

By: Peter Oakford, Deputy Leader and Cabinet Member for Finance and Traded Services
Dave Shipton, Head of Finance (Policy, Planning and Strategy)

To: Governance and Audit Committee – 24 July 2019

Subject: **TREASURY MANAGEMENT ANNUAL REVIEW 2018-19**

Classification: Unrestricted

Summary: To report a summary of Treasury Management activity in 2018-19

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. Members of the Treasury Management Advisory Group (TMAG) also receive monthly updates.
2. The Council's Treasury Management Strategy for 2018-19 was approved by full Council on 20 February 2018.
3. 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.
 - a) Reports on the implications of treasury decisions and transactions;
 - b) Gives details of the outturn position on treasury management transactions in 2018-19;
 - c) Confirms compliance with its Treasury Management Strategy, Treasury Management Practices and Prudential Indicators.
4. When this report is agreed by this Committee it will go forward to full Council.

EXTERNAL CONTEXT

Economic background

5. After falling to 0.2% in Q4 2018 quarter-on-quarter GDP increased by 0.5% in Q1 2019 and annual GDP growth rose to 1.8% mainly due to positive private and government consumption. Both the quarter's figure and the year-on-year figure met expectations.

6. UK Consumer Price Inflation (CPI) for March 2019 was up 1.9% year/year, unchanged from February 2019. The most recent labour market data for the three months to March 2019 showed the unemployment rate at 3.8%, the lowest since October to December 1974 while the employment rate of 76.1% was the joint highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.3% while real wages were up 1.5% compared with a year earlier.
7. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have been made since. While in the US the Federal Reserve continued its tightening bias throughout 2018, pushing rates to the 2.25%-2.50% range in December. However a recent softening in US data caused the Fed to signal a pause in hiking interest rates at the last Federal Open Market Committee (FOMC) meeting in March.
8. The ongoing uncertainty around the UK's departure from the EU continues to weigh on sterling and UK markets. Globally the first quarter of 2019 was overshadowed by a gathering level of broader based economic uncertainty. The US continues to be set on a path of protectionist trade policies and tensions with China in particular, but with the potential for this to spill over into wider trade relationships, most notably with EU. The EU itself appeared to show signs of a rapid slowdown in economic growth with the major engines of its economy, Germany and France, both suffering misfires from downturns in manufacturing alongside continued domestic/populist unrest in France. The International Monetary Fund downgraded its forecasts for global economic growth in 2019 and beyond as a consequence.

Financial markets

9. After a significant fall in equity values in December markets have rallied since the beginning of 2019, and the FTSE 100 and FTSE All share indices were both around 10% higher at the end of March than at the end of 2018.
10. Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. After rising in October, gilts regained their safe-haven status throughout December and into the new year - the 5-year benchmark gilt yield fell as low as 0.80% and there were similar falls in the 10-year and 20-year gilts over the same period dropping from 1.73% to 1.08% and from 1.90% to 1.55%. The increase in Bank Rate in August pushed up money markets rates over the year and 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.53%, 0.67% and 0.94% respectively over the period.

Credit background

11. Credit Default Swap (CDS) spreads drifted up towards the end of 2018 on the back of Brexit uncertainty before declining again in 2019 and continuing to remain low in historical terms. The big four UK banks (Barclays, Bank of Scotland/Lloyds, HSBC and RBS/NatWest Bank plc) completed the transfer of their business lines into retail (ringfenced) and investment banking (non-ringfenced) entities and started trading as separate entities from 1 January 2019.
12. In February, Fitch put the UK AA sovereign long-term rating on Rating Watch Negative as a result of Brexit uncertainty, following this move with the same treatment for UK banks and a number of government-related entities. There were minimal other credit rating changes during the period.

13. The impact on KCC's counterparties and investments of the uncertain economic environment is being carefully monitored by officers and Arlingclose, the Council's treasury advisors.

LOCAL CONTEXT

15. 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 strategy continues to be to maintain borrowing and investments below their underlying levels, known as internal borrowing, in order to reduce risk and keep interest costs low.
16. At 31 March 2019 the Council's useable reserves and working capital amounted to £620m. The Council used £165m of its available resources to fund capital spend rather than borrow from 3rd parties leaving £455m available for investment, an increase on 2018 of £153m.

BORROWING STRATEGY

17. 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.
18. 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. The Council's strategy has enabled it to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.
19. During the year the total value of KCC's long term debt fell by £36m to £906m and the average interest rate payable reduced by 0.16%. The year-end borrowing position and the year-on-year change are shown in the table below.

Borrowing Position

	31/3/2018 balance £m	2018-19 new loans £m	2018/19 repayment £m	31/03/2019 balance £m	Average rate %	Value waited average life (yrs)
Public Works Loan Board	472.28	40.00	-21.34	490.94	5.05%	16.77
Banks (LOBO)	150.00	0.00	-60.00	90.00	4.15%	44.96
Banks (Fixed Term)	320.32	11.44	-6.50	325.26	4.03%	35.77
Total borrowing	942.60	51.44	-87.84	906.21	4.59%	26.34

20. In October having assessed the risks and benefits including restructuring savings the Council successfully negotiated the prepayment of its 3 RBS LOBO loans with a principal value of £60m as follows:

Prepaid RBS LOBO loans

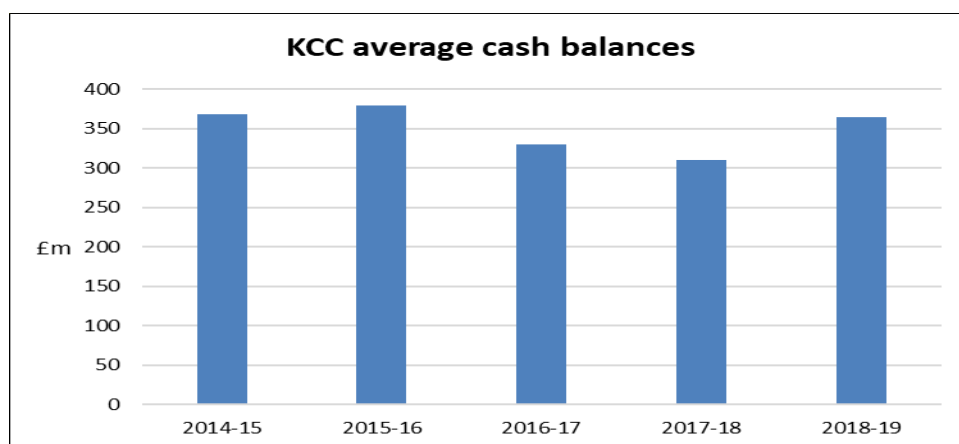
Start date	End date	Yrs to mty	Principal	Coupon	Disc rate	Premium	Redemption Amount
			£m	%	%	£m	£m
10/8/11	10/8/57	38.85	25.0	3.83	2.95	5.1	30.1
10/8/11	10/5/58	40.0	25.0	3.83	2.94	5.2	30.2
30/1/09	30/1/69	50.33	10.0	3.95	2.90	2.8	12.8
		41.19	60.0	3.85		13.1	73.1

21. 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.
22. 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.
23. KCC continues to hold £90m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as 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. A further £11.44m was drawn of the loans agreed specifically to fund improvements to Kent's street lighting under the government's energy efficiency loans programme while £6.5m of the Salix Finance Ltd loan principal advanced had been repaid as at 31 March 2019. At 31 March 2019 the Council had borrowed £38.5m of the total £40m funding agreed of which £28.7m has been an interest free loan provided by Salix Finance Ltd.

INVESTMENT ACTIVITY

25. KCC holds significant invested funds representing income received in advance of expenditure plus balances and reserves held. During 2018-19 the Council's average investment balance was £364m. Cash balances have risen during the year mainly as the result of the receipt of an additional £100m of capital grants and funds for highway repairs ahead of Brexit, offset by the net outflow in respect of the LOBOs prepayment of £33m. The following chart shows the Council's average cash balances over the last 5 years.

Average cash balances 2014 – 19



26. The value of KCC's investments increased during the year by £157m to £455m. At 31 March 2019 KCC had invested £150m in pooled funds, 33% of its total cash. The year-end investment position and the year-on-year change are shown in the tables below.

Investment Counterparty	31-Mar-18	2018/2019	31-Mar-19		
	Balance	Movement	Balance	Rate of Return	Average Credit Rating
	£m	£m	£m	%	
Banks and building societies	5.4	(3.0)	2.4	0.40	A
Money Market Funds	79.8	13.1	92.9	0.75	AA-
Local Authorities	9.0	56.0	65.0	0.97	AA-
UK Government	3.1	49.3	52.4	0.74	AA
Covered Bonds	64.5	25.9	90.4	1.18	AAA
Equity	2.1	0	2.1		
Internally managed cash	163.9	141.3	305.2	0.92	AA
Strategic Pooled Funds	113.7	36.1	149.8	4.46	
Cashplus / Short Bond Funds	20.0	(20.0)	-		
External Investments	133.7	16.1	149.8	4.46	
Total	297.6	157.4	455.0	2.25	

27. 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.
28. During 2018-19 in furtherance of these objectives as well as taking into account the increased cash balances available for investment, £56m was loaned to other local authorities and KCC purchased £49m of treasury bills. In addition, the Council invested £26m in covered bonds and, while redeeming its investments in Cashplus and short bond

funds added to its holdings in the CCLA LAMIT property fund and in the Schroders equity fund, and invested in 2 diversified income funds.

28. The progression of credit risk and return metrics for KCC's investments are shown in the extract from Arlingclose's quarterly investment benchmarking in the table below.

Investment Benchmarking

	Credit Score	Credit Rating	Bail-in Exposure	WAM (days)	Rate of Return
31.03.2018	3.15	AA	53%	216	2.29%
31.03.2019	3.02	AA	31%	381	2.25%
Similar LAs	4.07	AA-	55%	692	1.56%
All LAs	4.20	AA-	55%	29	1.45%

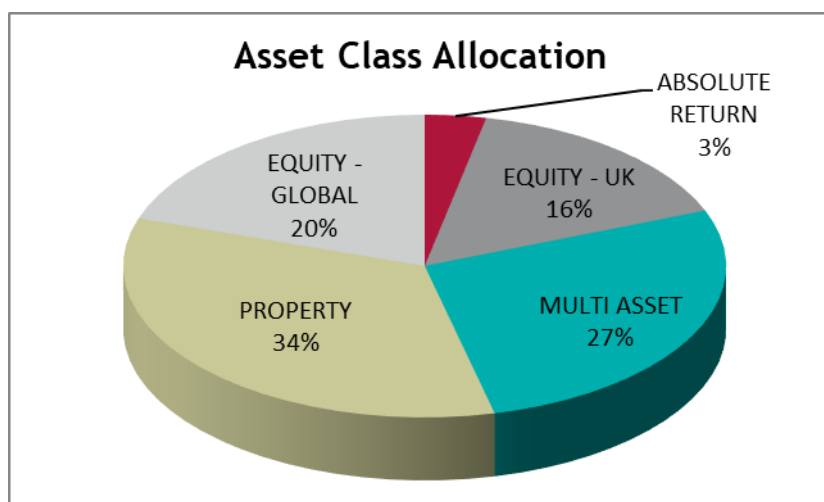
29. Details of the Council's investment position at 31 March 2019 are reported in Appendix 1.
30. KCC has invested £150m in externally managed pooled (bond, equity and property) funds. These are strategic long-term investments where the objectives are regular revenue income and long-term price stability with short-term security and liquidity being lesser considerations. These funds generated a total return of £7.7m, (5.21%) comprising a £6.6m (4.46%) income return which is used to support services in year, and £1.1m (0.76%) of unrealised capital growth.
31. Decisions to invest in these funds have been made taking account of advice from Arlingclose. Arlingclose monitor their performance and provide monthly updates for the Council. Because these funds have no defined maturity date but are available for withdrawal after a notice period their performance and continued suitability in meeting KCC's investment objectives are regularly reviewed.
32. These strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three to five-year period total returns will exceed cash interest rates.
33. Details of the externally managed pooled funds are shown in the following table.

Externally Managed Investments

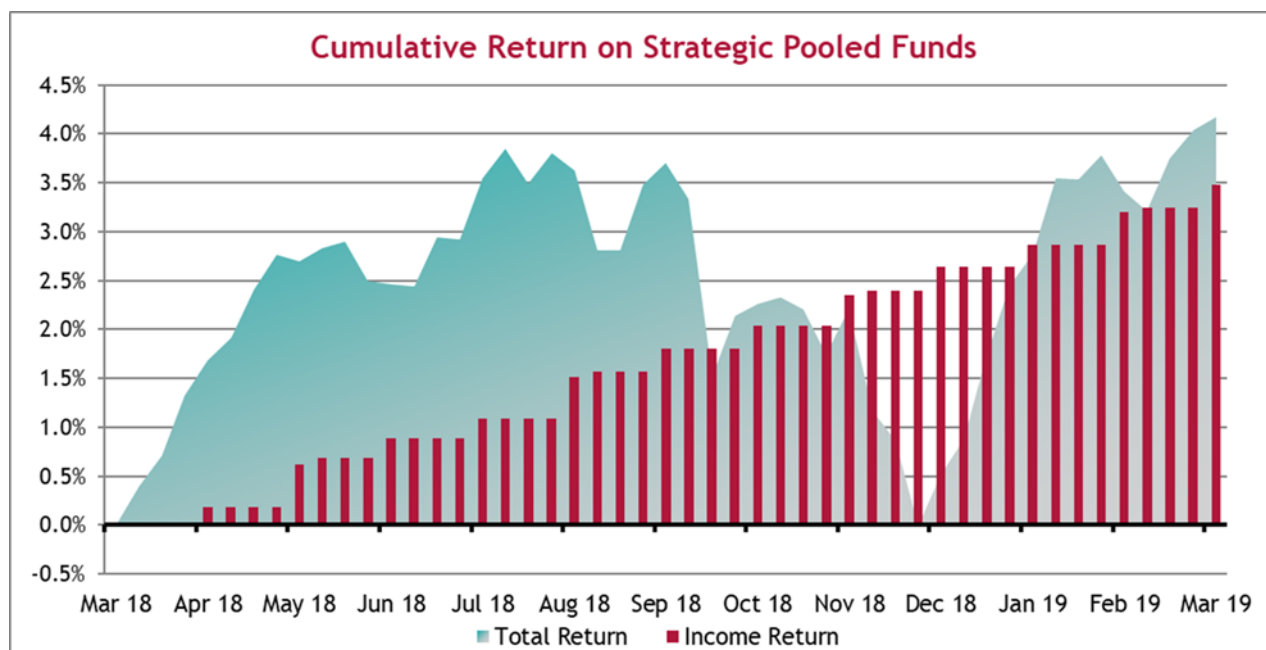
Investment Fund	Market Value at 31 Mar 2018 £m	2018-19 Movement £m	Market Value at 31 Mar 2019 £m	12 months return to 31 Mar 2019	
				Income	Total
CCLA - Diversified Income Fund		5.0	5.0	2.37%	2.77%
CCLA – LAMIT Property Fund	36.2	14.5	50.7	3.90%	2.98%
Fidelity Multi Asset Income Fund	24.7	0.7	25.4	3.93%	6.82%
Kames Diversified Monthly Income Fund		10.4	10.4	1.64%	5.36%
M&G Global Dividend Fund	9.9	0.7	10.6	4.40%	12.11%

Pyrford Global Total Return Sterling Fund	4.9	0.1	5.0	2.25%	3.12%
Schroder Income Maximiser Fund	19.5	4.1	23.6	8.22%	4.81%
Threadneedle Global Equity Income Fund	9.4	0.4	9.8	3.87%	7.99%
Threadneedle UK Equity Income Fund	9.2	0.1	9.3	5.00%	6.36%
Cashplus / short bond fund	20.0	-20.0		-	-
Total Externally Managed Investments	133.7	16.1	149.8	4.46%	5.21%

34. A breakdown of the external investments by asset class is as follows:



35. The following chart tracks the returns earned on the pooled funds over the 12 months to end March 2019.



36. Following consultation, MHCLG has implemented a statutory override relating to the introduction of the IFRS 9 Financial Instruments accounting standard from 2018/19.

While requiring IFRS 9 to be adopted in full, the statutory override requires fair value movements in pooled investment funds to be taken to a separate unusable reserve instead of the General Fund. The override will be in place for at least five years until 31 March 2023.

FINANCIAL OUTTURN

37. The Council's total investment income for the year was £8.2m, 2.25% on funds held. The above benchmark return reflects the investment in the pooled funds and spread of cash investments as detailed in the table at paragraph 24 above. KCC also received dividends on the equity held in Kent PFI Holding Co Ltd of £474,000.

COMPLIANCE WITH PRUDENTIAL INDICATORS

38. The Council confirms that it has complied with its Prudential Indicators for 2018-19, which were set as part of the Council's Treasury Management Strategy Statement. Details can be found in Appendix 2.

TREASURY ADVISOR

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

RECOMMENDATION

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

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Investments as at 31 March 2019

1. Internally Managed Investments

1.1 Term deposits, Call accounts and Money Market Funds

Instrument Type	Counterparty	Principal Amount £	Interest Rate	End Date
Call Account	NatWest	2,000,000	0.40%	n/a
Call Accounts		2,000,000		
Fixed Deposit	Flintshire County Council	5,000,000	0.90%	10/04/19
Fixed Deposit	Thurrock Borough Council	10,000,000	0.90%	31/05/19
Fixed Deposit	Blackpool Borough Council	10,000,000	0.95%	28/06/19
Fixed Deposit	Northumbria Police and Crime Commissioner	5,000,000	0.95%	04/07/19
Fixed Deposit	Plymouth City Council	10,000,000	1.00%	25/07/19
Fixed Deposit	Thurrock Borough Council	10,000,000	0.95%	30/08/19
Fixed Deposit	Falkirk Council	5,000,000	1.00%	05/09/19
Fixed Deposit	Highland Council	5,000,000	1.05%	23/10/19
Fixed Deposit	Highland Council	5,000,000	1.05%	06/01/20
Total Local Authority Deposits		65,000,000		
Treasury Bill	DMO	9,963,533	0.73%	31/05/19
Treasury Bill	DMO	9,963,732	0.73%	10/06/19
Treasury Bill	DMO	9,963,485	0.74%	08/07/19
Treasury Bill	DMO	9,962,495	0.76%	29/07/19
Treasury Bill	DMO	9,981,957	0.73%	29/04/19
Treasury Bill	DMO	2,528,429	0.76%	27/08/19
Total Govt Deposits		52,363,630		
Money Market Fund	Aberdeen Sterling Liquidity Fund	14,849,903	0.78%	n/a
Money Market Fund	Deutsche Managed Sterling Fund	14,952,121	0.76%	n/a
Money Market Fund	Federated (PR) Short-term GBP Prime Fund	17,801,495	0.78%	n/a
Money Market Fund	HSBC Global Liquidity Fund	14,980,930	0.71%	n/a
Money Market Fund	Insight Liquidity Funds PLC	775,066	0.71%	n/a
Money Market Fund	LGIM Sterling Liquidity Fund	14,518,342	0.75%	n/a
Money Market Fund	SSgA GBP Liquidity Fund	14,991,850	0.71%	n/a
Total Money Market Funds		92,869,707		
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
Floating Rate Covered Bond	Australia and New Zealand Banking group	3,000,000	1.39%	24/01/22
Floating Rate Covered Bond	Bank of Montreal	5,005,692	1.18%	17/04/23
Fixed Rate Covered Bond	Bank of Nova Scotia	4,990,619	0.88%	14/09/21
Fixed Rate Covered Bond	Bank of Scotland	4,703,496	1.71%	20/12/24
Floating Rate Covered Bond	Canadian Imperial Bank of Commerce	5,036,629	1.10%	10/01/22
Floating Rate Covered Bond	Coventry Building Society	3,002,075	1.08%	17/03/20
Floating Rate Covered Bond	Leeds Building Society	5,000,000	1.31%	01/10/19
Floating Rate Covered Bond	Lloyds	2,502,932	1.06%	27/03/23
Floating Rate Covered Bond	Lloyds	2,503,912	1.04%	27/03/23
Floating Rate Covered Bond	Lloyds	4,500,000	1.31%	14/01/22
Floating Rate Covered Bond	Lloyds	1,400,682	1.13%	18/07/19
Floating Rate Covered Bond	Lloyds	5,006,909	1.05%	27/03/23
Fixed Rate Covered Bond	National Australia Bank	3,001,889	1.10%	10/11/21
Fixed Rate Covered Bond	National Australia Bank	4,971,050	1.35%	10/11/21
Floating Rate Covered Bond	Nationwide Building Society	4,000,000	1.46%	10/01/24
Floating Rate Covered Bond	Nationwide Building Society	4,505,119	1.15%	12/04/23
Floating Rate Covered Bond	Nationwide Building Society	5,588,223	1.14%	12/04/23
Fixed Rate Covered Bond	Santander UK	3,397,332	0.65%	14/04/21
Floating Rate Covered Bond	Santander UK	3,752,281	1.11%	13/04/21
Floating Rate Covered Bond	Santander UK	5,003,249	1.08%	16/11/22
Floating Rate Covered Bond	Santander UK	5,008,721	1.04%	05/05/20
Floating Rate Covered Bond	Santander UK	2,003,372	1.40%	12/02/24
Floating Rate Covered Bond	TSB	2,504,200	1.54%	15/02/24
Total Bonds		90,388,382		

Total Internally managed investments	£305,124,366
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2. Externally Managed Investments

Investment Fund	Market Value at 31 March 2019 £
CCLA - Diversified Income Fund	5,020,086
CCLA – LAMIT Property Fund	50,691,932
Fidelity Multi Asset Income Fund	25,386,396
Kames Diversified Monthly Income Fund	10,372,034
M&G Global Dividend Fund	10,620,448
Pyrford Global Total Return Sterling Fund	4,931,918
Schroder Income Maximiser Fund	23,618,516
Threadneedle Global Equity Income Fund	9,795,431
Threadneedle UK Equity Income Fund	9,330,936
Total External Investments	149,767,697

3. Total Investments

Total Investments	£455,084,491
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