

By: Peter Oakford, Deputy Leader and Cabinet Member for Finance, Traded and Corporate Services
Zena Cooke, Corporate Director of Finance

To: County Council – 10 September 2020

Subject: **TREASURY MANAGEMENT ANNUAL REVIEW 2019-20**

Classification: Unrestricted

Summary: To report a summary of Treasury Management activity in 2019-20

**FOR
INFORMATION**

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 Kent County Council half yearly reports are made to the County 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 2019-20 was approved by full Council on 14 February 2019.
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 2019-20;
 - c) Confirms compliance with its Treasury Management Strategy, Treasury Management Practices and Prudential Indicators.

EXTERNAL CONTEXT

4. The UK's exit from the European Union and future trading arrangements, had remained one of the major influences on the UK economy and sentiment during 2019-20. The Brexit deadline was finally extended to 31 January 2020. Politics played a major role in financial markets over the period as the UK's tenuous progress negotiating its exit from the European Union together with its future trading arrangements drove volatility, particularly in foreign exchange markets. The outcome of December's General Election removed a lot of the uncertainty and looked set to provide a 'bounce' to confidence and activity.

5. At the beginning of 2020 the global economy was entering a period of slower growth. Then coronavirus swiftly changed everything. In response to the spread of the virus and the sharp increase in those infected, Central banks and governments around the world cut interest rates and introduced massive stimulus packages in an attempt to reduce some of the negative economic impact to domestic and global growth.
6. The Bank of England which had held policy rates steady at 0.75% through most of 2019-20, moved in March to cut bank rates to 0.25% from 0.75% and then swiftly brought them down further to the record low of 0.1% which has been maintained since.
7. The UK government also introduced a number of measures to help businesses and households impacted by a series of ever-tightening social restrictions, culminating in pretty much the entire lockdown of the UK. The nationwide lockdown in late March effectively shut down almost the entire UK economy and these measures have continued with only some easing of restrictions at the end of May and into June.
8. GDP growth contracted by 2.2% in Q1 (Jan-Mar) 2020 pushing the annual growth rate down to -1.6%. The lockdown only came into force on 23rd March, and the markets are braced for a dire set of growth data for Q2. In April UK GDP fell 20.4% month-on-month. On the back of the 5.8% month-on-month fall in March, this means economic output fell by 25% compared to its pre-coronavirus peak in February 2020.
9. Financial markets sold off sharply as the impact from the coronavirus worsened. After starting positively in 2020, the FTSE100 fell over 30% at its worst point with stock markets in other countries seeing similar huge falls. The measures implemented by central banks and governments have helped restore some confidence and financial markets have rebounded in recent weeks but remain extremely volatile.
10. In March sterling touched its lowest level against the dollar since 1985. Gilt yields fell substantially with 5-year yields falling to 0.26% on 31 March. The 10-year and 20-year yields fell to 0.4% and 0.76% over the same period. 1-month, 3-month and 12-month LIBID rates dropped to 0.61%, 0.72% and 0.88% respectively over the 12 months to 31 March. Rates have continued to fall with the 10-year gilt yield falling to 0.14% by the end of June and 1-month, 3-month and 12-month bid rates averaged 0.04%, 0.28% and 0.44% respectively over the 3 months.

LOCAL CONTEXT

11. 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.
12. At 31 March 2020 the Council's useable reserves and working capital amounted to £537m. The Council used £156m of its reserves to fund capital spend rather than borrow from 3rd parties leaving £381m available for investment, a decrease on 2019 of £74m.
13. Since the onset of the Covid-19 crisis and the resultant economic uncertainty officers with the assistance of Arlingclose, the council's treasury advisor, have been closely monitoring the council's cash balances as well as its debt and investment portfolios.

BORROWING UPDATE

14. On 9 October 2019 the PWLB raised the cost of certainty rate borrowing by 1% to 1.8% above UK gilt yields as HM Treasury was concerned about the overall level of local authority debt. PWLB borrowing remains available but the margin of 180bp above gilt yields appears relatively very expensive. Market alternatives are available and new products will be developed; however, the financial strength of individual authorities will be scrutinised by investors and commercial lenders.
15. The Chancellor's March 2020 Budget statement included significant changes to Public Works Loan Board (PWLB) policy and launched a wide-ranging consultation on the PWLB's future direction. Announcements included a reduction in the margin on new HRA loans to 0.80% above equivalent gilt yields, available from 12 March 2020 and £1.15bn of additional "infrastructure rate" funding at gilt yields plus 0.60% to support specific local authority infrastructure projects for England, Scotland and Wales for which there is a bidding process.
16. The consultation titled "Future Lending Terms" invites key stakeholders to contribute to developing a system whereby PWLB loans can be made available at improved margins to support qualifying projects. It contains proposals on allowing authorities that are not involved in "debt for yield" activity to borrow at lower rates as well as stopping local authorities using PWLB loans to buy commercial assets primarily for yield without impeding their ability to pursue their core policy objectives of service delivery, housing, and regeneration. The consultation also broaches the possibility of slowing, or stopping, individual authorities from borrowing large sums in specific circumstances.
17. The consultation closes on 31 July 2020 with implementation of the new lending terms expected in the latter part of this calendar year or financial year beginning 2021-22 and officers intend to respond to the consultation.

BORROWING STRATEGY

18. At 31 March 2020 the council held £883.82m of loans, a reduction of £22.38m from 31 March 2019 as part of its strategy of funding previous year's capital programmes. The year-end borrowing position and the year-on-year change are shown in the table below.

Borrowing Position

	31/03/2019	2019-20	31/03/2020		
	Principal Balance £m	Movement £m	Principal Balance £m	Average Rate %	Weighted Average Life (yrs)
Public Works Loan Board	490.94	-17.67	473.28	4.97%	16.21
Banks (LOBO)	90.00	0.00	90.00	4.15%	43.88
Banks (Fixed Term)	325.26	-4.71	320.55	4.09%	34.48
Total Long-term borrowing	906.20	-22.38	883.82	4.57%	25.66

19. 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

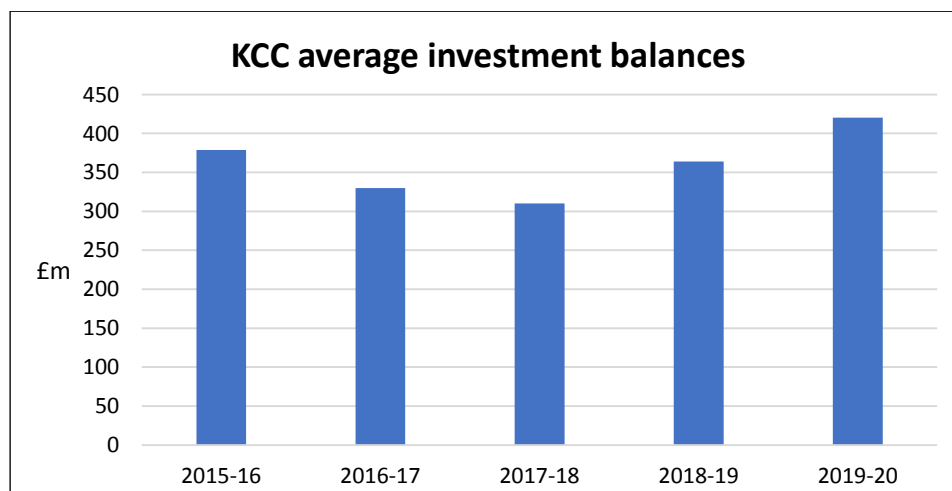
for which funds are required, with flexibility to renegotiate loans should the council's long-term plans change being a secondary objective.

20. 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.
21. The council 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.
22. A final £0.4m was drawn of the loans agreed specifically to fund improvements to Kent's street lighting under the government's energy efficiency loans programme while £12m of the Salix Finance Ltd loan principal advanced had been repaid as at 31 March 2020. At 31 March 2020 the council had borrowed the total £40.6m funding agreed of which £30.6m has been an interest free loan provided by Salix Finance Ltd.

TREASURY INVESTMENT ACTIVITY

23. KCC holds significant invested funds representing income received in advance of expenditure plus balances and reserves held. During 2019-20 the council's average investment balance was £422m. Balances fluctuated during the year falling at the year end to £381m although this balance was higher than anticipated as the result of the receipt in March of grants to cover COVID -19 costs and business rate compensation.

Average investment balances 2015 – 20



24. At 31 March 2020 the council held some £87.1m in its NatWest call account and in Money Market Funds with same day access to cover urgent payments and enhance the council's liquidity.
25. During the year £30m was invested in strategic pooled funds using the proceeds of maturing treasury bills and at 31 March 2020 the value of the council's investments in pooled funds was £157.3m, 41% of its total cash.

26. The year-end investment position and the year-on-year change are shown in the table below.

	31-Mar-19	2019-20	31-Mar-20		
	Balance	Movement	Balance	Rate of Return	Average Credit Rating
	£m	£m	£m	%	
Bank Call Accounts	2.4	28.0	30.4	0.50	A+
Money Market Funds	92.9	-36.2	56.7	0.42	AA-
Local Authorities	65.0	-15.0	50.0	0.90	AA-
Treasury Bills	52.4	-52.4	0		AA
Covered Bonds	90.4	-5.5	84.9	1.09	AAA
Equity	2.1	-	2.1		
Internally managed cash	305.2	-81.1	224.1	0.80	AA
Strategic Pooled Funds	150.0	+7.3	157.3	4.71	
Total	455.2	-73.8	381.4	2.42	

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 2019-20 the council added to its holdings in the CCLA LAMIT property fund, the Kames diversified income fund and made a new investment in the Investec diversified income fund.
29. 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
31.03.2019	3.02	AA	31%	381	2.25%
31.03.2020	3.02	AA	39%	349	2.42%
Similar LAs	3.83	AA-	41%	644	1.55%
All LAs	4.03	AA-	56%	20	1.23%

30. Details of the council's investment position at 31 March 2020 are reported in Appendix 1.
31. KCC has invested £180m 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. During the year these funds generated an income return of £7.6m, (4.71%) which is used to support services in year.

32. The Authority is invested in bond, equity, multi-asset and property funds. As a result of considerable global market volatility during the Covid-19 crisis we saw falls in the capital values of the underlying assets which were reflected in the 31 March fund valuations, with every fund registering negative capital returns over 12 months to March. Several March-end dividend details are awaited, but early calculations suggest that, despite decent income returns in 2019-20, these funds will post negative total return over the one-year period due to the capital component of total returns.
33. Trading in the CCLA property fund was also suspended during March based on advice from the fund's valuer that an accurate fund price cannot be calculated and CCLA's duty to treat customers fairly. The unrealised capital losses in equity income funds were especially large.
34. These unrealised capital losses will not have an impact on the General Fund. The council has adopted accounting standard IFRS 9 in full however MHCLG has implemented a statutory override which 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.
35. 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. 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.
36. Details of the externally managed pooled funds are shown in the following table.

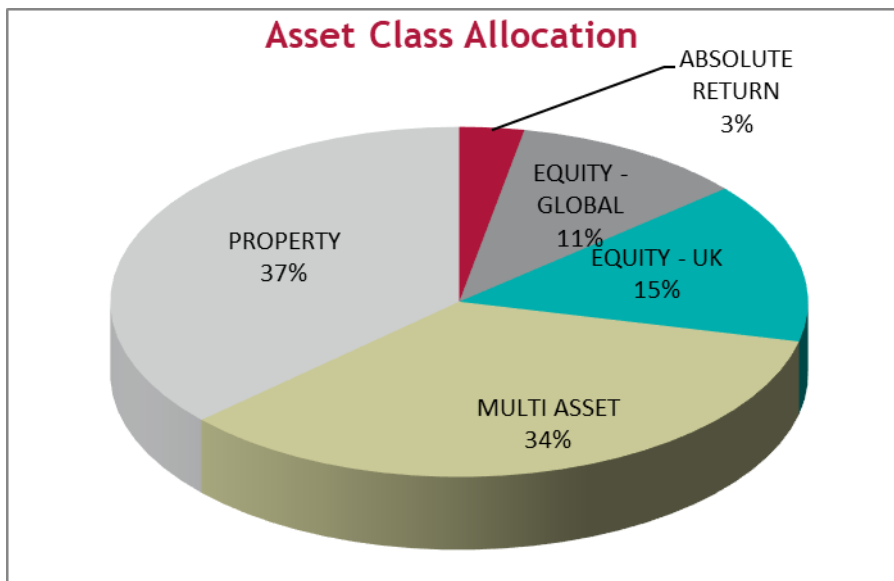
Externally Managed Investments

Investment Fund	Market Value at 31 Mar 2019	New investment	2019-20 Movement in market value	Market Value at 31 Mar 2020	12 months return to 31 Mar 2020	
	£m	£m	£m	£m	Income	Total
CCLA - Diversified Income Fund	5.0		-0.4	4.6	3.70%	-5.28%
CCLA – LAMIT Property Fund	50.8	10.0	-2.9	57.9	3.80%	-0.83%
Fidelity Global Multi Asset Income Fund	25.5		-1.8	23.7	5.03%	-1.60%
Investec Diversified Income Fund		10.0	-0.8	9.2	1.58%	-6.44%
Kames Diversified Monthly Income Fund	10.4	10.0	-3.5	16.9	3.52%	-13.53%
M&G Global Dividend Fund	10.6		-2.0	8.6	3.40%	-15.86%
Pyrford Global Total Return Sterling Fund	5.0		-0.3	4.7	1.84%	-2.60%

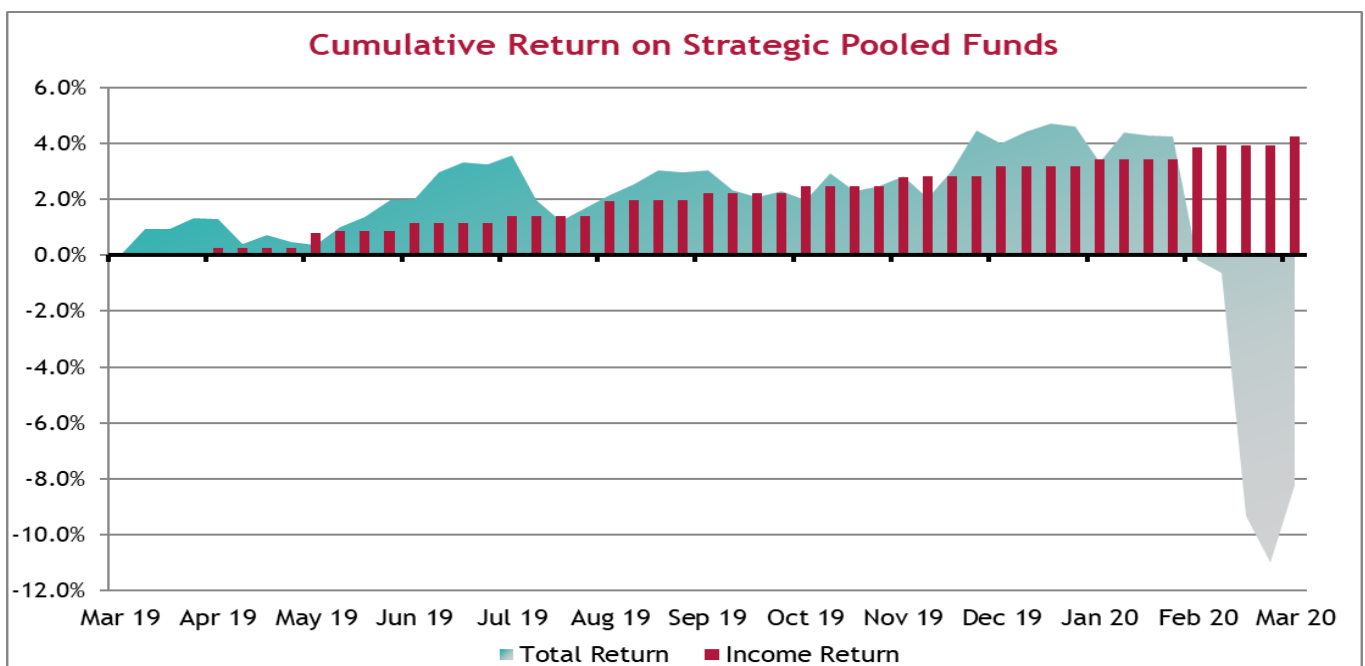
Schroder Income Maximiser Fund	23.6		-7.8	15.8	7.63%	-25.61%
Threadneedle Global Equity Income Fund	9.8		-1.4	8.4	3.41%	-10.31%
Threadneedle UK Equity Income Fund	9.3		-1.7	7.6	4.44%	-14.24%
Total Externally Managed Investments	150.0	30.0	-22.7	157.3	4.71%	-8.04%

37. Since the end of March 2020 the strategic pooled funds have recovered some of their capital losses as the financial markets have rebounded. At 30 June the market value of the portfolio was £163.9m.

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



39. The following chart tracks the returns earned on the pooled funds over the 12 months to end March 2020.



FINANCIAL OUTTURN

40. The Council's total investment income for the year was £10.4m, £2.42% on funds held. The above benchmark return reflects the investment in the pooled and spread of cash investments as detailed in the table at paragraph 25 above. KCC also received dividends on the equity held in Kent PFI Holding Co Ltd of £452,000.

COMPLIANCE WITH TREASURY MANAGEMENT INDICATORS

41. The Corporate Director of Finance reports that all treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

Treasury Management Indicators

42. The Council measures and manages its exposures to treasury management risks using the following indicators.
43. **Security:** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its internally managed investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Credit risk indicator	Actual 31/03/2020	Target	Complied
Portfolio average credit rating	AA	AA	Yes

44. **Liquidity:** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing.

Liquidity risk indicator	Actual 31/03/2020	Target	Complied
Total cash available within 3 months	£137m	£110m	Yes

45. **Interest rate exposures:** This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

Interest rate risk indicator	Actual 31/03/2020	Upper Limit
One-year revenue impact of a 1% <u>rise</u> in interest rates	660k	£10m
One-year revenue impact of a 1% <u>fall</u> in interest rates	-£900k	-£10m

46. **Maturity structure of borrowing:** This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

	Actual 31/03/2020	Upper limit	Lower limit	Complied
Under 12 months	3.42%	100%	0%	Yes
12 months and within 5 years	11.43%	50%	0%	Yes
5 years and within 10 years	6.44%	50%	0%	Yes
10 years and within 20 years	20.13%	50%	0%	Yes
20 years and within 40 years	32.43%	50%	0%	Yes
40 years and longer	26.15%	50%	0%	Yes

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

47. **Principal sums invested for periods longer than a year:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

	Actual	Limit	
Price risk indicator	31/03/2020	2020/21	2021/22
Principal invested beyond year end	£244m	£300m	£300m

RECOMMENDATION

48. The County Council is asked to note the report

Alison Mings
Treasury and Investments Manager
Alison.mings@kent.gov.uk
Ext: 03000 416488