

## Treasury Management Report Q2 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.

The Authority's treasury management strategy for 2019/20 was approved at a meeting on 6<sup>th</sup> 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 6<sup>th</sup> March 2019.

### External Context

**Economic background:** UK Consumer Price Inflation (CPIH) fell to 1.7% year/year in August 2019 from 2.0% in July, weaker than the consensus forecast of 1.9% and below the Bank of England's target. The most recent labour market data for the three months to July 2019 showed the unemployment rate edged back down to 3.8% while the employment rate remained at 76.1%, the joint highest since records began in 1971. Nominal annual wage growth measured by the 3-month average excluding bonuses was 3.8% and 4.0% including bonuses. Adjusting for inflation, real wages were up 1.9% excluding bonuses and 2.1% including.

The Quarterly National Accounts for Q2 GDP confirmed the UK economy contracted by 0.2% following the 0.5% gain in Q1 which was distorted by stockpiling ahead of Brexit. Only the services sector registered an increase in growth, a very modest 0.1%, with both production and construction falling and the former registering its largest drop since Q4 2012. Business investment fell by 0.4% (revised from -0.5% in the first estimate) as Brexit uncertainties impacted on business planning and decision-making.

Politics, both home and abroad, continued to be a big driver of financial markets over the last quarter. Boris Johnson won the Conservative Party leadership contest and has committed to leaving the EU on 31<sup>st</sup> October regardless of whether a deal is reached with the EU. Mr Johnson prorogued Parliament which led some MPs to put forward a bill requiring him to seek a Brexit extension if no deal is in place by 19th October. The move was successful and, having been approved by the House of Lords, was passed into law. The Supreme Court subsequently ruled Mr Johnson's suspension of Parliament unlawful.

Tensions continued between the US and China with no trade agreement in sight and both countries imposing further tariffs on each other's goods. The US Federal Reserve cut its target Federal Funds rates by 0.25% in September to a range of 1.75% - 2%, a pre-emptive move to maintain economic growth amid escalating concerns over the trade war and a weaker economic environment leading to more pronounced global slowdown. The euro area Purchasing Manager Indices (PMIs) pointed to a deepening slowdown in the Eurozone. These elevated concerns have caused key government yield curves to invert, something seen by many commentators as a predictor of a global recession. Market expectations are for further interest rate cuts from the Fed and in September the European

Central Bank reduced its deposit rate to -0.5% and announced the recommencement of quantitative easing from 1<sup>st</sup> November.

The Bank of England maintained Bank Rate at 0.75% and in its August Inflation Report noted the deterioration in global activity and sentiment and confirmed that monetary policy decisions related to Brexit could be in either direction depending on whether or not a deal is ultimately reached by 31<sup>st</sup> October.

**Financial markets:** After rallying early in 2019, financial markets have been adopting a more risk-off approach in the following period as equities saw greater volatility and bonds rallied (prices up, yields down) in a flight to quality and anticipation of more monetary stimulus from central banks. The Dow Jones, FTSE 100 and FTSE 250 are broadly back at the same levels seen in March/April.

Gilt yields remained volatile over the period on the back of ongoing economic and political uncertainty. From a yield of 0.63% at the end of June, the 5-year benchmark gilt yield fell to 0.32% by the end of September. There were falls in the 10-year and 20-year gilts over the same period, with the former dropping from 0.83% to 0.55% and the latter falling from 1.35% to 0.88%. 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.65%, 0.75% and 1.00% respectively over the period.

Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth remains a global risk. The US yield curve remains inverted with 10-year Treasury yields lower than US 3-month bills. History has shown that a recession hasn't been far behind a yield curve inversion. Following the sale of 10-year Bunds at -0.24% in June, yields on German government securities continue to remain negative in the secondary market with 2 and 5-year securities currently both trading around -0.77%.

**Credit background:** Credit Default Swap (CDS) spreads rose and then fell again during the quarter, continuing to remain low in historical terms. After rising to almost 120bps in May, the spread on non-ringfenced bank NatWest Markets plc fell back to around 80bps by the end of September, while for the ringfenced entity, National Westminster Bank plc, the spread remained around 40bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 34 and 76bps at the end of the period.

There were minimal credit rating changes during the period. Moody's upgraded The Co-operative Bank's long-term rating to B3 and Fitch upgraded Clydesdale Bank and Virgin Money to A-.

### **Local Context**

On 31<sup>st</sup> 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**

	<b>31.3.19 Actual £m</b>
General Fund CFR	57,865
HRA CFR	71,912
<b>Total CFR</b>	<b>129,777</b>
Less: Usable reserves	(69,514)

Less: Working capital	(7,951)
<b>Net borrowing</b>	<b>52,312</b>

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 30<sup>th</sup> September 2019 and the change during the year is shown in Table 2 below.

**Table 2: Treasury Management Summary**

	<b>31.3.19 Balance £m</b>	<b>Movement £m</b>	<b>30.9.19 Balance £m</b>	<b>30.9.19 Rate %</b>
Long-term borrowing	77,999		77,999	
Short-term borrowing	25,794	(7,638)	18,156	
<b>Total borrowing</b>	<b>103,793</b>		<b>96,155</b>	<b>3.36%</b>
Long-term investments	47,496	504	48,000	
Short-term investments	4	1	5	
Cash and cash equivalents	3,981	1,944	5,925	
<b>Total investments</b>	<b>51,481</b>	<b>2,449</b>	<b>53,930</b>	<b>3.09%</b>
<b>Net borrowing</b>	<b>(52,312)</b>		<b>(42,225)</b>	

£6.5m of short term borrowing repaid since 31.3.19 and £1.1m repayment made to the HRA self-financing loan in September. 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 30.3.19. The increase in cash and cash equivalents is due to normal cash flow fluctuations.

#### **Borrowing Strategy during the period**

At 30<sup>th</sup> September 2019 the Authority held £96.2m of loans, a decrease of £7.6m 31<sup>st</sup> March 2019, as part of its strategy for funding previous years' capital programmes. Outstanding loans on 30<sup>th</sup> September are summarised in Table 3 below.

**Table 3: Borrowing Position**

	<b>31.3.19 Balance £m</b>	<b>Net Movement £m</b>	<b>30.9.19 Balance £m</b>	<b>30.9.19 Weighted Average Rate %</b>
Public Works Loan Board	80,293	(1,138)	79,155	3.36%
Local authorities (short-term)	23,500	(6,500)	17,000	0.84%
<b>Total borrowing</b>	<b>103,793</b>		<b>96,155</b>	

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.

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 £48.1 and £53.9 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	<b>31.3.19 Balance £m</b>	<b>Net Movement £m</b>	<b>30.9.19 Balance £m</b>	<b>30.9.19 Income Return %</b>
Banks & building societies (unsecured)	347	(265)	82	0.10%
Money Market Funds	3,638	2,210	5,848	0.71%
Other Pooled Funds:				
- Short-dated bond funds	7,981	19	8,000	0.97%
- Strategic bond funds	7,908	92	8,000	2.57%
- Property funds	5,834	166	6,000	4.24%
- Multi asset income funds	25,773	227	26,000	4.56%
Other Pooled Funds Sub-Total	47,496	504	48,000	
<b>Total investments</b>	<b>51,481</b>	<b>2,449</b>	<b>53,930</b>	

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 is currently invested in pooled investment funds rather than bank or building society deposits. 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
30.09.2019	4.88	A+	100%	1	3.01
<b>Similar LAs</b>	<b>4.26</b>	<b>AA-</b>	<b>61%</b>	<b>80</b>	<b>1.68</b>
<b>All LAs</b>	<b>4.28</b>	<b>AA-</b>	<b>62%</b>	<b>28</b>	<b>1.34</b>

£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 4.52%, comprising 3.30% income return which is used to support services in year, and 1.23% 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

Readiness for Brexit: The scheduled leave date for the UK to leave the EU is now 31<sup>st</sup> October 2019 and there remains little political clarity as to whether a deal will be agreed by this date and there is the possibility that the exit date is pushed back yet again. As 31<sup>st</sup> October approaches the Authority will ensure there are enough accounts open at UK-domiciled banks and Money Market Funds to hold sufficient liquidity required in the near term 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	1,675	1,824	(149)	3.09	0.67	2.42
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

	30.9.19 Actual £m	2019/20 Operational Boundary £m	2019/20 Authorised Limit £m	Complied?
Borrowing	96.1	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

	30.9.19 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	£5.8m	£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.

	30.9.19 Actual	2019/20 Target	Complied?
Portfolio average credit rating	4.88	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.

	30.9.19 Actual	2019/20 Target	Complied?
Total cash available within 3 months	£5.9m	£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	30.9.19 Actual	2019/20 Limit	Complied?
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	539	600	✓
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	539	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:

	<b>30.9.19 Actual</b>	<b>Upper Limit</b>	<b>Lower Limit</b>	<b>Complied?</b>
Under 12 months	18.2m	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	£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:

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



