

By: John Simmonds, Deputy Leader and Cabinet Member for
Finance and Procurement
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To: Governance and Audit Committee – 21 July 2016

Subject: **TREASURY MANAGEMENT ANNUAL REVIEW 2015-16**

Classification: Unrestricted

Summary: To report a summary of Treasury Management activities
in 2015-16

FOR DECISION

INTRODUCTION

1. 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). At KCC half yearly reports are made to Council and quarterly updates are provided to the Governance and Audit Committee.
2. 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."
3. The Council's Treasury Management Strategy for 2015-16 was approved by full Council on 12 February 2015.
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 during 2015-16:
 - a) Reports on the implications of treasury decisions and transactions;
 - b) Gives details of the outturn position on treasury management transactions in 2015-16;
 - c) Confirms compliance with its Treasury Management Strategy, Treasury Management Practices and Prudential Indicators.
5. When this report is agreed by this Committee it will go forward to full Council.

BORROWING STRATEGY

6. At 31 March 2016 KCC held £980m of loans, a decrease of £4m on 31 March 2015.
7. 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.
8. In 2015-16 KCC funded £26.5m of its capital expenditure from borrowing.
9. In April 2015 based on 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 from the PWLB for 40 years at a fixed rate of 3.16%.
10. The council has agreed an £22m interest free loan to be used specifically to fund improvements to Kent's street lighting under the government's energy efficiency loans programme. In March 2016 we received the first instalment (£1.5m).
11. 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.
12. This strategy has lowered overall treasury risk by reducing both external debt and temporary investments however the sustainability of this approach continues to be kept under review.

	Balance on 01/04/2015 £m	Debt Maturing £m	New Borrowing £m	Balance on 31/3/2016 £m	Average Rate % / Average Life (yrs)
Capital Financing Requirement (CFR)	1,383			1,348	
Long Term Borrowing	984	-31	27	980	5.24% / 31
Other Long Term Liabilities					
TOTAL EXTERNAL DEBT	984			980	
Decrease in Borrowing				-4	

13. 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 KCC has the option to either accept the new rate or to repay the loan at no additional cost. £200.7m of these LOBOs had options during the year, none of which were exercised by the lender. These LOBO loans were primarily taken out between 2004 and 2007 at very low interest rates (average 4.2%) and were the most cost effective means of funding large scale capital spending at that time.

INVESTMENT ACTIVITY

14. KCC holds significant invested funds, representing income received in advance of expenditure plus balances and reserves. During 2015-16 the Council's average investment balance was £379m.
15. The Guidance on Local Government Investments gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.
16. Investment Activity in 2015-16

Investment Counterparty	Balance on 01/04/2015 £m	Net Investments Made £m	Balance on 31/03/2016 £m	Avg Rate % / Avg Life (yrs)
UK Central Government	0.0	0.0	0.0	
Banks and building societies	202.5	-83.5	119.0	0.62% / 0.45
Marketable instruments (Covered Bonds)	89.7	-1.3	88.4	1.02% / 1.75
Money Market Funds	4.0	55.7	59.7	0.42% / overnight
Icelandic recoveries outstanding	4.2	-3.7	0.5	
Icelandic deposits held in Escrow (incl interest)	3.3	0.0	3.3	
Total Internally Managed Investments	303.7	-32.8	270.9	0.73% / 1.8
Pooled property fund	15.3	10.4	25.7	3.48% pa
Pooled investments fund	5.1	0.0	5.1	2.96% pa
Equity / Loan notes	2.1	0.0	2.1	7.20% pa
Total Externally Managed Investments	22.5	10.4	32.9	
Total investments	326.2	-22.4	303.8	
Decrease in Investments (£m)			22.4	

17. Security of capital has remained the Council's main investment objective. This has been maintained by following KCC's counterparty policy as set out in its Treasury Management Strategy Statement for 2015-16.

18. Counterparty credit quality was assessed and monitored with reference to credit ratings (KCC's minimum long-term counterparty rating is A- across rating agencies Fitch, S&P and Moody's); for financial institutions analysis of funding structure and susceptibility to bail-in, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.
19. KCC has also used secured investments products in particular covered bonds that provide collateral in the event that the counterparty cannot meet its obligations for repayment.

COUNTERPARTY UPDATE

20. The application of two European Union directives into UK legislation placed the burden of rescuing failing EU banks disproportionately onto unsecured institutional investors which include local authorities such as KCC. During the year, all three credit ratings agencies reviewed their ratings to reflect the loss of government support for most financial institutions and the potential for loss given default as a result of new bail-in regimes in many countries. Despite reductions in government support many institutions saw upgrades due to an improvement in their underlying strength and an assessment that that the level of loss given default is low.
21. All three credit ratings agencies (Moody's, S&P and Fitch) reviewed their ratings in the first quarter of 2015-16 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 saw upgrades due to an improvement in their underlying strength and an assessment that that the level of loss given default is low.
22. 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.
23. In September, Volkswagen was found to have been cheating emissions tests over several years in many of their diesel vehicles. As issues surrounding the scandal continued there were credit rating downgrades across the Volkswagen group by all of the ratings agencies. The £1.75m corporate bond that KCC had purchased in March matured in October at par.
24. In December the Bank of England released the results of its latest stress tests on the seven largest UK banks and building societies which showed that the RBS and Standard Chartered Bank were the weakest performers. However, the regulator did not require either bank to submit revised capital plans, since both firms had already improved their ratios over the year.

25. The first quarter of 2016 was characterised by financial market volatility and a weakening outlook for global economic growth. In March 2016 the ratings of Standard Chartered Bank were downgraded due to concerns around the profitability and quality of the bank's assets. Taking account of advice from Arlingclose, the bank was suspended from the Council's counterparty list.
26. The end of bank bail-outs, the introduction of bail-ins, and the preference being given to large numbers of depositors other than local authorities means that the risks of making unsecured deposits continues to be elevated relative to other investment options.
27. During 2015-16 KCC made greater use of money market funds to support short term liquidity requirements and reduced the proportion of surplus cash invested in unsecured bank deposits. The total amount invested in covered bonds and pooled funds increased.
28. At the end of March 2016 some 40% of KCC's cash was invested in covered and corporate bonds as well as investment funds and equity which are not subject to bail in risk.

FINANCIAL OUTTURN

29. The UK Bank Rate was maintained at 0.5% through the year. Short term money market rates remained at very low levels and continued to have a significant impact on investment income.
30. The Council's total investment income for the year, including dividends received on the investment funds and equity, was £4.32m, 1.15% on funds held. The above benchmark return primarily reflects:
 - a) Internally managed deposits made at an average of 0.73% compared to the average 7 day LIBID rate during 2015-16 of 0.36%. The higher return in particular reflects the investment in a diversified covered bond portfolio which earned £1.89m during 2015-16; and
 - b) KCC maintained its investment in the Pyrford Absolute Return Fund and Kent PFI (Holdings) Ltd, and added to its investment in the CCLA Property Fund. Total income received in the year from these investments was £1.364m.
31. With the full recovery of monies held in Landsbanki total recoveries are now £52.4m (£50.5m was deposited) with £370,000 outstanding from Heritable.
32. Investments as at 31 March 2016 are shown in Appendix 2.

COMPLIANCE WITH PRUDENTIAL INDICATORS

33. The Council confirms that it has complied with its Prudential Indicators for 2015-16, which were set as part of the Council's Treasury Management Strategy Statement. Details can be found in Appendix 1.
34. The Treasury Management activities were once again subject to review by Internal Audit whose assessment of the controls in place and the level of compliance with these controls was High assurance.

TREASURY ADVISOR

35. KCC currently contracts with Arlingclose as Treasury Advisers.

RECOMMENDATION

36. Members are asked to agree the report and recommend that it is submitted to County Council.

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2015-16 Final Monitoring of Prudential Indicators**1. Estimate of Capital Expenditure (excluding PFI)**

	£m
Actuals 2014-15	205.979
Original estimate 2015-16	289.838
Actuals 2015-16	234.911

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

	2014-15 Actual £m	2015-16 Original Estimate £m	2015-16 Actual as at 31 March £m
CFR	1,382.856	1,382.620	1,348.259
Annual increase/(decrease) in underlying need to borrow	-52.407	-9.053	-34.597

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

Actual 2014-15	14.19%
Original estimate 2015-16	13.17%
Actual 2015-16	13.90%

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 2015-16

Operational boundary for debt relating to KCC assets and activities

	Prudential Indicator £m	Position as at 31 March 2016 Actual £m
Borrowing	983	941
Other Long Term Liabilities	254	245
Total	1,237	1,186

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

	Prudential Indicator £m	Position as at 31 March 2016 £m
Borrowing	1,024	980
Other Long Term Liabilities	254	245
Total	1,278	1,225

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.

Authorised limit for debt relating to KCC assets and activities

	Prudential Indicator £m	Position as at 31 March 2016 £m
Borrowing	1,023	941
Other long term liabilities	254	245
Total	1,277	1,186

Authorised limit for total debt managed by KCC including that relating to Medway Council etc (pre Local Government Reorganisation)

	Prudential Indicator £m	Position as at 31 March 2016 £m
Borrowing	1,064	980
Other long term liabilities	254	245
Total	1,318	1,225

The additional allowance over and above the operational boundary has not needed to be utilised and external debt has and will be maintained well within the authorised limit.

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 31 March 2016
	%	%	%
Under 12 months	10	0	0.00
12 months and within 24 months	10	0	3.30
24 months and within 5 years	15	0	9.00
5 years and within 10 years	15	0	10.20
10 years and within 20 years	20	5	10.50
20 years and within 30 years	20	5	18.30
30 years and within 40 years	25	10	13.30
40 years and within 50 years	25	10	23.60
50 years and within 60 years	30	10	11.80

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

Prudential Indicator	Actual
£m	£m
175.00	130.00

Appendix 2

Investments as at 31 March 2016

1. Internally Managed Investments

Instrument Type	Counterparty	Principal Amount	Maturity Date	Interest Rate
Same Day Call Deposit	Barclays Bank	£1,300,000.00	n/a	0.35%
Same Day Call Deposit	Barclays FIBCA	£0.00	n/a	0.50%
Fixed Deposit	Close Brothers	£10,000,000.00	21/06/2016	0.80%
Fixed Deposit	Lloyds Bank	£5,000,000.00	19/08/2016	1.00%
Fixed Deposit	Lloyds Bank	£5,000,000.00	30/09/2016	1.05%
Fixed Deposit	Lloyds Bank	£5,000,000.00	24/05/2016	0.80%
Fixed Deposit	Lloyds Bank	£5,000,000.00	22/07/2016	0.85%
Fixed Deposit	Lloyds Bank	£5,000,000.00	08/08/2016	1.00%
Fixed Deposit	Lloyds Bank	£5,000,000.00	09/05/2016	0.80%
Fixed Deposit	Lloyds Bank	£5,000,000.00	05/09/2016	1.00%
Call Deposits	Santander UK	£5,000,000.00	n/a	0.40%
31 Day Call Notice Account	Santander UK	£5,000,000.00	n/a	0.65%
60 Day Call Notice Account	Santander UK	£5,000,000.00	n/a	0.75%
95 Day Call Notice Account	Santander UK	£5,000,000.00	n/a	0.90%
120 Day Call Notice Account	Santander UK	£5,000,000.00	n/a	1.05%
180 Day Call Notice Account	Santander UK	£5,000,000.00	n/a	1.15%
Certificate of Deposit	Standard Chartered Bank	£10,000,000.00	01/04/2016	0.73%
Certificate of Deposit	Standard Chartered Bank	£10,000,000.00	07/04/2016	0.73%
Certificate of Deposit	Standard Chartered Bank	£10,000,000.00	22/04/2016	0.73%
Certificate of Deposit	Standard Chartered Bank	£5,000,000.00	15/07/2016	0.78%
Certificate of Deposit	Standard Chartered Bank	£5,000,000.00	06/05/2016	0.74%
Total UK Bank Deposits		£116,300,000.00		

Fixed Deposit	Nationwide Building Society	£3,600,000.00	19/04/2016	0.66%
Fixed Deposit	Nationwide Building Society	£10,000,000.00	22/04/2016	0.68%
Total UK Building Society Deposits		£13,600,000.00		

Same Day Call Deposit	Svenska Handelsbanken	£750,000.00	n/a	0.40%
Total Swedish Bank Deposits		£750,000.00		

Money Market Funds

Fund Name	Principal Amount	Interest Rate
Deutsche Managed Sterling Fund	£9,966,735.74	0.43 (variable)
HSBC Global Liquidity Fund	£9,931,055.97	0.46 (variable)
Insight Sterling Liquidity Fund	£9,939,656.80	0.46 (variable)
LGIM Liquidity Fund	£9,962,710.43	0.49 (variable)
SSgA GBP Liquidity Fund	£2,807,919.87	0.42 (variable)
Aberdeen Sterling Liquidity Fund	£51,423.69	0.42 (variable)
Total Money Market Fund Deposits	£42,659,502.50	

Covered Bond Portfolio

Bond Type	Issuer	Adjusted Principal	Maturity Date	Net Yield
Fixed Rate Covered Bond	Bank of Scotland	£2,070,756.25	08/11/2016	1.293%
Fixed Rate Covered Bond	Bank of Scotland	£2,980,463.78	08/11/2016	1.309%
Fixed Rate Covered Bond	Coventry Building Society	£3,233,354.82	19/04/2018	1.933%
Fixed Rate Covered Bond	Coventry Building Society	£5,420,183.39	19/04/2018	1.703%
Fixed Rate Covered Bond	Coventry Building Society	£2,180,527.85	19/04/2018	1.520%
Fixed Rate Covered Bond	Leeds Building Society	£2,128,007.54	17/12/2018	2.016%
Fixed Rate Covered Bond	Leeds Building Society	£1,601,727.09	17/12/2018	1.187%
Fixed Rate Covered Bond	Yorkshire Building Society	£2,160,066.52	12/04/2018	1.981%
Fixed Rate Covered Bond	Yorkshire Building Society	£3,279,738.32	12/04/2018	1.550%
Floating Rate Covered Bond	Abbey National Treasury	£5,758,592.03	20/01/2017	0.820%
Floating Rate Covered Bond	Abbey National Treasury	£3,004,402.93	20/01/2017	0.714%
Floating Rate Covered Bond	Abbey National Treasury	£2,443,008.22	05/04/2017	0.776%
Floating Rate Covered Bond	Abbey National Treasury	£1,380,318.37	05/04/2017	0.716%
Floating Rate Covered Bond	Abbey National Treasury	£3,003,661.25	29/05/2018	0.787%
Floating Rate Covered Bond	Barclays Bank	£5,004,600.45	15/09/2017	0.693%
Floating Rate Covered Bond	Barclays Bank	£3,002,939.62	15/09/2017	0.685%
Floating Rate Covered Bond	Barclays Bank	£5,003,051.62	12/02/2018	0.721%
Floating Rate Covered Bond	Coventry Building Society	£3,008,305.65	17/03/2020	0.877%
Floating Rate Covered Bond	Leeds Building Society	£2,502,474.96	09/02/2018	0.784%
Floating Rate Covered Bond	Leeds Building Society	£2,502,513.75	09/02/2018	0.784%
Floating Rate Covered Bond	Leeds Building Society	£5,000,000.00	01/10/2019	0.967%
Floating Rate Covered Bond	Lloyds	£3,004,176.72	14/01/2017	0.806%
Floating Rate Covered Bond	Lloyds	£3,902,346.56	19/01/2018	0.721%
Floating Rate Covered Bond	Lloyds	£1,404,814.83	18/07/2019	0.758%
Floating Rate Covered Bond	National Australia Bank	£5,004,479.88	12/08/2016	0.647%
Floating Rate Covered Bond	Nationwide Building Society	£1,899,995.91	17/07/2017	0.769%
Floating Rate Covered Bond	Nationwide Building Society	£1,000,737.57	17/07/2017	0.719%
Floating Rate Covered Bond	Nationwide Building Society	£2,101,859.88	17/07/2017	0.709%
Floating Rate Covered Bond	Nationwide Building Society	£3,430,284.48	27/04/2018	0.740%
Total Bonds		£88,417,390.24		

Iceland

ISK held in Escrow at Islandsbanki	Glitnir	£3,783,749.00
ISK held in Escrow at Islandsbanki	Landsbanki Islands	£164,000.00
Total ISK held in Escrow		£3,947,749.00

Icelandic Recoveries outstanding	Heritable Bank Ltd	£366,905.37
Total Icelandic Recoveries outstanding		£366,905.37

Total of Internally Managed Funds	£266,041,547.11
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2. Externally Managed Funds

Investment Fund Name	Purchase Book Cost	Market Value at 31/03/2016	Total Annualised Return (%)
CCLA LAMIT Property Fund	£25,000,000.00	£25,742,571.96	3.48%
Pyrford Global Total Return (Sterling) Fund	£5,000,000.00	£5,123,674.25	2.96%
Total Externally Managed Investments	£30,000,000.00	£30,866,246.21	

Investment Fund Name	Purchase Book Cost	Market Value at 31/03/2016	Total Annualised Return (%)
Kent PFI (Holdings) Ltd	£2,135,740.59	£2,135,740.59	0.00%
Total UK Private Equity Holding	£2,135,740.59	£2,135,740.59	

Total of Externally Managed Funds	£33,001,986.80
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Grand Total of All Investments	£299,043,533.91
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