effective in the near term to use internal resources. The Council's strategy has enabled it to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

5.4 The Council 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.

5.5 The Council's borrowing activity in the 8 months to 30 November is as follows:

	31 Mar 2021	2021-22	30 Nov 2021	30 Nov 2021	30 Nov 2021
	Balance	**Movement**	**Balance**	**Average Rate**	**Value Weighted Average Life**
	£m	**£m**	**£m**	**%**	**yrs**
Public Works Loan Board	449.6	-21.3	428.3	4.69%	16.01
Banks (LOBO)	90.0	0.0	90.0	4.15%	42.21
Banks (Fixed Term)	291.8	0.0	291.8	4.40%	36.84
Streetlighting project	22.3	-3.9	18.5	1.51%	10.78
Total borrowing	**853.7**	**-25.2**	**828.5**	**4.46%**	**26.08**

5.6 The maturity profile of the Council's outstanding debt at 30 November was as follows:



5.7 The following table shows the maturity profile of our debt in 5 year tranches.

Loan Principal Maturity Period	Total Loan Principal Maturing	Balance of Loan Principal Outstanding
Balance 30 Nov 2021		£828,522,486
Maturity 0 - 5 years	£105,744,001	£722,778,486
Maturity 5 - 10 years	£3,616	£722,774,870

Maturity 10 - 15 years	£117,472,634	£605,302,236
Maturity 15 - 20 years	£97,702,236	£507,600,000
Maturity 20 - 25 years	£105,800,000	£401,800,000
Maturity 25 - 30 years	£25,000,000	£376,800,000
Maturity 30 - 35 years	£135,700,000	£241,100,000
Maturity 35 - 40 years	£20,000,000	£221,100,000
Maturity 40 - 45 years	£165,600,000	£55,500,000
Maturity 45 - 50 years	£55,500,000	£0
Total	£828,522,486	

6 Treasury investment activity

6.1 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 £484m and £657m due to timing differences.

6.2 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.

6.3 The Council continues to hold significant cash balances in money market funds as well as in bank call accounts which have same day availability. This liquid cash was diversified over several counterparties and money market funds to manage both credit and liquidity risks.

6.4 On 30 November the Council had lent £14m to one other local authority. We do not have explicit information about how individual local authority applicants for loans plan to apply the funds they borrow however each request to borrow or to renew an existing loan is assessed in terms of our own cashflow requirements and within our effective lending policies and procedures. We are also mindful of the perceived financial and reputational risks of this lending.

6.5 During the 8 months the Council also made loans totalling £12.8m to the no use empty loans programme achieving a return of 1.5% which is available to fund general services.

6.6 The Council's investments during the 8 months to the end of November are summarised in the table below and a detailed schedule of investments as at 30 November is in Appendix 1.

	31 Mar 2021	2021-22	30 Nov 2021	30 Nov 2021	30 Nov 2021
	Balance	**Movement**	**Balance**	**Rate of Return**	**Average Credit Rating**
	£m	**£m**	**£m**	**%**	
Bank Call Accounts	45.0	-9.8	35.2	0.06	A+
Money Market Funds	135.0	-80.6	54.3	0.00	A+
Local Authorities	51.0	-37.0	14.0	0.05	A+
Covered Bonds	79.7	16.6	96.3	0.47	AAA
DMO Deposits (DMADF)	9.4	80.7	90.1	0.02	AA-
Government Bonds	0.0	17.0	17.0	0.04	AA-
No Use Empty Loans	6.1	6.7	12.8	1.50	
Equity	2.1	0.0	2.1		
Internally managed cash	**327.4**	**-5.7**	**321.7**	**0.16**	AA
Strategic Pooled Funds	**174.7**	**8.1**	**182.8**	**4.36**	
Total	**502.1**	**2.4**	**504.5**	**1.76**	

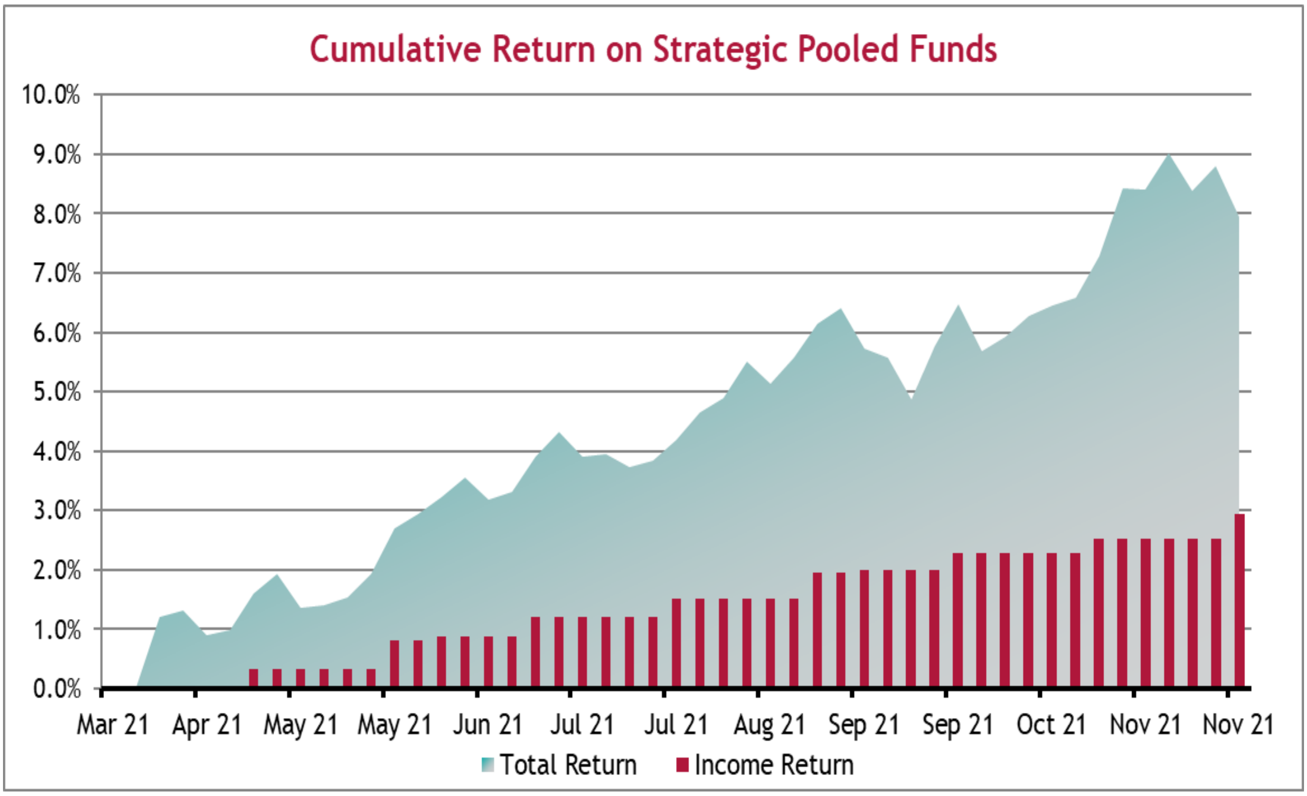
7 Externally managed investments

7.1 The Council is invested in equity, multi-asset and property funds. Because the pooled 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 are regularly reviewed.

7.2 Strategic pooled fund investments are made in the knowledge that capital values will fluctuate however the Council is invested in these funds for the long term and with the confidence that over a three to five year period total returns will exceed cash interest rates.

7.3 Under IFRS 9, the accounting for certain investments depends on the Council's "business model" for managing them. The Council aims to achieve value from its treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost. The IFRS 9 statutory override ends in 2024 so the Council is exploring options for mitigating the risks related to the fluctuation in the value of its investments in pooled funds

7.4 **Performance YTD**. Since March 2021 financial markets have continued to recover with the value of our holdings increasing in value to £182.8m at the end of the month, a gain of £8.1m since the end of March 2021. The following chart tracks the returns earned on the pooled funds over the 8 months to end November 2021.

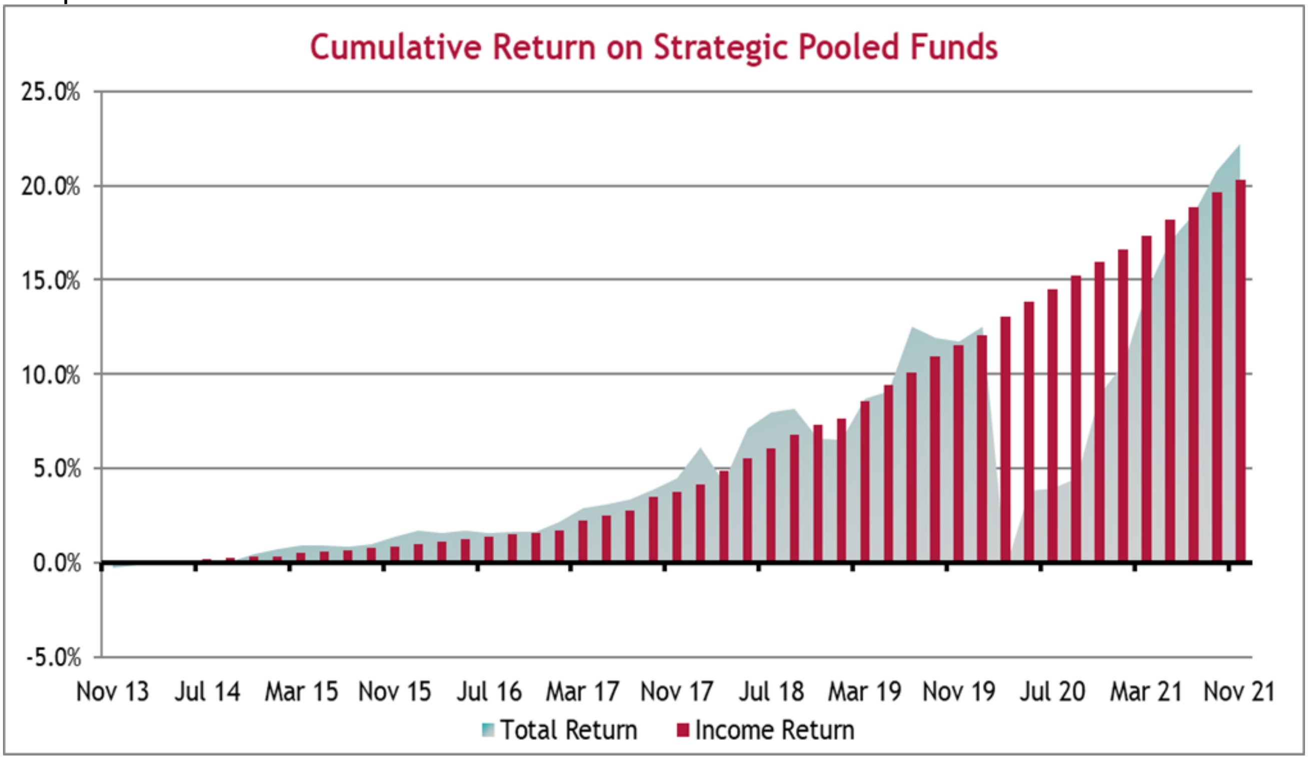


7.5 As shown in the next table the increase in the value of KCC's pooled fund portfolio mainly resulted from the good performance of the CCLA LAMIT property fund after a period of uncertainty. All the funds have continued to pay significant dividends.

		31 Mar 2021	2021-22	30 Nov 2021	30 Nov 2021	
Investment Fund		**Market Value**	**Movement**	**Market Value**	**8 months**	
	Book cost				**Income return**	**Total return**
	£m	**£m**	**£m**	**£m**	%	%
Aegon (Kames) Diversified Monthly Income Fund	20.0	20.1	0.0	20.1	3.33%	3.38%
CCLA - Diversified Income Fund	5.0	4.9	0.4	5.3	1.39%	8.53%
CCLA – LAMIT Property Fund	60.0	57.5	5.6	63.1	2.54%	12.37%
Fidelity Global Multi Asset Income Fund	25.0	24.8	0.1	24.9	2.93%	3.97%
M&G Global Dividend Fund	10.0	12.3	0.9	13.2	1.31%	8.95%
Ninety One (Investec) Diversified Income Fund	10.0	10.1	-0.3	9.8	2.57%	-0.76%
Pyrford Global Total Return Sterling Fund	5.0	5.1	-0.1	5.0	1.07%	1.17%
Schroder Income Maximiser Fund	25.0	19.4	0.5	19.9	5.56%	7.97%
Threadneedle Global Equity Income Fund	10.0	10.9	0.4	11.3	2.39%	6.52%

Threadneedle UK Equity Income Fund	10.0	9.6	0.6	10.2	1.93%	8.70%
Total Externally Managed Investments	**180.0**	**174.7**	**8.1**	**182.8**	**2.82%**	**7.66%**

7.6 **Performance since inception:** KCC initially invested in pooled funds in 2013. By the end of November 2021 the pooled funds had achieved a total income return of £34.1m, 16.63%, with a rise in the capital value of the portfolio of £3.2m, 1.59%. We are long term investors and invested for income to support the Council's services. The following chart tracks the returns earned on the pooled funds over the period from inception.



8 Investment benchmarking at 30 September 2021

8.1 The Council's treasury advisor, Arlingclose, monitors the risk and return of some 130 local authority investment portfolios. The metrics over the 6 months to 30 September 2021 extracted from their quarterly investment benchmarking, per the table below, show that the risk within the Kent internally managed funds has been consistent throughout the 6 month period and in line with that of other local authorities. The income return has fallen reflecting reduced rates payable on our cash investments.

Internally managed investments	Credit Score	Credit Rating	Bail-in Exposure %	Weighted Average Maturity (days)	Rate of Return %
Kent - 31.03.2021	3.76	AA-	53	146	0.21
Kent - 30.09.2021	**3.58**	**AA-**	**41**	**117**	**0.14**
Similar LAs	4.48	AA-	56	116	0.22

All LAs	4.69	A+	69	10	0.08

8.2 The following table shows that overall KCC's investments in strategic pooled funds are achieving a strong income return compared with that of other local authorities.

	Rate of Return – Income only %	**Total Rate of Return %**
Strategic Funds at 30.09.2021		
Kent	**4.60**	**12.35**
Similar LAs	4.31	10.10
All LAs	4.27	9.42
Total Investments at 30.09.2021		
Kent	**1.52**	**5.34**
Similar LAs	0.91	2.73
All LAs	0.78	2.35

9 Actual and forecast outturn

9.1 Over the 8 months to end November the Council's strategic investments generated an average total return of 10.48%, comprising a 2.82% income return which is used to support services in year, and 7.66% of unrealised capital gains. Our view is that during 2021-22 income from the pooled funds will be in line with 2020-21 and higher than the returns available on cash investments. We are invested for income.

9.2 Bank interest rates have moved higher but the returns on our cash deposits are expected to remain close to zero for the foreseeable future.

9.3 Forecast net debt costs remain in line with budget with lower investment income offset by savings on borrowing costs

10 Compliance

10.1 The Corporate Director of Finance reports that all treasury management activities undertaken during the quarter complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

11 Treasury Management Indicators

11.1 The Council measures and manages its exposures to treasury management risks using the following indicators.

11.1 **Security:** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its internally managed investment portfolio. This is calculated by applying a score to each investment

(AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Credit risk indicator	**Actual 30/11/2021**	**Target**
Portfolio average credit rating	AA	AA

11.2 **Liquidity:** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing.

Liquidity risk indicator	**Actual 30/11/2021**	**Target**
Total cash available within 3 months	£193m	£100m

11.3 **Interest rate exposures**: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

Interest rate risk indicator	**Actual 30/11/2021**	**Upper Limit**
One-year revenue impact of a 1% <u>rise</u> in interest rates	£1.5m	£10m
One-year revenue impact of a 1% <u>fall</u> in interest rates	-£898K	-£10m

11.4 **Maturity structure of borrowing:** This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

	Actual 30/11/2021	**Upper limit**	**Lower limit**
Under 12 months	0.31%	100%	0%
12 months and within 5 years	14.56%	50%	0%
5 years and within 10 years	1.92%	50%	0%
10 years and within 20 years	21.94%	50%	0%
20 years and within 40 years	34.58%	50%	0%
40 years and longer	26.69%	50%	0%

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

11.5 **Principal sums invested for periods longer than a year:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

	Actual	Limit	Limit	Limit
Price risk indicator	**30/11/2021**	**2021/22**	**2022/23**	**2023/24**
Principal invested beyond year end	£254.5m	£300m	£300m	£300m

12 Recommendation

Members are asked to endorse this report and recommend that it is submitted to Council.

Alison Mings, Acting Business Partner – Kent Pension Fund

T: 03000 416488

E: Alison.mings@kent.gov.uk

17 January 2022