

By: John Simmonds, Deputy Leader and Cabinet Member for Finance and Procurement
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To: Governance and Audit Committee – 29 January 2015

Subject: **TREASURY MANAGEMENT 6 MONTH REVIEW 2014/15**

Classification: Unrestricted

Summary: To present the Treasury Management 6 Month Review.

FOR DECISION

Introduction

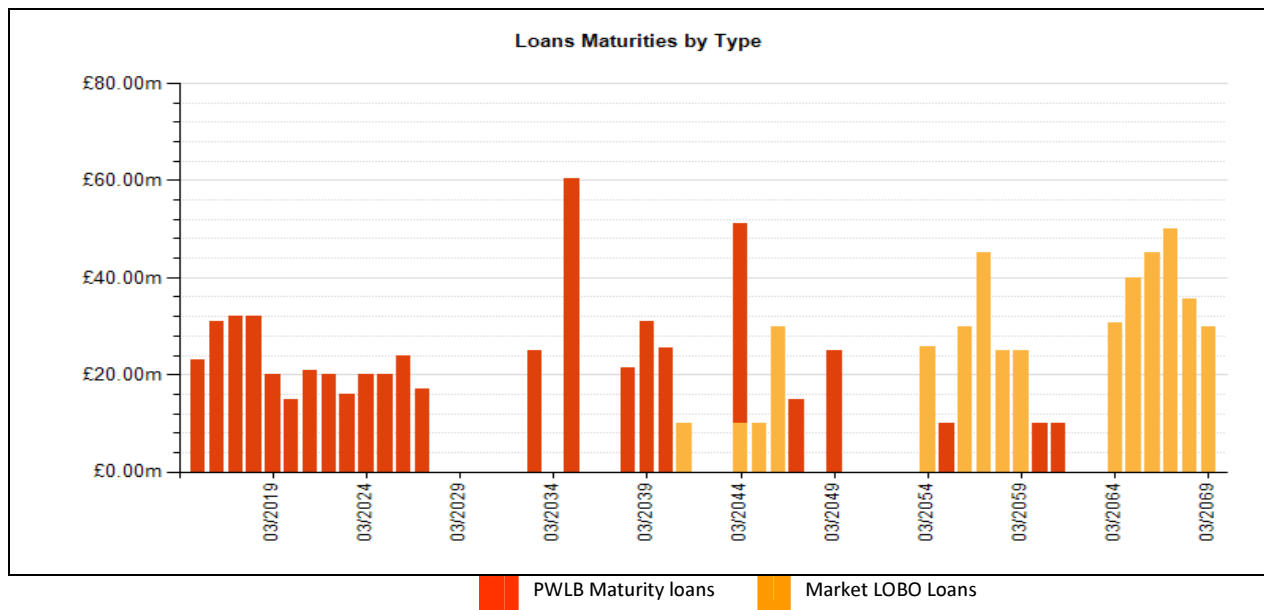
1. This is a 6 month update on treasury management issues.

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 therefore ensures this authority is embracing Best Practice in accordance with CIPFA's recommendations.
3. 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."
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.
5. Although formally this report is to 30 September it covers developments in the period since up to the date of this report.
6. If agreed by members this 6 month report will then go on to Council.

Borrowing Strategy

7. As at 30 September the Council had long term borrowings of £1,007million with a maturity profile as follows:



7. Total external debt managed by KCC includes £40.6m pre-LGR debt managed by KCC on behalf of Medway Council and £2.5million for other bodies.
8. The Council does not expect to borrow in 2014/15. £23m of existing loans are due for repayment before 31 March 2015.
9. The Council's chief objective when borrowing continues to be striking 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.
10. 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 have remained, and are likely to remain at least over the forthcoming two years, lower than long-term rates, the Council has determined it is more cost effective in the short-term to use internal resources instead.
11. 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. This strategy has also lowered overall treasury risk by reducing both external debt and temporary investments.
12. The Council holds £441.8m of 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. £55.7m of these LOBOS had options during the half year, none of which were exercised by the lender. As a further £75m of LOBOS have options during 2014/15, the Council acknowledges there is

an element of refinancing risk even though in the current interest rate environment lenders are unlikely to exercise their options.

Investment Activity

Counterparty Update

13. UK and European Governments have been working on options to avoid a repeat of the “bail out” of banks which we have seen since 2008. This has been replaced with the concept of “bail in” where classes of owners or depositors in the bank take the first tranches of any losses.
14. The European Parliament approved the EU Bank Recovery and Resolution Directive (BRRD) on April 15, 2014. Over the next 5 months the rating agencies changed their outlook for UK, European and Canadian banks from stable to negative citing the reduction of government support for systemic banks and the potential bail in risk now faced by investors as the reason.
15. In October the European Union legislated to pass the cost of failing banks onto a smaller number of creditors, including local authority and financial institution depositors.

Investment activity 2014/15

16. The Council holds significant invested funds averaging £421m year to date, representing income received in advance of expenditure plus balances and reserves held. Cash balances are expected to fall towards the end of the financial year.
17. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council’s aim is to achieve a yield commensurate with these principles. This has been maintained by following the Council’s counterparty policy as set out in its Treasury Management Strategy Statement (TMSS) for 2014/15.
18. In response to the likely impact of “bail in” on local authorities Cabinet on 2 June approved the following changes to the Treasury Management Strategy Statement for 2014/15.
 - a. Increase the Svenska Handelsbanken limit to £40m.
 - b. Increase the allocation to Covered Bonds to £100m in aggregate with a £20m limit by institution.
 - c. Increase the maximum investment in the CCLA LAMIT Property Fund to £10m.
 - d. Introduce Corporate Bonds with a maximum individual limit of £5m.

- e. Introduce Bond Funds with a maximum investment in any one fund of £5m within the investment portfolio aggregate limit of £75m
19. In August it was decided not to place any new deposits with Standard Chartered Bank as the result of concerns relating to their trading particularly in China and falling share price. To date no investments have been made in corporate bonds or bond funds.
20. Taking account of advice from Arlingclose maximum duration limits for deposits have been reduced. In September the Barclays limit was reduced to 6 months and in October limits with HSBC, Standard Chartered, Nationwide Building Society, Lloyds Bank, Bank of Scotland, Svenska Handelsbanken, Australian and Canadian banks were reduced to 6 months, Barclays was reduced to 100 days while the duration of deposits with Close Brothers and smaller building societies remained at 100 days.
21. As at the end of November the types of investment held were as follows:

| Type of Investment | Total | |
|--------------------------------|---------------------|---------------|
| Call Account | £67,800,000 | 20.1% |
| Certificate of Deposit | £35,000,000 | 10.4% |
| Fixed Deposit | £104,850,000 | 31.0% |
| Supranational Bond | £13,792,950 | 4.1% |
| Covered Bond | £71,256,671 | 21.1% |
| T-Bill | £14,964,538 | 4.4% |
| Total Icelandic Deposits | £12,416,710 | 3.7% |
| Internally managed cash | £320,080,869 | 94.7% |
| External Investments | £15,268,077 | 4.5% |
| Equity | £2,681,260 | 0.8% |
| Total | £338,030,206 | 100.0% |

22. The UK Bank Rate has been maintained at 0.5% since March 2009 and short-term money market rates have remained at relatively low levels. The purchase of covered bonds has beneficially impacted on the investment return, extended the maturity profile of the fund and reduced the risk. New internally managed investments were made at an average rate of 0.72%.

Iceland

23. Shortly before Christmas a large dividend was received from Landsbanki, the total received was £5.3m and it brings the recovery to date to £14.7m (86% of the principal sum) and total recoveries to £48m. Dividend payments to priority creditors from Landsbanki had been held up by issues involving the Central Bank of Iceland. The expected recovery from Landsbanki and Heritable is 100%, after receiving 100% of the Glitnir funds, and so a full recovery is anticipated.

Forecast outturn

24. The continued low interest rate on savings and investments, partially offset by the re-phasing of last year's capital programme, means that we are continuing to forecast a pressure of £0.4m.

Compliance with Prudential Indicators

25. The Council can confirm that it has complied with its Prudential Indicators for 2014/15 set as part of the Council's Treasury management Strategy Statement. Details can be found in Appendix 2.

Recommendation

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

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KCC Investments as at 30 November 2014

Internally Managed Investments

| Instrument Type | Counterparty | Principal Amount | End Date | Interest Rate |
|---|---|--------------------|------------|---------------|
| Certificate of Deposit | Barclays Bank | £5,000,000 | 14/08/2015 | 0.99% |
| Same Day Call Deposit | Barclays FIBCA | £30,000,000 | n/a | 0.5% |
| | Total Barclays | £35,000,000 | | |
| Fixed Deposit | Close Brothers Ltd | £5,000,000 | 23/01/2015 | 0.6% |
| | Total Close Brothers Ltd | £5,000,000 | | |
| Fixed Deposit | Bank of Scotland | £5,000,000 | 07/05/2015 | 0.7% |
| Fixed Deposit | Bank of Scotland | £5,000,000 | 22/01/2015 | 0.7% |
| Fixed Deposit | Lloyds Bank | £5,000,000 | 06/05/2015 | 0.7% |
| Fixed Deposit | Lloyds Bank | £5,000,000 | 19/05/2015 | 0.7% |
| Fixed Deposit | Lloyds Bank | £5,000,000 | 19/02/2015 | 0.7% |
| Fixed Deposit | Lloyds Bank | £5,000,000 | 23/02/2015 | 0.7% |
| Fixed Deposit | Lloyds Bank | £5,000,000 | 22/04/2015 | 0.7% |
| Fixed Deposit | Lloyds Bank | £5,000,000 | 31/12/2014 | 0.7% |
| | Total Lloyds Group | £40,000,000 | | |
| Certificate of Deposit | Standard Chartered | £10,000,000 | 07/01/2015 | 0.56% |
| | Total Standard Chartered | £10,000,000 | | |
| Total UK Bank Deposits | | £90,000,000 | | |
| Fixed Deposit | Nationwide Building Society | £4,850,000 | 31/12/2014 | 0.64% |
| Fixed Deposit | Nationwide Building Society | £6,400,000 | 21/01/2015 | 0.64% |
| Fixed Deposit | Nationwide Building Society | £5,600,000 | 11/02/2015 | 0.64% |
| Fixed Deposit | Nationwide Building Society | £5,000,000 | 05/01/2015 | 0.5% |
| Fixed Deposit | Nationwide Building Society | £5,000,000 | 03/02/2015 | 0.56% |
| Fixed Deposit | Nationwide Building Society | £5,000,000 | 02/04/2015 | 0.66% |
| | Total Nationwide Building Society | £31,850,000 | | |
| Fixed Deposit | Vernon Building Society | £1,000,000 | 30/01/2015 | 0.55% |
| | Total Vernon Building Society | £1,000,000 | | |
| Total UK Building Society Deposits | | £32,850,000 | | |
| Fixed Deposit | Commonwealth Bank of Australia | £7,000,000 | 02/12/2014 | 0.5% |
| | Total Commonwealth Bank of Australia | £7,000,000 | | |
| Fixed Deposit | Australia and New Zealand Banking Group | £10,000,000 | 08/12/2014 | 0.52% |

KCC Investments as at 30 November 2014

| | | | | |
|---------------------------------------|--|--------------------|------------|-----------|
| Fixed Deposit | Australia and New Zealand Banking Group | £10,000,000 | 07/01/2015 | 0.56% |
| | Total Australia and New Zealand Banking Group | £20,000,000 | | |
| Total Australian Bank Deposits | | £27,000,000 | | |
| Certificate of Deposit | Bank of Montreal | £10,000,000 | 22/04/2015 | 0.53% |
| Certificate of Deposit | Bank of Montreal | £10,000,000 | 07/04/2015 | 0.56% |
| | Total Bank of Montreal | £20,000,000 | | |
| Total Canadian Bank Deposits | | £20,000,000 | | |
| Same Day Call Deposit | Svenska Handelsbanken | £37,800,000 | n/a | 0.5% |
| | Total Svenska Handelsbanken | £37,800,000 | | |
| Total Swedish Bank Deposits | | £37,800,000 | | |
| Treasury Bill | DMO | £4,987,193 | 29/12/2014 | 0.515% |
| Treasury Bill | DMO | £4,987,689 | 26/01/2015 | 0.495% |
| Treasury Bill | DMO | £4,989,656 | 16/03/2015 | 0.47% |
| Total UK Govt. Deposits | | £14,964,538 | | |
| Floating Rate Covered Bond | Abbey National Treasury | £2,486,016 | 05/04/2017 | 0.77594% |
| Floating Rate Covered Bond | Abbey National Treasury | £1,405,637 | 05/04/2017 | 0.71594% |
| Floating Rate Covered Bond | Abbey National Treasury | £5,769,320 | 20/01/2017 | 0.81969% |
| Floating Rate Covered Bond | Abbey National Treasury | £3,009,901 | 20/01/2017 | 0.7139% |
| Fixed Rate Covered Bond | Bank of Scotland | £2,140,610 | 08/11/2016 | 1.293% |
| Fixed Rate Covered Bond | Bank of Scotland | £3,079,599 | 08/11/2016 | 1.309% |
| Floating Rate Covered Bond | Barclays Bank | £5,008,933 | 15/09/2017 | 0.6934% |
| Fixed Rate Covered Bond | Coventry Building Society | £3,308,211 | 19/04/2018 | 1.933% |
| Fixed Rate Covered Bond | Coventry Building Society | £5,495,025 | 19/04/2018 | 1.703% |
| Fixed Rate Covered Bond | Coventry Building Society | £2,208,806 | 19/04/2018 | 1.52% |
| Fixed Rate Covered Bond | Leeds Building Society | £2,182,448 | 17/12/2018 | 2.016% |
| Floating Rate Covered Bond | Leeds Building Society | £5,000,000 | 01/10/2019 | 0.966506% |
| Floating Rate Covered Bond | Lloyds | £3,009,392 | 14/01/2017 | 0.8056% |
| Floating Rate Covered Bond | Lloyds | £1,406,519 | 01/07/2019 | 0.7578% |
| Floating Rate Covered Bond | National Australia Bank | £5,015,729 | 12/08/2016 | 0.64688% |
| Floating Rate Covered Bond | Nationwide Building Society | £1,899,992 | 17/07/2017 | 0.7572% |
| Floating Rate Covered Bond | Nationwide Building Society | £1,001,356 | 17/07/2017 | 0.7502% |

KCC Investments as at 30 November 2014

| | | | | |
|----------------------------------|---|--------------------|------------|---------|
| Floating Rate Covered Bond | Nationwide Building Society | £2,103,420 | 17/07/2017 | 0.6972% |
| Floating Rate Covered Bond | Yorkshire Building Society | £3,059,206 | 23/03/2016 | 0.911% |
| Floating Rate Covered Bond | Yorkshire Building Society | £5,108,065 | 23/03/2016 | 0.911% |
| Fixed Rate Covered Bond | Yorkshire Building Society | £2,192,863 | 12/04/2018 | 1.981% |
| Floating Rate Covered Bond | Yorkshire Building Society | £2,044,781 | 23/03/2016 | 0.911% |
| Fixed Rate Covered Bond | Yorkshire Building Society | £3,320,841 | 12/04/2018 | 1.55% |
| Total Covered Bonds | | £71,256,671 | | |
| Fixed Rate Supranational Bond | European Bank of Regeneration and Development | £10,027,756 | 15/12/2014 | 0.43% |
| Fixed Rate Supranational Bond | Nordic Investment Bank | £3,765,194 | 16/12/2014 | 0.4% |
| Total Supranational Bonds | | £13,792,950 | | |
| Total Bonds | | £85,049,621 | | |

| | | | | |
|---|------------------------------------|---------------------|--|--|
| Icelandic deposits | Recoveries outstanding | £9,270,107 | | |
| Icelandic deposits | ISK held in Escrow at Islandsbanki | £3,146,603 | | |
| Total Icelandic Deposits | | £12,416,710 | | |
| Total Internally Managed Investments | | £320,080,869 | | |

Externally Managed Investments

| Investment Fund | Book Cost | Market Value as at 30 November 2014 | Total annualised return to 30 November 2014 |
|---|-------------|-------------------------------------|---|
| CCLA LAMIT Property Fund | £10,000,000 | £10,114,921 | 4.45% |
| Pyrford Global Total Return (Sterling) Fund | £5,000,000 | £5,153,156 | 5.61% |
| Total Investment Funds | | £15,268,077 | |
| Equity | Book Cost | Market Value as at 30 November 2014 | |
| Kent PFI (Holdings) Ltd | £2,681,260 | £2,681,260 | |
| Total Equity Investments | | £2,681,260 | |
| Total Externally Managed Investments | | £17,949,337 | |

| | |
|--------------------------|---------------------|
| Total Investments | £338,030,206 |
|--------------------------|---------------------|

2014-15 Quarter 2 Monitoring of Prudential Indicators

1. Estimate of capital expenditure (excluding PFI)

| | |
|---------------------------|-----------|
| Actuals 2013-14 | £219.458m |
| Original estimate 2014-15 | £270.967m |
| Revised estimate 2014-15 | £320.878m |

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

| | 2013-14 | 2014-15 | 2014-15 | 2015-16 | 2016-17 |
|--|-----------|-------------------|-------------------------|-------------------------|-------------------------|
| | Actual | Original Estimate | Forecast as at 30-09-14 | Forecast as at 30-09-14 | Forecast as at 30-09-14 |
| | £m | £m | £m | £m | £m |
| Capital Financing requirement | 1,435.263 | 1,437.960 | 1,398.508 | 1,379.677 | 1,321.485 |
| Annual increase/reduction in underlying need to borrow | -29.697 | -27.001 | -36.755 | -18.831 | -58.192 |

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 2013-14 | 14.55% |
| Original estimate 2014-15 | 13.42% |
| Revised estimate 2014-15 | 13.51% |

Appendix 2

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 2014-15

Operational boundary for debt relating to KCC assets and activities

| | Prudential Indicator | Position as at 30.09.14 |
|-----------------------------|----------------------|-------------------------|
| | £m | £m |
| Borrowing | 993 | 966 |
| Other Long Term Liabilities | 261 | 254 |
| | 1,254 | 1,220 |

(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 30.09.14 |
|-----------------------------|----------------------|-------------------------|
| | £m | £m |
| Borrowing | 1,038 | 1,007 |
| Other Long Term Liabilities | 261 | 254 |
| | 1,299 | 1,261 |

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 County Council. The revised limits for 2014-15 are:

| | Authorised limit for debt relating to KCC assets and activities | Position as at 30.09.14 | Authorised limit for total debt managed by KCC | Position as at 30.09.14 |
|-----------------------------|---|-------------------------|--|-------------------------|
| | £m | £m | £m | £m |
| Borrowing | 1,033 | 966 | 1,078 | 1,010 |
| Other long term liabilities | 261 | 254 | 261 | 254 |
| | 1,294 | 1,220 | 1,339 | 1,264 |

Appendix 2

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 2014-15

| | |
|------------------------------|------|
| Fixed interest rate exposure | 100% |
| Variable rate exposure | 40% |

These limits have been complied with in 2014-15.

8. Upper limits for maturity structure of borrowings

| | Upper limit | Lower limit | As at 30.09.14 |
|--------------------------------|-------------|-------------|----------------|
| | % | % | % |
| Upper 12 months | 10 | 0 | 2.28 |
| 12 months and within 24 months | 10 | 0 | 6.25 |
| 24 months and within 5 years | 15 | 0 | 6.65 |
| 5 years and within 10 years | 15 | 0 | 9.63 |
| 10 years and within 20 years | 15 | 5 | 12.6 |
| 20 years and within 30 years | 20 | 5 | 14.8 |
| 30 years and within 40 years | 20 | 10 | 10.48 |
| 40 years and within 50 years | 25 | 10 | 21.41 |
| 50 years and within 60 years | 30 | 10 | 15.94 |

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

| | |
|-----------|---------|
| Indicator | £175.0m |
| Actual | £67.1m |