

By: John Simmonds, Deputy Leader and Cabinet Member for Finance and Procurement
Andy Wood, Corporate Director of Finance and Procurement

To: Governance and Audit Committee – 27 January 2016

Subject: **TREASURY MANAGEMENT 6 MONTH REVIEW 2015/16**

Classification: Unrestricted

Summary: To present the Treasury Management 6 Month Review.

FOR DECISION

INTRODUCTION

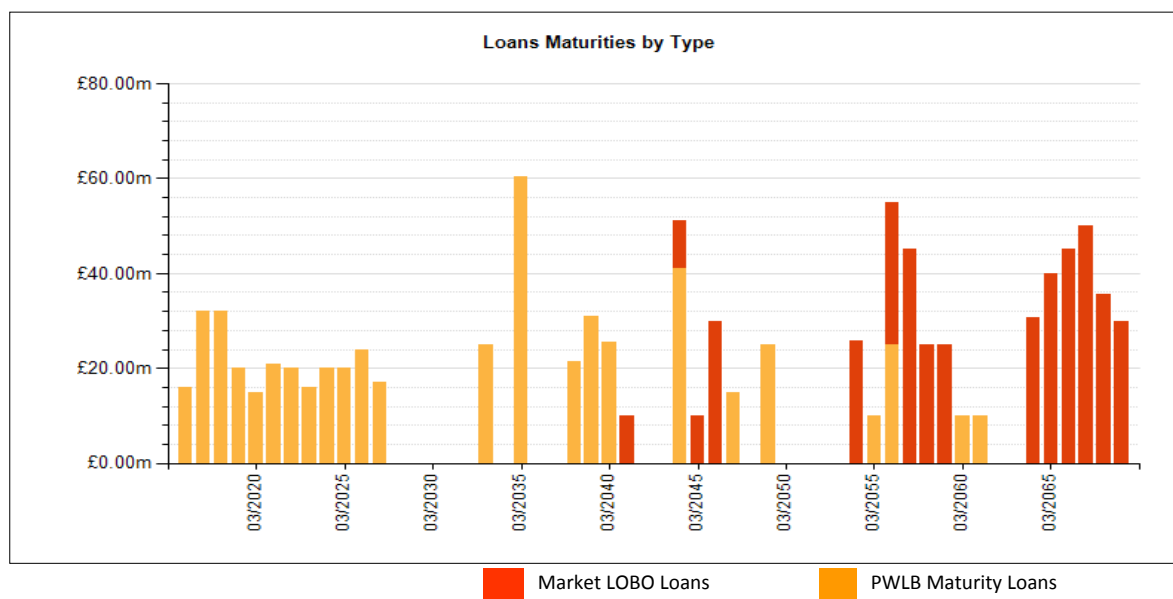
1. This report covers Treasury Management activity for the 6 months to 30 September 2015 and developments in the period since up to the date of this report.

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 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. At 30 November the Council had long term borrowings of £994.08m, an increase of £10m from the balance as at 31 March 2015, with a maturity profile as follows:



8. Total external debt managed by KCC includes £38.2m pre-LGR debt managed by KCC on behalf of Medway Council and £2.3million for other bodies.
9. The Council's chief objective when borrowing continues to be to consider borrowing at advantageous points in interest rate cycles as well as 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 Authority's long-term plans change being a secondary objective.
10. In April, given concerns regarding the likely outcome of the UK general election and possible impact on the UK financial market as well as uncertainty over the future for Greece in the EU, the decision was made given the availability of advantageous rates from the PWLB for long term fixed rate maturity loans, to borrow £25m for 40 years from the PWLB at a fixed rate of 3.16%. Subsequently KCC has repaid £15m of maturing PWLB loans and expects to repay a further £16m by 31 March 2016. It does not expect to undertake further borrowing during 2015/16.
11. The average interest rate payable on the Council's debt portfolio reduced slightly from 5.51% to 5.311%.
12. 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.
13. 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.

14. 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. To date no lender has exercised an option.

INVESTMENT ACTIVITY

Counterparty Update

15. With assistance from Arlingclose counterparty credit quality continues to be assessed and monitored.
16. All three credit ratings agencies (Moody's, S&P and Fitch) have reviewed their ratings in the first six months to reflect the loss of government support for most financial institutions and the potential for varying loss given defaults as a result of new bail-in regimes in many countries. Despite reductions in government support many institutions on the KCC approved counterparty list have seen their credit ratings upgraded due to an improvement in their underlying strength and an assessment that the level of loss given default is low.
17. In August duration limits were increased for some UK and European banks, and building societies based on advice from Arlingclose. Those for Close Brothers, Coventry BS, Nationwide BS and Santander UK were increased to 6 months from 100 days and Bank of Scotland, HSBC Bank, Lloyds Bank and Svenska Handelsbanken increased to 13 months from 6 months. The limit for Barclays was unchanged while RBS / NatWest remained suspended from the list as their ratings continue to be below the Council's agreed threshold.
18. In September, Volkswagen was found to have been cheating emissions tests over several years in many of their diesel vehicles. This scandal is still playing out and the full extent of the financial implications yet to become clear. Arlingclose recommended suspending VW (as a non-financial corporate bond counterparty) for new investments whilst the situation is monitored. The ratings of the VW group were placed on Rating Watch Negative by Fitch, CreditWatch with negative implications by S&P and the outlook revised to negative by Moody's. Moody's also revised the outlook on VW Financial Services to negative.

Investment activity 2015/16

19. The Council holds significant invested funds averaging £395.4m 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.

20. 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.
21. Security of capital has remained the Authority's main investment objective. This has been maintained by following the Authority's counterparty policy as set out in its Treasury Management Strategy Statement for 2015/16.
22. Counterparty credit quality was assessed and monitored with reference to credit ratings (the Authority's minimum long-term counterparty rating is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.
23. The Council has continued its policy of diversifying its investments. It holds £100m of covered bonds and increased its investment in the CCLA LAMIT fund to £20m. KCC has also placed £25m in a number of Santander notice call accounts. All these investments have beneficially impacted on the investment return, extended the maturity profile of the Council's investment portfolio and reduced the risk. The Volkswagen £1.75m corporate bond purchased in March matured in October at par.
24. As at the end of November the types of investment held were as follows:

| Type of Investment | Total | |
|----------------------------------|---------------|------------|
| | £m | % |
| Call Account | 42.20 | 12 |
| Money Market Fund | 18.21 | 5 |
| Notice Account | 25.00 | 7 |
| Certificate of Deposit | 50.00 | 14 |
| Fixed Deposit | 82.00 | 23 |
| Covered Bond | 98.59 | 28 |
| ISK held in Escrow | 3.28 | 1 |
| Icelandic Recoveries outstanding | 3.34 | 1 |
| Internally managed cash | 322.62 | 91 |
| External Investments | 26.40 | 8 |
| Equity | 2.14 | 1 |
| Total | 351.15 | 100 |

25. 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. New internally managed investments were made at an average rate of 0.6%.

ICELAND DEPOSITS

26. On 14 January the Council received a dividend of £2.9m from Landsbanki. This now brings the total recovered to £51.3m with £300-400,000 still to be received from Heritable Bank.

FORECAST OUTTURN

27. An underspend of £299k is forecast reflecting increased interest on cash balances as a result of higher cash balances, investing for longer durations and increased dividends.

COMPLIANCE WITH PRUDENTIAL INDICATORS

28. The Council can confirm that it has complied with its Prudential Indicators for 2015/16 set as part of the Council's Treasury management Strategy Statement. Details can be found in Appendix 2.

RECOMMENDATION

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

Alison Mings
Treasury and Investments Manager
Ext: 03000 416488

Investments as at 30 November 2016

1. Internally Managed Investments

1.1 Term deposits, Call accounts and Money Market Funds

| Instrument Type | Counterparty | Principal Amount | End Date | Interest Rate |
|-------------------------------------------|---------------------------------|---------------------|------------|---------------|
| Call Account | Barclays Bank | £5,000,000 | n/a | 0.35% |
| Call Account | Barclays FIBCA | £5,000,000 | n/a | 0.50% |
| | Total Barclays | £10,000,000 | | |
| Fixed Deposit | Lloyds Bank | £5,000,000 | 19/08/2016 | 1.00% |
| Fixed Deposit | Lloyds Bank | £5,000,000 | 26/02/2016 | 0.70% |
| Fixed Deposit | Lloyds Bank | £5,000,000 | 30/09/2016 | 1.05% |
| Fixed Deposit | Lloyds Bank | £5,000,000 | 24/05/2016 | 0.80% |
| Fixed Deposit | Lloyds Bank | £5,000,000 | 22/07/2016 | 0.85% |
| Fixed Deposit | Lloyds Bank | £5,000,000 | 08/08/2016 | 1.00% |
| Fixed Deposit | Lloyds Bank | £5,000,000 | 09/05/2016 | 0.80% |
| Fixed Deposit | Lloyds Bank | £5,000,000 | 05/09/2016 | 1.00% |
| | Total Lloyds Group | £40,000,000 | | |
| Call Account | Santander UK | £12,200,000 | n/a | 0.40% |
| 31 Day Call Notice Account | Santander UK | £5,000,000 | n/a | 0.65% |
| 60 Day Call Notice Account | Santander UK | £5,000,000 | n/a | 0.75% |
| 95 Day Call Notice Account | Santander UK | £5,000,000 | n/a | 0.90% |
| 120 Day Call Notice Account | Santander UK | £5,000,000 | n/a | 1.05% |
| 180 Day Call Notice Account | Santander UK | £5,000,000 | n/a | 1.15% |
| | Total Santander UK | £37,200,000 | | |
| Certificate of Deposit | Standard Chartered | £10,000,000 | 01/04/2016 | 0.73% |
| Certificate of Deposit | Standard Chartered | £10,000,000 | 07/04/2016 | 0.73% |
| Certificate of Deposit | Standard Chartered | £10,000,000 | 22/04/2016 | 0.73% |
| Certificate of Deposit | Standard Chartered | £5,000,000 | 15/01/2016 | 0.72% |
| Certificate of Deposit | Standard Chartered | £5,000,000 | 06/05/2016 | 0.74% |
| | Total Standard Chartered | £40,000,000 | | |
| Total UK Bank Deposits | | £127,200,000 | | |
| Fixed Deposit | Nationwide Building Society | £18,000,000 | 18/12/2015 | 0.59% |
| Fixed Deposit | Nationwide Building Society | £3,600,000 | 19/04/2016 | 0.66% |
| Fixed Deposit | Nationwide Building Society | £10,000,000 | 22/04/2016 | 0.68% |
| | Total Nationwide BS | £31,600,000 | | |
| Total UK Building Society Deposits | | £31,600,000 | | |
| Fixed Deposit | Commonwealth Bank of Australia | £10,400,000 | 10/02/2016 | 0.59% |
| Total Australian Bank Deposits | | £10,400,000 | | |

Appendix 1

| | | | | |
|-------------------------------------|----------------------------------|--------------------|------------|------------------|
| Certificate of Deposit | Bank of Montreal | £5,000,000 | 22/01/2016 | 0.63% |
| Certificate of Deposit | Toronto Dominion Bank | £5,000,000 | 07/11/2016 | 0.74% |
| Total Canadian Bank Deposits | | £10,000,000 | | |
| Call Account | Svenska Handelsbanken | £20,000,000 | n/a | 0.40% |
| Total Swedish Bank Deposits | | £20,000,000 | | |
| Money Market Fund | Deutsche Managed Sterling Fund | £439,833 | n/a | 0.38% (variable) |
| Money Market Fund | HSBC Global Liquidity Fund | £8,247 | n/a | 0.36% (variable) |
| Money Market Fund | Insight Sterling Liquidity Fund | £8,838,920 | n/a | 0.40% (variable) |
| Money Market Fund | LGIM Liquidity Fund | £8,833,808 | n/a | 0.44% (variable) |
| Money Market Fund | SSgA GBP Liquidity Fund | £66,930 | n/a | 0.38% (variable) |
| Money Market Fund | Aberdeen Sterling Liquidity Fund | £19,239 | n/a | 0.35% (variable) |
| Total Money Market Funds | | £18,206,977 | | |

1.2 Iceland Deposits

| Instrument Type | Principal Amount |
|-----------------------------------------|-------------------|
| Total Icelandic Recoveries outstanding | £3,343,747 |
| Total ISK held in Escrow (est GBP) | £3,278,427 |
| Icelandic Recoveries outstanding | £6,622,174 |

1.3 Bond Portfolio

| Bond Type | Issuer | Adjusted Principal | Maturity Date | Net Yield |
|----------------------------|---------------------------|--------------------|---------------|-----------|
| Floating Rate Covered Bond | Abbey National Treasury | £5,760,752 | 23/03/2016 | 0.911% |
| Floating Rate Covered Bond | Abbey National Treasury | £3,005,510 | 23/03/2016 | 0.911% |
| Floating Rate Covered Bond | Abbey National Treasury | £2,451,685 | 23/03/2016 | 0.911% |
| Floating Rate Covered Bond | Abbey National Treasury | £1,385,426 | 12/08/2016 | 0.647% |
| Floating Rate Covered Bond | Abbey National Treasury | £3,004,487 | 08/11/2016 | 1.293% |
| Fixed Rate Covered Bond | Bank of Scotland | £2,070,756 | 08/11/2016 | 1.309% |
| Fixed Rate Covered Bond | Bank of Scotland | £2,980,464 | 14/01/2017 | 0.806% |
| Floating Rate Covered Bond | Barclays Bank | £5,006,126 | 20/01/2017 | 0.820% |
| Floating Rate Covered Bond | Barclays Bank | £3,003,914 | 20/01/2017 | 0.714% |
| Floating Rate Covered Bond | Barclays Bank | £5,003,436 | 05/04/2017 | 0.776% |
| Fixed Rate Covered Bond | Coventry Building Society | £3,233,355 | 05/04/2017 | 0.716% |

Appendix 1

| | | | | |
|----------------------------|-----------------------------|--------------------|------------|--------|
| Fixed Rate Covered Bond | Coventry Building Society | £5,420,183 | 17/07/2017 | 0.769% |
| Fixed Rate Covered Bond | Coventry Building Society | £2,180,528 | 17/07/2017 | 0.719% |
| Floating Rate Covered Bond | Coventry Building Society | £3,009,340 | 17/07/2017 | 0.709% |
| Floating Rate Covered Bond | Leeds Building Society | £2,502,786 | 15/09/2017 | 0.685% |
| Floating Rate Covered Bond | Leeds Building Society | £2,502,830 | 15/09/2017 | 0.721% |
| Fixed Rate Covered Bond | Leeds Building Society | £2,168,991 | 19/01/2018 | 0.784% |
| Fixed Rate Covered Bond | Leeds Building Society | £1,640,010 | 09/02/2018 | 0.784% |
| Floating Rate Covered Bond | Leeds Building Society | £5,000,000 | 09/02/2018 | 0.721% |
| Floating Rate Covered Bond | Lloyds | £3,005,227 | 12/02/2018 | 1.981% |
| Floating Rate Covered Bond | Lloyds | £3,902,567 | 12/04/2018 | 1.550% |
| Floating Rate Covered Bond | Lloyds | £1,405,221 | 12/04/2018 | 1.933% |
| Floating Rate Covered Bond | National Australia Bank | £5,006,744 | 19/04/2018 | 1.703% |
| Floating Rate Covered Bond | Nationwide Building Society | £1,899,995 | 19/04/2018 | 1.520% |
| Floating Rate Covered Bond | Nationwide Building Society | £1,000,861 | 19/04/2018 | 0.740% |
| Floating Rate Covered Bond | Nationwide Building Society | £2,102,170 | 27/04/2018 | 0.787% |
| Floating Rate Covered Bond | Nationwide Building Society | £3,430,540 | 29/05/2018 | 0.685% |
| Floating Rate Covered Bond | Yorkshire Building Society | £3,019,699 | 17/12/2018 | 2.016% |
| Floating Rate Covered Bond | Yorkshire Building Society | £5,035,956 | 17/12/2018 | 1.187% |
| Floating Rate Covered Bond | Yorkshire Building Society | £2,014,900 | 01/07/2019 | 0.758% |
| Fixed Rate Covered Bond | Yorkshire Building Society | £2,160,067 | 01/10/2019 | 0.967% |
| Fixed Rate Covered Bond | Yorkshire Building Society | £3,279,738 | 17/03/2020 | 0.877% |
| Total Covered Bonds | | £98,594,264 | | |

| | |
|---------------------------------------------|---------------------|
| Total Internally managed investments | £322,623,415 |
|---------------------------------------------|---------------------|

2. Externally Managed Investments

| Investment Fund | Book Cost | Market Value as at 30 November 2015 | 12 months return to 30 November 2015 |
|---------------------------------------------|-------------|-------------------------------------|--------------------------------------|
| CCLA LAMIT Property Fund | £20,000,000 | £21,339,486 | 9.67% |
| Pyrford Fund | £5,000,000 | £5,050,011 | 1.21% |
| Kent PFI (Holdings) Ltd | £2,135,741 | £2,135,741 | |
| Total Externally Managed Investments | | £28,525,239 | |

3. Total Investments

| | Value at 30 November 2015 |
|--------------------------|------------------------------|
| Total Investments | £351,148,654 |

2015-16 Quarter 2 Monitoring of Prudential Indicators

1. Estimate of capital expenditure (excluding PFI)

| | |
|---------------------------|-----------|
| Actuals 2014-15 | £219.896m |
| Original estimate 2015-16 | £289.838m |
| Revised estimate 2015-16 | 277.815m |

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

| | 2014-15 | 2015-16 | 2015-16 | 2016-17 | 2017-18 |
|--------------------------------------------------------|-----------|-------------------|-------------------------|-------------------------|-------------------------|
| | Actual | Original Estimate | Forecast as at 30-09-15 | Forecast as at 30-09-15 | Forecast as at 30-09-15 |
| | £m | £m | £m | £m | £m |
| Capital Financing requirement | 1,382.856 | 1,382.620 | 1,374.698 | 1,347.369 | 1,306.975 |
| Annual increase/reduction in underlying need to borrow | -52.407 | -9.053 | -8.158 | -27.329 | -40.394 |

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 2014-15 | 14.19% |
| Original estimate 2015-16 | 13.17% |
| Revised estimate 2015-16 | 13.71% |

4. Operational Boundary for External Debt

Appendix 2

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 2015-16

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

| | Prudential Indicator | Position as at 30.09.15 |
|-----------------------------|----------------------|-------------------------|
| | £m | £m |
| Borrowing | 993 | 955 |
| Other Long Term Liabilities | 254 | 248 |
| | <u>1,237</u> | <u>1,203</u> |

(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 30.09.15 |
|-----------------------------|----------------------|-------------------------|
| | £m | £m |
| Borrowing | 1,024 | 994 |
| Other Long Term Liabilities | 254 | 248 |
| | <u>1,278</u> | <u>1,242</u> |

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 2015-16 are:

| | Authorised limit for debt relating to KCC assets and activities | Position as at 30.09.15 | Authorised limit for total debt managed by KCC | Position as at 30.09.15 |
|-----------------------------|-----------------------------------------------------------------|-------------------------|------------------------------------------------|-------------------------|
| | £m | £m | £m | £m |
| Borrowing | 1,023 | 955 | 1,064 | 994 |
| Other long term liabilities | 254 | 248 | 254 | 248 |
| | <u>1,277</u> | <u>1,203</u> | <u>1,318</u> | <u>1,242</u> |

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 2015-16

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

These limits have been complied with in 2015-16.

8. Upper limits for maturity structure of borrowings

| | Upper limit | Lower limit | As at 30.09.15 |
|--------------------------------|-------------|-------------|----------------|
| | % | % | % |
| Upper 12 months | 10 | 0 | 1.61 |
| 12 months and within 24 months | 10 | 0 | 3.22 |
| 24 months and within 5 years | 15 | 0 | 6.74 |
| 5 years and within 10 years | 15 | 0 | 9.76 |
| 10 years and within 20 years | 20 | 5 | 12.72 |
| 20 years and within 30 years | 20 | 5 | 14.99 |
| 30 years and within 40 years | 25 | 10 | 10.61 |
| 40 years and within 50 years | 30 | 10 | 24.2 |
| 50 years and within 60 years | 30 | 10 | 16.15 |

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

| | |
|-----------|-------|
| Indicator | £175m |
| Actual | £126m |