

By: John Simmonds, Deputy Leader and Cabinet Member for Finance and Procurement
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To: Governance and Audit Committee – 25 January 2017

Subject: **TREASURY MANAGEMENT 6 MONTH REVIEW 2016/17**

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 2016 and developments in the period since up to the date of this report.
2. If agreed by members this 6 month report will then go on to Council.
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.
4. The Council's Treasury Management Strategy for 2016/17 was approved by full Council on 11 February 2016.
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. This report covers treasury activity and the associated monitoring and control of risk.

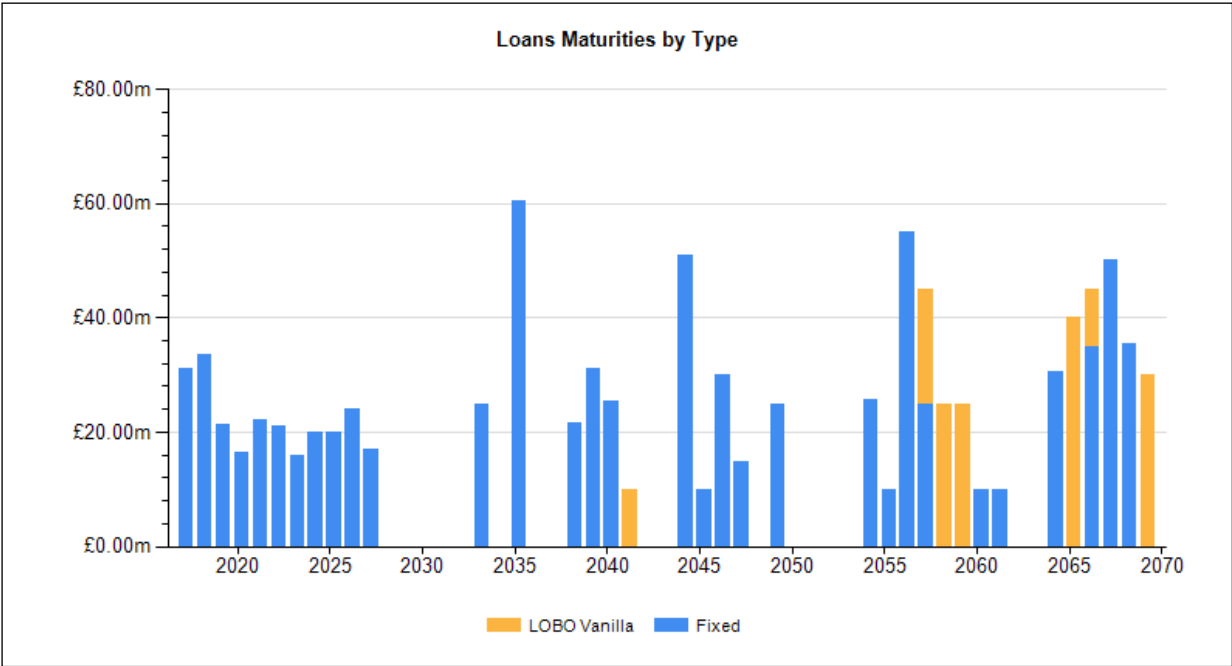
EXTERNAL CONTEXT

6. The main external issues in the first six months of the year were the Bank of England's decision in August to reduce the base rate to 0.25%, to make further gilt and corporate bond purchases (Quantitative Easing), and to provide cheap funding for banks (Term Funding Scheme) in order to maintain the supply of credit to the economy. These post- Brexit vote actions were made to pre-empt a slowdown in the economy but second quarter growth of 0.5% was better than expected. The reduction in the base rate has led to further reductions in the rates offered by banks for deposits and available from money market funds.

- 7. The Council had some exposure to equity markets, through its investment in the Pyrford Fund, which have performed strongly in the first half of the year.
- 8. Inflation has picked up due to a rise in import prices, dampening real wage growth and real investment returns. The Consumer Price Index (CPI) rose to 1.2% in the year to November 2016 and the Bank of England forecasts a rise closer to the Bank's 2% target over the coming year, as previous rises in commodity prices and the sharp depreciation in sterling begin to drive up imported material costs for companies.
- 9. Some of the UK's largest property pooled fund providers closed their funds in the immediate aftermath of the Brexit vote and the CCLA LAMIT Property Fund, which the Council invests in, wrote down capital values by 4%. Since the initial Brexit reaction capital values have reduced marginally and it is already widely forecast that UK Commercial Property returns in the next few years will be driven by income returns. Fidelity are forecasting returns for UK Commercial Property of 6-7% per annum for the next five years.

BORROWING STRATEGY

- 10. At 30 November the Council had long term borrowings of £983.84m, an increase of £4.3m from the balance as at 31 March 2016, with a maturity profile as follows:



- 11. Total external debt managed by KCC includes £37.4m pre-LGR debt managed by KCC on behalf of Medway Council and £0.91m for other bodies.
- 12. 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 Council's long-term plans change being a secondary objective.

13. In June Barclays Bank advised the Council of their decision to cancel all the embedded options within their standard Lender's Option Borrower's Option loans. This converted the Barclays LOBOs, totalling £281.8m, into fixed rate loans and is a highly welcome move by the bank.
14. Since the start of the current financial year the Council has received £6.2m of the funding agreed for the County's street lighting and expects to receive a total of £8.8m in 2016-17. KCC also expects to repay £32m of maturing and EIP PWLB loans by 31 March 2017
15. As a result of the borrowing relating to the street lighting, the average interest rate payable on the Council's debt portfolio reduced to 5.181%.
16. 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 remain lower than long-term rates, the Council has determined it is more cost effective in the short-term to use internal resources instead.
17. 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.

INVESTMENT ACTIVITY

Counterparty Update

18. The impact on KCC's counterparties and investments of the uncertain economic environment is being carefully monitored by officers and the Council's treasury advisors. Arlingclose's credit advice remains cautious however duration limits for major UK banks and building societies were unchanged with Standard Chartered remaining suspended from the list.

Investment activity 2016/17

19. The Council holds significant invested funds representing income received in advance of expenditure plus balances and reserves held. Cashflow forecast indicated that during 2016/17 investment balances would range between £285m and £434m.
20. 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.

21. Security of capital has remained the Council's main investment objective. Against a background of increasing uncertainty, the continuing risk of bail-in and continued low returns, it is the Council's aim to further diversify into more secure and/or higher yielding asset classes as set out in its Treasury Management Strategy Statement for 2016-17.
22. As at the end of November the types of investment held were as follows:

Type of Investment	Total	
	£m	%
Call Account	11.00	3.59
Money Market Fund	34.85	11.39
Notice Account	25.00	8.17
Certificate of Deposit	5.00	1.63
Fixed Deposit	68.60	22.42
Covered Bond	115.34	37.69
ISK held in Escrow	3.28	1.07
Icelandic Recoveries Outstanding	0.51	0.17
Internally managed cash	263.57	86.13
External Investments	30.31	9.90
Cashplus Fund	10.00	3.27
Equity	2.14	0.70
Total	306.02	100.00

FORECAST OUTTURN

23. The average cash balances were £345.7m in the half year. Short-term money market rates have remained at relatively low rates. Following the reduction in the base rate, rates for very short-dated periods (overnight – 1 month) have fallen to between 0.1% and 0.2%. Debt Management Account Deposit Facility (DMADF) rates have fallen to 0.15% for periods up to 3 months and to 0.10% for 4 – 6 month deposits.
24. New internally managed investments over the 6-month period were made at an average rate of 0.78%
25. The forecast anticipates an underspend of £0.487m on the net debt charges budget.

COMPLIANCE WITH PRUDENTIAL INDICATORS

26. The Council can confirm that it has complied with its Prudential Indicators for 2016/17 set as part of the Council's Treasury management Strategy Statement. Details can be found in Appendix 2.

TREASURY ADVISOR

27. Following a full tendering process for treasury advisory services Arlingclose were reappointed for a 3 year period from 1 August 2016.

RECOMMENDATION

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

Alison Mings
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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	£1,000,000	n/a	0.35%
	Total Barclays	£1,000,000		
Fixed Deposit	Lloyds Bank	£5,000,000	21/08/2017	1.00%
Fixed Deposit	Lloyds Bank	£5,000,000	29/09/2017	1.00%
Fixed Deposit	Lloyds Bank	£5,000,000	24/02/2017	0.80%
Fixed Deposit	Lloyds Bank	£5,000,000	24/07/2017	1.05%
Fixed Deposit	Lloyds Bank	£5,000,000	08/08/2017	1.00%
Fixed Deposit	Lloyds Bank	£5,000,000	09/02/2017	0.90%
Fixed Deposit	Lloyds Bank	£5,000,000	05/09/2017	1.00%
	Total Lloyds Group	£35,000,000		
Call Account	Santander UK	£10,000,000	n/a	0.15%
180 Day Call Notice Account	Santander UK	£25,000,000	n/a	0.90%
	Total Santander	£35,000,000		
Total UK Bank Deposits		£71,000,000		
Fixed Deposit	Nationwide Building Society	£3,600,000	19/04/2017	0.42%
Fixed Deposit	Nationwide Building Society	£10,000,000	24/04/2017	0.43%
Total UK Building Society Deposits		£13,600,000		
Certificate of Deposit	Toronto-Dominion Bank	£5,000,000	10/02/2017	0.80%
Total Canadian Bank Deposits		£5,000,000		
Fixed Deposit	United Overseas Bank	£10,000,000	10/02/2017	0.73%
Fixed Deposit	United Overseas Bank	£5,000,000	10/02/2017	0.70%
Fixed Deposit	Overseas Chinese Banking Corp	£5,000,000	10/02/2017	0.65%
Total Singapore Bank Deposits		£20,000,000		
Money Market Fund	Aberdeen Sterling Liquidity Fund	£4,496,679	n/a	0.31 (variable)
Money Market Fund	Deutsche Managed Sterling Fund	£93,593	n/a	0.30 (variable)
Money Market Fund	Federated (PR) Short-term GBP Prime Fund	£9,990,000	n/a	0.30 (variable)
Money Market Fund	HSBC Global Liquidity Fund	£96,302	n/a	0.29 (variable)
Money Market Fund	Insight Sterling Liquidity Fund	£97,412	n/a	0.29 (variable)
Money Market Fund	LGIM Liquidity Fund	£9,991,781	n/a	0.37 (variable)
Money Market Fund	SSgA GBP Liquidity Fund	£94,334	n/a	0.26 (variable)
Money Market Fund	Standard Life Liquidity Fund	£9,990,000	n/a	0.33 (variable)
Total Money Market Funds		£34,850,100		
Cash Plus Fund	Aberdeen Ultra Short Duration Sterling Fund	£10,002,230	n/a	0.30 (variable)
Total Cash Plus Funds		£10,002,230		

1.2 Iceland Deposits

Instrument Type	Principal Amount
Total Icelandic Recoveries outstanding	£506,554
Total ISK held in Escrow (est GBP)	£3,278,427
Icelandic Recoveries outstanding	£3,784,981

1.3 Bond Portfolio

Bond Type	Issuer	Adjusted Principal	Maturity Date	Net Yield
Fixed Rate Covered Bond	Coventry Building Society	£3,157,053	19/04/2018	1.931%
Fixed Rate Covered Bond	Coventry Building Society	£5,282,513	19/04/2018	1.726%
Fixed Rate Covered Bond	Coventry Building Society	£2,121,260	19/04/2018	1.524%
Fixed Rate Covered Bond	Leeds Building Society	£2,128,008	17/12/2018	2.029%
Fixed Rate Covered Bond	Leeds Building Society	£1,601,727	17/12/2018	1.192%
Fixed Rate Covered Bond	Yorkshire Building Society	£2,107,752	12/04/2018	1.976%
Fixed Rate Covered Bond	Yorkshire Building Society	£3,187,918	12/04/2018	1.545%
Floating Rate Covered Bond	Abbey National Treasury	£5,752,160	20/01/2017	0.820%
Floating Rate Covered Bond	Abbey National Treasury	£3,001,107	20/01/2017	0.714%
Floating Rate Covered Bond	Abbey National Treasury	£2,417,166	05/04/2017	0.776%
Floating Rate Covered Bond	Abbey National Treasury	£1,365,105	05/04/2017	0.716%
Floating Rate Covered Bond	Abbey National Treasury	£3,002,438	29/05/2018	0.787%
Floating Rate Covered Bond	Barclays Bank	£5,003,059	15/09/2017	0.693%
Floating Rate Covered Bond	Barclays Bank	£3,001,954	15/09/2017	0.685%
Floating Rate Covered Bond	Barclays Bank	£5,001,899	12/02/2018	0.721%
Floating Rate Covered Bond	Barclays Bank	£2,395,754	12/02/2018	0.781%
Floating Rate Covered Bond	Coventry Building Society	£3,007,248	17/03/2020	0.877%
Floating Rate Covered Bond	Leeds Building Society	£2,501,547	09/02/2018	0.784%
Floating Rate Covered Bond	Leeds Building Society	£2,501,572	09/02/2018	0.784%
Floating Rate Covered Bond	Leeds Building Society	£5,000,000	01/10/2019	0.967%

Appendix 1

Floating Rate Covered Bond	Lloyds	£3,001,050	14/01/2017	0.806%
Floating Rate Covered Bond	Lloyds	£3,901,503	19/01/2018	0.721%
Floating Rate Covered Bond	Lloyds	£1,403,781	18/07/2019	0.758%
Floating Rate Covered Bond	Lloyds	£10,004,572	16/01/2017	0.459%
Floating Rate Covered Bond	Nationwide Building Society	£1,899,998	17/07/2017	0.769%
Floating Rate Covered Bond	Nationwide Building Society	£1,000,369	17/07/2017	0.719%
Floating Rate Covered Bond	Nationwide Building Society	£2,100,930	17/07/2017	0.709%
Floating Rate Covered Bond	Nationwide Building Society	£3,429,522	27/04/2018	0.740%
Floating Rate Covered Bond	Nationwide Building Society	£2,147,283	27/04/2018	0.771%
Fixed Rate Covered Bond	National Australia Bank	£3,003,113	10/11/2021	1.104%
Floating Rate Covered Bond	Toronto Dominion	£5,456,592	01/02/2019	1.016%
Fixed Rate Covered Bond	Leeds Building Society	£5,851,747	17/12/2018	0.623%
Fixed Rate Covered Bond	Santander UK PLC	£3,615,957	14/04/2021	0.649%
Fixed Rate Covered Bond	Bank Of Nova Scotia	£4,984,225	14/09/2021	0.813%
Total Bonds		£115,337,881		

Total Internally Managed Investments	£273,575,193
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2. Externally Managed Investments

Investment Fund	Book Cost	Market Value as at 31 October 2016	12 months return to 31 October 2016
CCLA LAMIT Property Fund	£20,000,000	£24,807,891	0.16%
Pyrford Fund	£5,000,000	£5,498,197	10.99%
Kent PFI (Holdings) Ltd	£2,135,741	£2,135,741	
Total Externally Managed Investments		£32,441,828	

3. Total Investments

Total Investments	£306,017,020
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2016-17 October Monitoring of Prudential Indicators

1. Estimate of capital expenditure (excluding PFI)

Actuals 2015-16	£249.121m
Original estimate 2016-17	£299.658m
Revised estimate 2016-17	£291.264m

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

	2015-16	2016-17	2016-17	2017-18	2018-19
	Actual	Original Estimate	Forecast as at 31-10-16	Forecast as at 31-10-16	Forecast as at 31-10-16
	£m	£m	£m	£m	£m
Capital Financing requirement	1,348.259	1,335.724	1,363.995	1,320.627	1,272.689
Annual increase/reduction in underlying need to borrow	-34.597	-17.266	-15.736	-43.368	-47.938

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 2015-16	13.90%
Original estimate 2016-17	13.71%
Revised estimate 2016-17	13.89%

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 2016-17

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

	Prudential Indicator	Position as at 31.10.16
	£m	£m
Borrowing	975	944
Other Long Term Liabilities	248	248
	<hr/> 1,223	<hr/> 1,192

(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 31.10.16
	£m	£m
Borrowing	1,015	983
Other Long Term Liabilities	248	248
	<hr/> 1,263	<hr/> 1,231

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 2016-17 are:

	Authorised limit for debt relating to KCC assets and activities	Position as at 31.10.16	Authorised limit for total debt managed by KCC	Position as at 31.10.16
	£m	£m	£m	£m
Borrowing	1,015	944	1,055	983
Other long term liabilities	248	248	248	248
	<hr/> 1,263	<hr/> 1,192	<hr/> 1,303	<hr/> 1,231

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 2016-17

Fixed interest rate exposure	100%
Variable rate exposure	40%

These limits have been complied with in 2016-17.

8. Upper limits for maturity structure of borrowings

	Upper limit	Lower limit	As at 31.10.16
	%	%	%
Upper 12 months	10	0	3.17
12 months and within 24 months	10	0	3.37
24 months and within 5 years	15	0	6.10
5 years and within 10 years	15	0	10.22
10 years and within 20 years	20	5	10.43
20 years and within 30 years	20	5	18.21
30 years and within 40 years	25	10	13.28
40 years and within 50 years	30	10	23.46
50 years and within 60 years	30	10	11.75

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

Indicator	£230m
Actual	£178.3m