Treasury Management Report Q1 2019/20

Introduction

In March 2012 the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports. This quarterly report provides an additional update.

The Authority's treasury management strategy for 2019/20 was approved by full Council on 6th March 2019. The Authority has 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. The successful identification, monitoring and control of risk remains central to the Authority's treasury management strategy.

The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 6th March 2019.

External Context

Economic background: UK Consumer Price Inflation (CPI) for June 2019 was 2.0% year/year, coming in at consensus and meeting the Bank of England's inflation target. The most recent labour market data for the three months to May 2019 showed the unemployment rate remain at a low of 3.8% while the employment rate of 76.0% dipped by 0.1%, the first quarterly decrease since June to August 2018. The 3-month average annual growth rate for pay excluding bonuses was 3.6% as wages continue to rise steadily and provide some upward pressure on general inflation. Once adjusted for inflation, real wages were up 1.7%.

There was a rise in quarterly GDP growth in the first calendar quarter for 2019 to 0.5%, from 0.2% in Q4 2018 with stockpiling ahead of the (now delayed) 29th March Brexit distorting data. Production and construction registered positive output and growth, however at the end of June 2019, seasonally adjusted Markit UK Construction PMI (Purchasing Manager's Index) logged a record-low figure of 43.1, suggesting that construction has suffered a largest contraction in output since April 2009. GDP growth was 1.8% year/year, however with the service sector slowing and a weaker global backdrop the outlook was for subdued growth.

Politics has been a big driver over the last quarter. The 29th March Brexit deadline was extended to 12th April and then to 31st October 2019: there is still no clear consensus as to the terms on which the UK will leave the EU. Theresa May announced her resignation as Prime Minister and leader of the Conservative Party in May and the leadership contest for her successor is ongoing with Boris Johnson the current favourite.

The struggling British high street has continued to dominate headlines with the Arcadia group being saved from collapse in June following an agreement for rent reductions from landlords. The car industry has also struggled in the UK and beyond with announcements of cuts to 12,000 jobs across Europe by Ford.

With the deterioration in the wider economic environment, compounded by Brexit-related uncertainty and the risk of a no-deal Brexit still alive, the speech by Bank of England Governor Mark Carney in early July signalled a major shift to the Bank's rhetoric and increased the

possibility of interest rate cuts, rather the Bank's erstwhile 'gradual and limited' rate hike guidance.

Globally, tensions between the US and China became progressively more fraught with US President Donald Trump threatening to more than double tariffs on some Chinese goods. There were also moves in both the US and UK to block or restrict access to markets by Chinese telecoms giant Huawei. Amid low inflation and a weak economy in the Eurozone Mario Draghi signalled in late June that another round of stimulus (QE) may be likely. The US and EU have also carved the path for interest rates to be cut in the future.

Financial markets: 2018 was a year to forget in terms of performance of riskier asset classes, most notably equities. However, since the beginning of 2019 markets have rallied, and the FTSE 100 is up over 10% in pure price terms for the first 6 months of the calendar year. Nearly all of these gains were realised in the last quarter of FY 2018/19, as Q1 2019/20 has only seen a modest increase of around 2%.

Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. Gilt yields fell - the 5-year benchmark gilt yield falling to 0.63% at the end of June from 0.75% at the start of April. There were falls in the 10-year and 20-year gilts over the same period dropping from 1.00% to 0.83% and from 1.47% to 1.35% respectively. Money markets rates stabilised with 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.60%, 0.68% and 0.92% respectively over the period.

Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth is not just a UK phenomenon but a global risk. The US yield curve inverted (10-year Treasury yields were lower than US 3-month money market rates) in March 2019 and this relationship remained and broadened throughout the period. History has shown that a recession hasn't been far behind a yield curve inversion. Germany sold 10-year Bunds at -0.24% in June, the lowest yield on record. Bund yields had been trading at record lows in the secondary market for some time, however the negative yield in the primary market suggests that if investors were to hold until maturity, they are guaranteed to sustain a loss - highlighting the uncertain outlook for Europe's economy.

Credit background: Credit Default Swap (CDS) spreads fell slightly across the board during the quarter, continuing to remain low in historical terms. After hitting around 97bps at the start of the period, the spread on non-ringfenced bank NatWest Markets plc fell back to around 82bps at the end of June, while for the ringfenced entity, National Westminster Bank plc, the spread fell from 67bps to 58bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 28 and 59bps at the end of the period.

S&P upgraded RBS Group and its subsidiaries, including National Westminster Bank PLC, Natwest Markets PLC, The Royal Bank of Scotland and Ulster Bank Ltd. S&P raised the long-term issuer ratings by one notch due to RBS Group's strengthened credit fundamentals following a long period of restructuring. S&P believes the group and its subsidiaries have enhanced their capacity to manage the current UK political and economic uncertainties.

There were minimal other credit rating changes during the period. Moody's revised the outlook on Barclays Bank PLC to positive from stable to reflect the bank's progress in its restructuring plans, including de-risking the balance sheet, improving its risk profile and profitability and resolving litigation issues in the US. Moody's also revised the outlook to stable from negative for Goldman Sachs International Bank, reflecting a slowdown in loan growth as well as a stronger revenue growth for sales and trading.

Local Context

On 31st March 2019, the Authority had net borrowing of £52m arising from its revenue and capital income and expenditure. 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. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31.3.19 Actual £000
General Fund CFR	57,865
HRA CFR	71,912
Total CFR	**129,777**
Less: Usable reserves	(69,514)
Less: Working capital	(7,951)
Net borrowing	**52,312**

The Authority pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

The treasury management position at 30th June 2019 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.19 Balance £000	**Movement £000**	**30.6.19 Balance £000**	**30.6.19 Rate %**
Long-term borrowing	77,999	0	77,999	
Short-term borrowing	25,794	(6,500)	19,294	
Total borrowing	**103,793**	**(6,500)**	**97,293**	**3.36%**
Long-term investments	47,496	504	48,000	
Short-term investments	4	1	5	
Cash and cash equivalents	3,981	(2,301)	1,680	
Total investments	**51,481**	**(4,796)**	**46,685**	**3.74%**
Net borrowing	**(52,312)**		**(50,608)**	

£6.5m of short term borrowing repaid in the quarter. The long term investments are valued at their fair value at 31.3.19 for accounting purposes; the adjustment of £504k is added back to the investments for 30.6.19. The reduction in cash and cash equivalents is due to normal cash flow fluctuations.

Borrowing Strategy during the period

At 30th June 2019 the Authority held £97.3m of loans, a decrease of £6.5m since 31st March 2019, as part of its cashflow management strategy for funding previous years' capital programmes. Outstanding loans on 30th June are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.19 Balance £000	Net Movement £000	30.6.19 Balance £000	30.6.19 Weighted Average Rate %
Public Works Loan Board	80,293	0	80,293	3.36%
Local authorities (short-term)	23,500	6,500	17,000	0.85%
Total borrowing	**103,793**		**97,293**	

The Authority'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 Authority's long-term plans change being a secondary objective.

In keeping with these objectives, no new borrowing was undertaken in the quarter. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

With short-term interest rates remaining much lower than long-term rates, the Authority considered it to be more cost effective in the near term to use internal resources or borrowed rolling temporary / short-term loans instead.

As the Authority has an increasing CFR due to the capital programme and an estimated borrowing requirement as determined by the Liability Benchmark which also takes into account usable reserves and working capital.

Treasury Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances ranged between £47.9 and £49.7 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.19 Balance £000	Net Movement £000	30.6.19 Balance £000	30.6.19 Income Return %
Banks & building societies (unsecured)	347	9	356	0.10%
Money Market Funds	3,638	(2,309)	1,329	0.71%
Other Pooled Funds:				
- Short-dated bond funds	7,981	19	8,000	0.97%
- Strategic bond funds	7,908	92	8,000	4.74%
- Property funds	5,834	166	6,000	4.07%
- Multi asset income funds	25,773	227	26,000	5.00%
Other Pooled Funds Sub-Total	47,496	504	48,000	
Total investments	**51,481**	**(1,796)**	**49,685**	

The balance of the other pooled funds at 31.3.19 includes accounting adjustments of £504k for unrealised losses, which were included at year-end for statutory reporting purposes (and separately reversed out through a non-useable reserve, as permitted).

Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Authority'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.

Given the increasing risk and low returns from short-term unsecured bank investments, the Authority has diversified into more secure and/or higher yielding asset classes as shown in table 4 above. £48m that is available for longer-term investment was moved from bank and building society deposits into pooled Investment funds. As a result, investment risk was diversified.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	**Credit Rating**	**Bail-in Exposure**	**Weighted Average Maturity (days)**	**Rate of Return %**
31.03.2019	4.46	AA-	100%	1	3.19
30.06.2019	4.52	A+	100%	1	3.71
Similar LAs	**4.28**	**AA-**	**63%**	**81**	**1.74%**
All LAs	**4.31**	**AA-**	**62%**	**28**	**1.41%**

£48m of the Authority's investments are held in externally managed strategic pooled funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds generated an average total return of 4.74%, comprising a 3.82% income return which is used to support services in year, and 0.92% of capital growth.

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 Authority's investment objectives are regularly reviewed. 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. In light of their performance and the Authority's latest cash flow forecasts, investment in these funds has been maintained.

Readiness for Brexit: The scheduled leave date for the UK to leave the EU is now 31st October 2019 and there remains little political clarity as to whether a deal will be agreed by this date, the potential of a no-deal Brexit has not been ruled out. Particularly as this new leave date approaches the Authority will ensure there are enough accounts open at UK-domiciled banks and Money Market Funds to hold sufficient liquidity and that its account with the Debt Management Account Deposit Facility (DMADF) remains available for use in an emergency.

Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

Following the approval of the Property Investment Strategy in November 2016, work continues to identify and progress suitable investments to deliver economic regeneration and to generate additional income streams for the future. Additionally, the Property Investment team continues to work on a number of residential developments both utilising DDC owned properties and land, as well as with external developers.

In 2018/19 total income (rent and service charges) of £1.97m was received from the investments made to date, including B&Q, Whitfield Court, Castle Street, garages and shops. Costs including management costs, minimum revenue provision and short term borrowing of £880k were incurred resulting in retained income for the General Fund of £1.1m. These costs were £360k lower than the 2018/19 budget as no long term borrowing has yet been undertaken to fund the investments with the costs being covered by cash flow and short term borrowing as required. This saving was transferred to earmarked reserves in 2018/19 to allow for possible future void periods and support further investment opportunities.

The 2019/20 budget includes a forecast of total income (rent and service charges) of £1.97m. Costs including management costs, minimum revenue provision and term borrowing of £1.37m are forecast resulting in retained income for the General Fund of £600k.

Treasury Performance

The Authority measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in table 6 below.

Table 6: Performance

	Actual £000	Budget £000	Over/ under	Actual %	Benchmark %	Over/ under
Interest Received	1,734	1,824	(90)	3.74	0.76	2.98
Interest Payable	2,762	2,762	0	3.36	3.36	0

Compliance

The Chief Finance Officer reports that all treasury management activities undertaken during the quarter complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 8 below.

Table 7: Debt Limits

	30.6.19 Actual £m	2019/20 Operational Boundary £m	2019/20 Authorised Limit £m	Complied?
Borrowing	97.3	333	338.5	✓

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Table 8: Investment Limits

	30.6.19 Actual	2019/20 Limit	Complied?
Any single organisation, except the UK Government	<£1m	£8m per bank	✓
Any group of organisations under the same ownership	**0**	£16m per group	✓
Negotiable instruments held in a broker's nominee account	**0**	£15m	✓
UK Government	**0**	Unlimited	✓
Unsecured investments with building societies	**0**	£8m	✓
Pooled Investment Funds	£48m	£10m per fund	✓
Operation bank	<£1m	£20m	✓
Money Market Funds	£1.3m	£10m per fund	✓

Treasury Management Indicators

The Authority measures and manages its exposures to treasury management risks using the following indicators.

Security: The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its 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.

	30.6.19 Actual	2019/20 Target	Complied?
Portfolio average credit rating	4.52	6	✓

Liquidity: The Authority 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 excluding deposits due back < 3 months.

	30.6.19 Actual	2019/20 Target	Complied?
Total cash available within 3 months	£9.7m	£8m	✓

Interest Rate Exposures: This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interests was:

Interest rate risk indicator	30.6.19 Actual £000	2019/20 Limit £000	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	496	600	✓
Upper limit on one-year revenue impact of a 1% fall in interest rates	496	600	✓

The impact of a change in interest rates is calculated on the assumption that maturing loans and investment will be replaced at current rates.

Maturity Structure of Borrowing: This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	30.6.19 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	£19.3m	25%	0%	✓
12 months and within 24 months	£3.5m	50%	0%	✓
24 months and within 5 years	£7.7m	50%	0%	✓
5 years and within 10 years	£15.5m	100%	0%	✓
10 years and above	£51.2m	100%	0%	✓

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.

Principal Sums Invested for Periods Longer than a year: The purpose of this indicator is to control the Authority'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 were:

	2019/20	2020/21	2021/22
Actual principal invested beyond year end	0	0	0
Limit on principal invested beyond year end	£30m	£30m	£30m
Complied?	✓	✓	✓

Outlook for the remainder of 2019/20

Having increased interest rates by 0.25% in November 2018 to 0.75%, the Bank of England's Monetary Policy Committee (MPC) is now expected to maintain Bank Rate at this level for the foreseeable future. There are, however, upside and downside risks to this forecast, dependant on Brexit outcomes and the evolution of the global economy.

The resignation of Theresa May has added further political uncertainty. Boris Johnson appears to be the frontrunner to become Prime Minister and also appears to favour exiting the EU on 31st October. It is unlikely the UK will be able to negotiate a different withdrawal deal before the deadline.

With the downside risks to the UK economy growing and little likelihood of current global trade tensions being resolved imminently and global growth recovering soon thereafter, our treasury advisor Arlingclose's central forecast is for that the Bank of England's MPC will maintain Bank Rate at 0.75% but will stand ready to cut rates should the Brexit process engender more uncertainty for business and consumer confidence and for economic activity.

	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50
Arlingclose Central Case	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Downside risk	0.00	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50

Gilt yields have fallen to recent lows. Resolution of global political uncertainty would see yields rise but volatility arising from both economic and political events continue to offer longer-term borrowing opportunities for those clients looking to lock in some interest rate certainty.