

By: Peter Oakford, Deputy Leader and Cabinet Member for Finance and Traded Services
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To: Governance and Audit Committee – 23 January 2019

Subject: **TREASURY MANAGEMENT 6 MONTH REVIEW 2018-19**

Classification: Unrestricted

Summary: To present a review of Treasury Management Activity 2018-19 to date

FOR DECISION

INTRODUCTION

1. This report covers Treasury Management activity for the 6 months to 30 September 2018 and developments in the period since up to the date of this report.
2. If agreed by members this report will 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 2018-19 was approved by full Council on 20 February 2018.
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.

GOVERNANCE

6. The Corporate Director Finance is responsible for the Council's treasury management operations and day to day responsibility is delegated to the Head of Finance (Policy, Planning & Strategy) / Head of Finance (Operations) and Treasury and Investments Manager. The detailed responsibilities are set out in the Council's Treasury Management Practices.
7. The Treasury Management Advisory Group (TMAG) which is a sub-committee of Cabinet has been established to work with the Officers on treasury management. The group consists of the Cabinet Member for Finance and Traded Services, Deputy Cabinet Member for Finance and Traded Services, Chairman Policy and Resources Cabinet Committee, Chairman Superannuation Fund Committee, Liberal Democrat Finance spokesman and a Labour Group Representative. The

agreed terms of reference are “The Treasury Management Advisory Group will be responsible for advising the Cabinet and Corporate Director Finance on treasury management policy within KCC’s overarching Treasury Management Strategy”. TMAG meets the requirement in the CIPFA TM Code for a member body focussing specifically on treasury management. TMAG meets half yearly and members of the group receive detailed information on a weekly and monthly basis.

8. Council will agree the Treasury Management Strategy and receives annual and half yearly reports on treasury management activity. Governance and Audit Committee receives annual and half-yearly reports and makes recommendations to County Council. It also receives quarterly updates.

EXTERNAL CONTEXT

Economic Background

9. The UK’s progress negotiating its exit from the European Union, together with its future trading arrangements, has continued to be a major influence on the Council’s treasury management activity in 2018/19.
10. UK Consumer Price Inflation (CPI) remained steady during the period with October up 2.4% year/year, slightly below the consensus forecast and broadly in line with the Bank of England’s November Inflation Report.
11. The most recent labour market data for October 2018 showed the unemployment rate edged up slightly from a low of 4.0%, its lowest on record, to 4.1% while the employment rate of 75.7% was the joint highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.3% as wages continue to rise steadily and provide some pressure on general inflation. Adjusted for inflation, real wages grew by 1.0%, a level still likely to have little affect on consumer spending.
12. The rise in quarterly GDP growth to 0.6% in the September quarter from 0.4% in the previous quarter was due to weather-related factors boosting overall household consumption and construction activity over the summer following the weather-related weakness in the March quarter. At 1.5%, annual GDP growth continues to remain below trend.
13. Following the Bank of England’s decision to increase the Bank Rate to 0.75% in August, no changes to monetary policy have been made since. The Monetary Policy Committee continues to reiterate that any further increases will be at a gradual pace and limited in extent.
14. While US growth has slowed over 2018, the economy continues to perform robustly. The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the current 2%-2.25% in September. Concerns over trade wars continue to drag on economic activity.

Credit outlook

15. The big four UK banking groups have now divided their retail and investment banking divisions into separate legal entities under ringfencing legislation. Credit rating agencies have adjusted the ratings of some of these banks with the ringfenced banks generally being better rated than their non-ringfenced counterparts.
16. The Bank of England has released its latest report on bank stress testing, illustrating that all entities included in the analysis were deemed to have passed the test once the levels of capital and potential mitigating actions presumed to be taken by management were factored in. The BoE did not require any bank to raise additional capital.

LOCAL CONTEXT

17. 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. The Council's current strategy is to maintain borrowing and investments below their underlying levels, known as internal borrowing, in order to reduce risk and keep interest costs low.

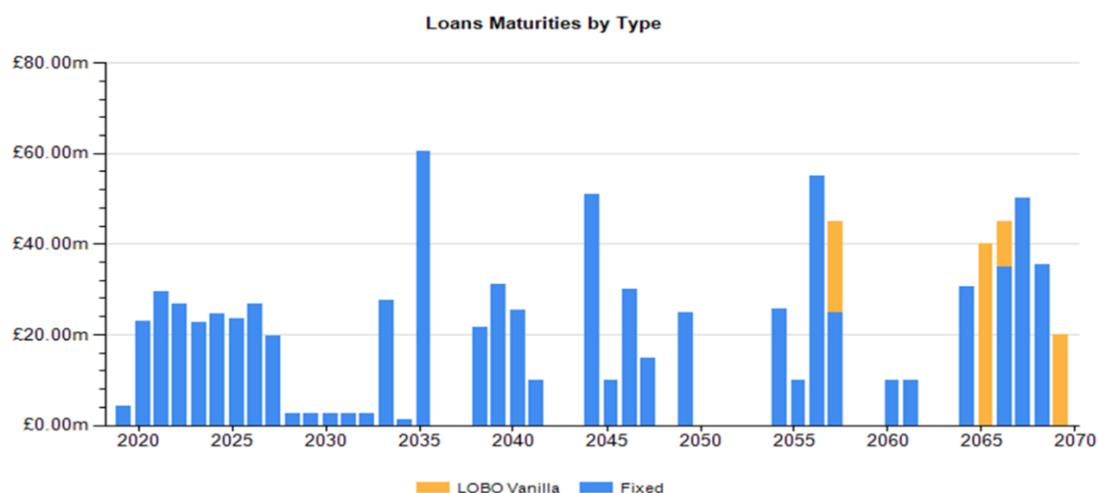
BORROWING STRATEGY

18. At 30 November 2018 the Council had total debt outstanding of £911.3m, a reduction of £31.33m from the balance as at 31 March 2018. Outstanding loans at 30 November are summarised in the table below.

Borrowing Position

	30/3/2018 Balance £m	2018/19 Movement £m	30/11/2018 Balance £m	Average Rate %	Years to final maturity
Public Works Loan Board	472.28	21.00	493.28	5.03%	16.99
Banks (LOBO)	150.00	-60.00	90.00	4.15%	45.21
Banks (Fixed Term)	320.32	7.67	327.99	3.97%	35.85
	942.60	-31.33	911.27	4.56%	26.56

19. The maturity profile of KCC's outstanding debt is as follows:



20. 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.
21. In keeping with these objectives no new borrowing was undertaken other than as part of the restructure of the LOBO portfolio and in respect of the Council's replacement streetlighting project. £19m of existing loans were allowed to mature without replacement.
22. With short-term interest rates remaining much lower than long-term rates, KCC has considered it to be more cost effective in the near term to use internal resources or borrowed short term loans instead. The Council's strategy has enabled it to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.
23. KCC 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.
24. During the period an assessment by Arlingclose (the council's advisors) of KCC's LOBO portfolio identified restructuring opportunities with RBS likely to achieve substantial value from a negotiated settlement with the bank. The risks and benefits including restructuring savings were assessed and in October the Council successfully negotiated the prepayment of its 3 RBS loans with a principal value of £60m as follows:

Prepaid RBS LOBO loans

Start date	End date	Yrs to mty	Principal	Coupon	Disc rate	Premium	Redemption Amount
			£m	%	%	£m	£m
10/8/11	10/8/57	38.85	25.0	3.83	2.95	5.1	30.1
10/8/11	10/5/58	40.0	25.0	3.83	2.94	5.2	30.2
30/1/09	30/1/69	50.33	10.0	3.95	2.90	12.8	12.8
		41.19	60.0	3.85		13.1	73.1

25. Taking account of advice from Arlingclose the prepayment was financed using a combination of a £40m 15-year EIP (Equal Instalment of Principal) loan from the PWLB at 2.21%, and cash balances. As a result of this change the Council was able to reduce the average interest rate payable on its borrowing and reduce its long-term debt exposure.
26. This funding arrangement using cash balances was deemed to represent the best balance between risk and reward. The combination of lower interest rate payments on debt partially offset by loss of investment income/cost of short-term borrowing is expected to deliver a net revenue saving of £400k to £500k per annum.

INVESTMENT ACTIVITY

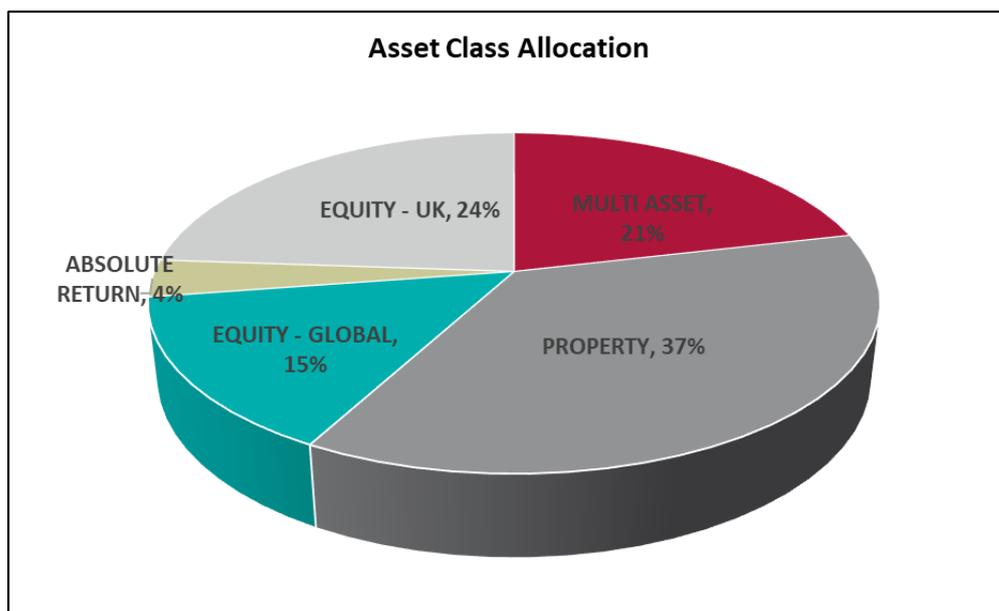
27. The Council holds significant invested funds representing income received in advance of expenditure plus balances and reserves held. During the period the Council's investment balance ranged between £274m and £434m due to timing differences. The investment position is shown below.

Investment Position

	31.3.18 Balance £m	2018 Movement £m	30.11.18 Balance £m	30.11.18 Rate of Return %	Days to maturity	Average Credit Rating
Money Market Fund	79.8	23.6	103.4	0.63	1	A+
Fixed Deposit	17.1	8.2	25.3	0.84	180	AA-
T Bill		10.0	10.0	0.73	179	AA
Covered Bond	64.5	14.8	79.3	1.02	930	AAA
Icelandic Recoveries o/s	0.4	0.0	0.4			
Equity	2.1	0.0	2.1			
Internally managed cash	163.9	56.6	220.5	0.82	368	AA
Strategic Pooled Funds	113.8	26.9	138.3	4.02		

Cashplus / Short term Bond Funds	20.0	-20.0	0.0			
External Investments	133.8	4.5	138.3	4.02		
Total	297.7	61.1	358.8	2.18		

28. 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.
29. In furtherance of these objectives and given the increasing risk and low returns from short-term unsecured bank investments the Council has continued to diversify into more secure and/or higher yielding asset classes as set out in its Treasury Management Strategy Statement for 2018-19.
30. The Council's £138.3m of externally managed pooled funds generated an average total return of 2.18%, comprising a 4.02% income return which is used to support services in year, and -1.57% of capital losses. Because these 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 is regularly reviewed. In light of their performance and the Council's latest cash flow forecasts, investment in these funds has been increased with a further £10m invested in a Kames Capital multi asset fund in early December.
31. A breakdown of the external investments by asset class is as follows



32. A detailed schedule of KCC's investments as at 30 November 2018 is attached in Appendix 1. This schedule is circulated to members of the Treasury Management Advisory Group (TMAG) every Friday.

33. The Ministry of Housing, Communities and Local Government (MHCLG) consulted in July on statutory overrides relating to the introduction of the IFRS 9 Financial Instruments accounting standard. KCC responded arguing that the adoption of IFRS 9 as proposed could add unwarranted volatility in the General Fund, and hence impact unnecessarily upon Council Tax or service expenditure. The MHCLG then announced in November that it has accepted the arguments made and decided to introduce a statutory override that while requiring IFRS 9 to be adopted in full, requires fair value movements in pooled investment funds to be taken to a separate reserve instead of the General Fund. MHCLG has also committed to keep the override in place for at least five years and to review this in to March 2023. The override will apply to all collective investment schemes, and not just to pooled property funds as suggested in the consultation.

FORECAST OUTTURN

34. It is anticipated that there will be an underspend against the net debt costs budget for the year of £0.6m as a result of higher dividends and interest receipts and the net impact of debt restructuring. Average cash balances during the year are forecast to be £351m earning an average return of 2.2%. The forecast average rate of debt interest payable in 2018-19, taking account of the cost of the premium paid on the restructure, is 4.7%, based on an average debt portfolio of £927m.

COMPLIANCE

30. The Corporate Director Finance reports that the treasury management activities undertaken during the period complied with the Council's Prudential Indicators for 2018-19 set as part of the Council's Treasury Management Strategy. Details can be found in Appendix 2.

RECOMMENDATION

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

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Investments as at 30 November 2018

1. Internally Managed Investments

1.1 Term deposits, Call accounts and Money Market Funds

Instrument Type	Counterparty	Principal Amount	Interest Rate	End Date
Fixed Deposit	Thurrock Borough Council	£10,000,000	0.90%	31/05/2019
Fixed Deposit	Thurrock Borough Council	£10,000,000	0.95%	30/08/2019
Fixed Deposit	Debt Management Account Deposit Facility	£5,350,000	0.50%	03/12/2018
Treasury Bill	DMO	£9,963,533	0.73%	28/05/2019
Total UK Bank Deposits		35,313,533		

Money Market Fund	Aberdeen Sterling Liquidity Fund	£14,962,953	0.42% (variable)	n/a
Money Market Fund	Deutsche Managed Sterling Fund	£14,991,935	0.73% (variable)	n/a
Money Market Fund	Federated (PR) Short-term GBP Prime Fund	£14,997,736	0.50% (variable)	n/a
Money Market Fund	HSBC Global Liquidity Fund	£14,991,497	0.84% (variable)	n/a
Money Market Fund	Insight Liquidity Funds PLC	£13,535,199	0.68% (variable)	n/a
Money Market Fund	LGIM Sterling Liquidity Fund	£14,992,189	0.73% (variable)	n/a
Money Market Fund	SSgA GBP Liquidity Fund	£14,957,206	0.67% (variable)	n/a
Total Money Market Funds		£103,428,714		
Equity and Loan Notes	Kent PFI (Holdings) Ltd	£2,135,741		n/a
Icelandic Recoveries outstanding	Heritable Bank Ltd	£366,905		n/a

1.2 Bond Portfolio

Bond Type	Issuer	Adjusted Principal	Coupon Rate	Maturity Date
Fixed Rate Covered Bond	Bank of Montreal	£5,006,029	1.06%	17/04/23
Fixed Rate Covered Bond	Bank of Nova Scotia	£4,990,619	0.88%	14/09/21
Fixed Rate Covered Bond	Canadian Imperial Bank of Commerce	£5,039,704	0.98%	10/01/22
Fixed Rate Covered Bond	Coventry Building Society	£3,003,110	1.03%	17/03/20
Fixed Rate Covered Bond	Leeds Building Society	£5,579,421	0.63%	17/12/18
Fixed Rate Covered Bond	Leeds Building Society	£2,043,411	2.03%	17/12/18
Floating Rate Covered Bond	Leeds Building Society	£1,514,308	1.19%	17/12/18
Floating Rate Covered Bond	Leeds Building Society	£5,000,000	1.20%	01/10/19
Floating Rate Covered Bond	Lloyds	£2,503,295	1.02%	27/03/23
Floating Rate Covered Bond	Lloyds	£2,504,397	1.01%	27/03/23
Floating Rate Covered Bond	Lloyds	£1,401,029	1.00%	18/07/19
Floating Rate Covered Bond	Lloyds	£5,007,765	1.01%	27/03/23

Appendix 1

Floating Rate Covered Bond	National Australia Bank	£3,001,889	1.10%	10/11/21
Floating Rate Covered Bond	Nationwide Building Society	£4,505,430	1.04%	12/04/23
Floating Rate Covered Bond	Nationwide Building Society	£5,588,843	1.03%	12/04/23
Floating Rate Covered Bond	Santander UK	£3,397,332	0.65%	14/04/21
Floating Rate Covered Bond	Santander UK	£5,010,484	0.97%	05/05/20
Floating Rate Covered Bond	Santander UK	£5,003,472	1.10%	16/11/22
Floating Rate Covered Bond	Santander UK	£3,752,534	1.01%	13/04/21
Floating Rate Covered Bond	Toronto-Dominion Bank	£5,450,707	1.26%	01/02/19
Total Bonds		£79,303,779		

Total Internally managed investments	£220,548,672
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2. Externally Managed Investments

Investment Fund / Equity		Market Value at 30 November 2018 £	12 months return to 30 November 2018	
Fund Name	Asset Class		Income %	Total %
CCLA - Diversified Income Fund	Multi asset	4,979,931	0.79	0.39
CCLA – LAMIT Property Fund	Property	50,546,043	3.91	4.31
Fidelity Multi Asset Income Fund	Multi asset	24,505,940	3.31	-0.33
M&G Global Dividend Fund	Equity - global	10,580,732	2.98	5.60
Pyrford Global Total Return Sterling Fund	Absolute return	4,906,058	2.31	0.10
Schroder Income Maximiser Fund	Equity - UK	23,607,427	6.70	3.17
Threadneedle Global Equity Income Fund	Equity - global	9,789,200	3.53	0.62
Threadneedle UK Equity Income Fund	Equity - UK	9,400,149	3.85	0.09
Total External Investments		138,315,480	4.02	2.45

3. Total Investments

Total Investments	£358,864,152
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2018-19 Monitoring of Prudential Indicators as at 30 November 2018

1. Estimate of capital expenditure (excluding PFI)

Actuals 2017-18	£188.249m
Original estimate 2018-19	£295.449m
Revised estimate 2018-19	£205.906m

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

	2017-18	2018-19	2018-19
	Actual	Original Estimate	Forecast as at 30.11.18
	£m	£m	£m
Capital Financing requirement	1,322.493	1,373.692	1,296.719
Annual increase/reduction in underlying need to borrow	-39.901	45.406	-25.774

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 2017-18	12.96%
Original estimate 2018-19	12.01%
Forecast 2018-19	11.86%

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 2018-19

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

	Prudential Indicator	Position as at 30.11.18
	£m	£m
Borrowing	1,003	875
Other Long-Term Liabilities	271	263
	<hr/> 1,274	<hr/> 1,138

(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 30.11.18
	£m	£m
Borrowing	1,038	911
Other Long-Term Liabilities	271	263
	<hr/> 1,309	<hr/> 1,174

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 Council. The revised limits for 2018-19 are:

	Authorised limit for debt relating to KCC assets and activities	Position as at 30.11.18	Authorised limit for total debt managed by KCC	Position as at 30.11.18
	£m	£m	£m	£m
Borrowing	1,043	875	1,078	911
Other long-term liabilities	271	263	271	263
	<hr/> 1,314	<hr/> 1,138	<hr/> 1,349	<hr/> 1,174

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 Strategy Statement. Compliance has been tested and validated by our independent professional treasury advisors.

7. Upper limits of fixed interest rate and variable rate exposures

The Council has determined the following upper limits for 2018-19

Fixed interest rate exposure	100%
Variable rate exposure	50%

These limits have been complied with in 2018-19.

8. Upper limits for maturity structure of borrowings

	Upper limit	Lower limit	Position as at 30.11.18
	%	%	%
Under 12 months	10	0	0.47
12 months and within 24 months	10	0	2.52
24 months and within 5 years	15	0	8.83
5 years and within 10 years	15	0	10.96
10 years and within 20 years	20	5	13.94
20 years and within 30 years	25	5	19.09
30 years and within 40 years	25	10	17.67
40 years and longer	30	10	26.52

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

Indicator	£250m
Actual	£218m