

Treasury Management Report Q3 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 at a meeting 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: The headline rate of UK Consumer Price Inflation remained unchanged in November 2019 at 1.5% year-on-year, the same as October 2019, as accommodation services and transport continued to pull the level of inflation below the Bank of England target of 2%. Labour market data remained positive. The ILO unemployment rate continued to hold at historic lows at 3.8%, its lowest level since 1975. The 3-month average annual growth rate for pay excluding bonuses rose to 3.5% in November 2019 providing some evidence that a shortage of labour is supporting wages. However, adjusting for inflation this means real wages were only up by 0.9%.

The Quarterly National Accounts for Q3 GDP showed the UK economy expanded by 0.4% following the 0.2% contraction in Q1. Construction rebounded by 1.2%, reversing the fall of the same magnitude in the previous quarter, while growth in the services sector was up 0.5%, beating the 0.1% gain in Q2. Production increased by a more modest 0.1% and agriculture fell 0.1%. On an annual basis, GDP growth continued to fall further below its trend rate, slipping to 1.1% from 1.2%.

Politics continued to play a major role in financial markets over the period as the UK's progress negotiating its exit from the European Union together with its future trading arrangements has driven volatility, particularly in foreign exchange markets. Following the General Election in December, the new government will now progress with achieving Brexit on 31st January 2020, but the subsequent limited Brexit transitional period, which the government is seeking to enforce, will result in continuing economic uncertainty.

The Bank of England maintained Bank Rate to 0.75% in December following a 7-2 vote by the Monetary Policy Committee. Despite keeping rates on hold, MPC members did confirm that if Brexit uncertainty drags on or global growth fails to recover, they are prepared to cut interest rates as required. Moreover, the downward revisions to some of the growth projections in the Monetary Policy Report (formerly the Quarterly Inflation Report) suggest the Committee may now be less convinced of the need to increase rates even if there is a Brexit deal.

The fallout from the US-China trade war continued and is likely to drag on global growth in 2020, however it has been reported that Phase I of the deal will be signed at the White House on 15th January. The US economy continued to perform relatively well compared to other developed

nations; however, the Federal Reserve started to unwind its monetary tightening through 2019. The Fed has cut rates three times to 1.5% - 1.75%, to stimulate growth as GDP continued to slow.

Slow economic growth in Europe continued and Christine Lagarde took control as the head of the European Central Bank. In her first announcement as ECB chief, Ms Lagarde confirmed that the bank would continue to provide the monetary support needed to bring euro area inflation back towards target.

Financial markets: Financial markets adopted a more risk-on approach over the quarter as equities rallied in expectation of ongoing monetary stimulus from central banks. The Dow Jones ended the 2019 calendar year up 22%, while the FTSE 100 and FTSE 250 jumped on the UK general election result with the former gaining 12% during 2019 and the latter around 25%.

Gilt yields remained volatile over the period. From 0.28% at the end of September, the 5-year benchmark gilt rose to 0.60% by the end of December. There were rises in the 10-year and 20-year gilts over the same period, with the former climbing from 0.48% to 0.82% and the latter from 0.88% to 1.24%. 1-month, 3-month and 12-month SONIA (Sterling Overnight Index Average) bid rates averaged 0.63%, 0.76% and 0.93% respectively over the period.

The US yield curve returned to 'normal' over the period with 2-year ending 2019 at 1.56% and the 10-year at 1.91%. German bunds continued to remain firmly negative with the 10-year ending 2019 at -0.19% with 2 and 5-year securities ending at -0.61% and -0.46% respectively.

Credit background: Credit Default Swap (CDS) spreads fell over the quarter. Non-ringfenced bank NatWest Markets plc CDS fell to 50 basis points at the end of December from over 80bp in September, while for the ringfenced entity, National Westminster Bank plc, the spread fell to around 30bp. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 29 and 50bp at the end of the quarter.

Fitch affirmed the UK's AA sovereign rating, removed it from Rating Watch Negative (RWN) and assigned a negative outlook. Fitch then affirmed UK banks' long-term ratings, removed the RWN and assigned a stable outlook. Standard & Poor's also affirmed the UK sovereign AA rating and revised the outlook to stable from negative.

Moody's revised HSBC Bank's outlook to negative from stable as it expects restructuring costs to negatively impact net income over the next year or two.

The Bank of England announced its latest stress tests results for the main seven UK banking groups. All seven passed on both a common equity Tier 1 (CET1) ratio and a leverage ratio basis. Under the test scenario the banks' aggregate level of CET1 capital would remain twice their level before the 2008 financial crisis.

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 31st December 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	31.12.19 Balance £000	31.12.19 Rate %
Long-term borrowing	77,999		77,999	
Short-term borrowing	25,794	(10,638)	15,156	
Total borrowing	103,793		91,155	3.36%
Long-term investments	47,496	2,504	50,000	
Short-term investments	4	1	5	
Cash and cash equivalents	3,981	1,379	5,360	
Total investments	51,481	3,884	55,365	3.03%
Net borrowing	(52,312)		(35,790)	

£11.5m 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; an additional £2m was invested in pooled investment funds on the 16.12.19. The increase in cash and cash equivalents is due to normal cash flow fluctuations.

Borrowing Strategy during the period

On 9th 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 currently available and new products will be developed; however, the financial strength of individual authorities will be scrutinised by investors and commercial lenders.

Short-term “local to local” funding is available at around Bank Rate of 0.75% and 1-year money around 1.1%.

At 31st December 2019 the Authority held £91.5m of loans, a decrease of £10.6m 31st March 2019, as part of its strategy for funding previous years’ capital programmes. Outstanding loans on 31st December 2019 are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.19 Balance £000	Net Movement £000	31.12.19 Balance £000	31.12.19 Weighted Average Rate %
Public Works Loan Board	80,293	(1,138)	79,155	3.36%
Local authorities (short-term)	23,500	(11,500)	12,000	0.84%
Total borrowing	103,793		91,155	

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 £56.2 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	31.12.19 Balance £000	31.12.19 Income Return %
Banks & building societies (unsecured)	347	3,209	3,556	0.18%
Money Market Funds	3,638	(1,829)	1,809	0.71%
Other Pooled Funds:				
- Short-dated bond funds	7,981	19	8,000	0.99%
- Strategic bond funds	7,908	92	8,000	2.48%
- Property funds	5,834	166	6,000	4.19%
- Multi asset income funds	25,773	2,227	28,000	4%
Other Pooled Funds Sub-Total	47,496	2,504	50,000	
Total investments	51,481	3,884	55,365	

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. £50m that is available for longer-term investment was moved from bank and building society deposits 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	4.86	AA-	100%	1	3.19
31.12.2019	4.98	A+	100%	1	3.16
Similar LAs	4.11	AA-	63%	62	1.75
All LAs	4.11	AA-	60%	28	1.43

£50m 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 6.69%, comprising a 3.46% income return which is used to support services in year, and 3.23% 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 increased by £2m.

Readiness for Brexit: Following the vote in parliament in favour of Prime Minister Boris Johnson's Brexit Withdrawal Agreement Bill, the UK is fully expected to leave the EU on the scheduled leave date of 31st January 2020 and enter into a post-Brexit transition period. The bill would also ban an extension to this transition period which means if a trade deal cannot be reached by 31st December 2020 the UK would then be forced to trade with the EU under a no-deal scenario. As this new leave date approaches, the Authority will ensure there are enough accounts open with UK-domiciled banks and Money Market Funds to hold sufficient liquidity and that its Debt Management Account Deposit Facility (DMADF) remains available for use in an emergency.

In November 2019 the Welsh Government published new Statutory Guidance on Local Government Investments to be effective from the 2020/21 financial year. This involves a complete re-write along the lines of the guidance issued last year by the Ministry of Housing, Communities and Local Government (MHCLG) for local authorities in England.

The definition of investments is widened to include "all of the financial and non-financial assets a local authority has invested money into primarily or partially for the purpose of generating a surplus including investment property" providing it has been made using the power to invest contained in the Local Government Act 2003. In addition, loans to wholly-owned companies or associates, to a joint venture, or to a third party count as investments, irrespective of the purpose or legal power used.

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 the Investment Guidance issued by Ministry of Housing, Communities and Local Government's (MHCLG) and Welsh Government, 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	1,678	1,824	146	3.03	0.66	2.37
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 7 below.

Table 7: Debt Limits

	31.12.19 Actual £m	2019/20 Operational Boundary £m	2019/20 Authorised Limit £m	Complied?
Borrowing	91.1	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

	31.12.19 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	£50m	£10m per fund	✓

Operational bank	£3.5m	£20m	✓
Money Market Funds	£1.8m	£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.

	31.12.19 Actual	2019/20 Target	Complied?
Portfolio average credit rating	4.98	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.

	31.12.19 Actual	2019/20 Target	Complied?
Total cash available within 3 months	£5.4m	£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	31.12.19 Actual £000	2019/20 Limit £000	Complied?
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	554	600	✓
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	554	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:

	31.12.19 Actual £m	Upper Limit	Lower Limit	Complied?
Under 12 months	13.2	25%	0%	✓
12 months and within 24 months	3.5	50%	0%	✓

24 months and within 5 years	7.7	50%	0%	✓
5 years and within 10 years	15.5	100%	0%	✓
10 years and above	51.2	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

The global economy continues to slow on the back of ongoing geopolitical issues, primarily the trade policy stance of the US and its spat with China. However, it has been reported that Phase I of a trade deal between the two countries will be signed on 15th January 2020.

The UK economy continues to slow due to both post-Brexit uncertainty and the downturn in global activity. In response, global and UK interest rate expectations have eased. Central bank actions and geopolitical risks will continue to produce significant volatility in financial markets over the period, including bond markets.

Parliament passed Prime Minister Boris Johnson's Withdrawal Agreement Bill and the UK will now exit the EU on 31st January 2020. The bill also rules out an extension to the transition period for agreeing a trade deal which means a no-deal Brexit cannot be entirely ruled out for 2020.

Our treasury advisor Arlingclose expects Bank Rate to remain at 0.75% for the foreseeable future but there remain substantial risks to this forecast, dependant on Brexit/trade deal outcomes as well as the evolution of the global economy. Arlingclose also expects gilt yields to remain at low levels for the foreseeable future and judges the risks to be weighted to the downside.

	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
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	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75