Treasury Management Q4 Outturn Report 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 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.

Treasury risk management at the Authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the Authority's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

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 UK's exit from the European Union and future trading arrangements, had remained one of major influences on the UK economy and sentiment during 2019/20. The 29th March 2019 Brexit deadline was extended to 12th April, then to 31st October and finally to 31st 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.

The headline rate of UK Consumer Price Inflation UK Consumer Price Inflation fell to 1.7% y/y in February, below the Bank of England's target of 2%. Labour market data remained positive. The ILO unemployment rate was 3.9% in the three months to January 2020 while the employment rate hit a record high of 76.5%. The average annual growth rate for pay excluding bonuses was 3.1% in January 2020 and the same when bonuses were included, providing some evidence that a shortage of labour had been supporting wages.

GDP growth in Q4 2019 was reported as flat by the Office for National Statistics and service sector growth slowed and production and construction activity contracted on the back of what at the time were concerns over the impact of global trade tensions on economic activity. The annual rate of GDP growth remained below-trend at 1.1%.

Then coronavirus swiftly changed everything. COVID-19, which had first appeared in China in December 2019, started spreading across the globe causing plummeting sentiment and falls in financial markets not seen since the Global Financial Crisis as part of a flight to quality into sovereign debt and other perceived 'safe' assets.

In response to the spread of the virus and sharp increase in those infected, the government enforced lockdowns, 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.

The Bank of England, which had held policy rates steady at 0.75% through most of 2019/20, moved in March to cut rates to 0.25% from 0.75% and then swiftly thereafter brought them down further to the record low of 0.1%. In conjunction with these cuts, the UK government 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 US economy grew at an annualised rate of 2.1% in Q4 2019. After escalating trade wars and a protracted standoff, the signing of Phase 1 of the trade agreement between the US and China in January was initially positive for both economies, but COVID-19 severely impacted sentiment and production in both countries. Against a slowing economic outlook, the US Federal Reserve began cutting rates in August. Following a series of five cuts, the largest of which were in March 2020, the Fed Funds rate fell from of 2.5% to range of 0% - 0.25%. The US government also unleashed a raft of COVID-19 related measures and support for its economy including a $2 trillion fiscal stimulus package. With interest rates already on (or below) the floor, the European Central Bank held its base rate at 0% and deposit rate at -0.5%.

Financial markets: Financial markets sold off sharply as the impact from the coronavirus worsened. After starting positively in 2020, the FTSE 100 fell over 30% at its worst point with stock markets in other countries seeing similar huge falls. In March sterling touch its lowest level against the dollar since 1985. The measures implemented by central banks and governments helped restore some confidence and financial markets have rebounded in recent weeks but remain extremely volatile. The flight to quality caused gilts yields to fall substantially. The 5-year benchmark falling from 0.75% in April 2019 to 0.26% on 31st March. The 10-year benchmark yield fell from 1% to 0.4%, the 20-year benchmark yield from 1.47% to 0.76% over the same period. 1-month, 3-month and 12-month bid rates averaged 0.61%, 0.72% and 0.88% respectively over the period.

Since the start of the calendar 2020, the yield on 2-year US treasuries had fallen from 1.573% to 0.20% and from 1.877% to 0.61% for 10-year treasuries. German bund yields remain negative.

Credit review: In Q4 2019 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. 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.

After remaining flat in January and February and between a range of 30-55bps, Credit Default Swap spreads rose sharply in March as the potential impact of the coronavirus on bank balance sheets gave cause for concern. Spreads declined in late March and through to mid-April but remain above their initial 2020 levels. NatWest Markets Plc (non-ringfenced) remains the highest at 128bps and National Westminster Bank Plc (ringfenced) still the lowest at 56bps. The other main UK banks are between 65bps and 123bps, with the latter being the thinly traded and volatile Santander UK CDS.

While the UK and Non-UK banks on the Arlingclose counterparty list remain in a strong and well-capitalised position, the duration advice on all these banks was cut to 35 days in mid-March.

Fitch downgraded the UK sovereign rating to AA- in March which was followed by a number of actions on UK and Non-UK banks. This included revising the outlook on all banks on the counterparty list to negative, with the exception of Barclays Bank, Rabobank, Handelsbanken and Nordea Bank which were placed on Rating Watch Negative, as well as cutting Close Brothers long-term rating to

A-. Having revised their outlooks to negative, Fitch upgraded the long-term ratings on Canadian and German banks but downgraded the long-term ratings for Australian banks. HSBC Bank and HSBC UK Bank, however, had their long-term ratings increased by Fitch to AA-.

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	57,685
HRA CFR	71,912
Total CFR	**129,777**
Less: Usable reserves	(69,514)
Less: Working capital	(7,951)
Net borrowing	**52,312**

* finance leases, PFI liabilities and transferred debt that form part of the Authority's total debt

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 March 2020 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.19 Balance £000	**Movement £000**	**31.3.20 Balance £000**	**31.3.20 Rate %**
Long-term borrowing	77,999	(2,367)	75,632	
Short-term borrowing	25,794	5,573	31,367	
Total borrowing	**103,793**	**3,206**	**106,999**	**3.36**
Long-term investments	47,496	(2,020)	45,476	
Short-term investments	4	0	4	
Cash and cash equivalents	3,981	6,673	10,624	
Total investments	**51,481**	**4,623**	**56,104**	**2.97**
Net borrowing	**(52,312)**			

An additional £29m of short-term borrowing taken out in March to support cash flow management over the financial year end considering the coronavirus pandemic and subsequent lockdown of the country.

The fair value of the pool investment funds was £2m lower than the previous year due to the impact of the pandemic on the underlying assets in the funds, particularly equities.

The increase £6.6m of cash and cash equivalents is due to the additional short term borrowing taken out and extra funding received from central government late in March as part of its emergency coronavirus funding package.

Borrowing Update

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

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 the value of this discount is 1% below the rate at which the authority usually borrows from the PWLB), available from 12th 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.

The consultation titled "Future Lending Terms" represents a frank, open and inclusive invitation, allowing 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.

The consultation closes on 4th June 2020 with implementation of the new lending terms expected in the latter part of this calendar year or financial year beginning 2021/22.

Borrowing strategy

At 31st March 2020 the Authority held £107m of loans, an increase of £3.2m 31st March 2019, as part of its strategy for funding previous years' capital programmes. Outstanding loans on 31st March are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.19 Balance £000	**Net Movement £000**	**31.3.20 Balance £000**	**31.3.20 Weighted Average Rate %**
Public Works Loan Board	80,293	(2,294)	77,999	3.36
Local authorities (short-term)	23,500	5,500	29,000	0.90
Total borrowing	**103,793**	**3,206**	**106,999**	

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 long term borrowing was undertaken during the year. 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 more cost effective in the near term to use internal resources or borrowed rolling temporary / short-term loans instead. The net movement in temporary / short-term loans is shown in table 3 above.

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 £60.2 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**	**31.3.20 Balance £000**	**31.3.20 Income Return %**
Banks & building societies (unsecured)	347	5,747	6,094	0.18%
Money Market Funds	3,638	896	4,534	0.36%
Other Pooled Funds:				
- *Short-dated bond funds*	7,981	(120)	7,861	0.97%
- *Strategic bond funds*	7,908	(434)	7,474	2.45%
- *Property funds*	5,834	(209)	5,625	4.19%
- *Multi asset income funds*	25,773	(1,257)	24,516	4.27%
Other Pooled Funds Sub-Total	47,496	(2,020)	45,476	
Total investments	**51,481**	**4,623**	**56,104**	

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 into pooled investment funds. As a result, investment risk was diversified.

The fair value of the pool investment funds was £2m lower than the previous year due to the impact of the pandemic on the underlying assets in the funds, particularly equities.
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 31.03.2020	4.86 4.88	AA- A+	100% 100%	1 1	3.19 2.75
Similar LAs **All LAs**	3.95 4.03	AA- AA-	59% 56%	14 14	1.55% 1.23%

£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 -4.57%, comprising a 3.32% income return which is used to support services in year, and -7.89% of unrealised capital loss.

In a relatively short period since the onset of the COVID-19 pandemic, the global economic fallout was sharp and large. Market reaction was extreme with large falls in equities, corporate bond markets and, to some extent, real estate echoing lockdown-induced paralysis and the uncharted challenges for governments, businesses and individuals. Volatility measured by the VIX index was almost as high as during the global financial crisis of 2008/9 and evidenced in plummeting equity prices and the widening of corporate bond spreads, very close to rivalling those twelve years ago. Gilt yields fell but credit spreads widened markedly reflecting the sharp deterioration in economic and credit conditions associated with a sudden stagnation in economies, so corporate bonds yields (comprised of the gilt yield plus the credit spread) rose and prices therefore fell.

The Authority is invested in bond, multi-asset and property funds. The falls in the capital values of the underlying assets were reflected in the 31st 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.

The Authority is using the alternative fair value through profit and loss (FVPL) accounting and must defer the funds' fair value losses to the Pooled Investment Fund Adjustment Account until 2023/24.

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 is 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 over the medium- / long-term and the Authority's latest cash flow forecasts, investment in these funds has been maintained.

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 2019/20 total income (rent and service charges) of £1.84m 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 £943k were incurred resulting in retained income for the General Fund of £0.90m. These costs were lower than the 2019/20 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.

The 2020/21 budget includes a forecast of total income (rent and service charges) of £1.94m. Costs including management costs, minimum revenue provision and long term borrowing of £1.30m are forecast resulting in retained income for the General Fund of £640k.

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	1,710	1,824	114	2.97	0.63	2.34
Interest Payable	2,672	2,762	0	3.36	3.36	0

Compliance

The Chief Finance Officer reports that all treasury management activities undertaken during the year 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

	31.3.20 Actual £m	2019/20 Operational Boundary £m	2019/20 Authorised Limit £m	Complied?

Borrowing	107	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

	31.3.20 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	£45.5m	£10m per fund	✓
Money Market Funds	£4.5m	£10m per fund	✓
Operational bank	£5.6m	£20m	✓

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.

	31.3.20 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.

	31.3.20 Actual	**2019/20 Target**	**Complied?**
Total cash available within 3 months	£10.6m	£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	31.3.20 Actual £000	2019/20 Limit £000	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	600	600	✓
Upper limit on one-year revenue impact of a 1% fall in interest rates	600	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:

	31.3.20 Actual £m	Upper Limit	Lower Limit	Complied?
Under 12 months	31.4	25%	0%	☒
12 months and within 24 months	3.7	50%	0%	✓
24 months and within 5 years	7.9	50%	0%	✓
5 years and within 10 years	16	100%	0%	✓
10 years and above	48	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. The indicator for under 12 months was breached at the end of March due to retaining additional cashflow funds whilst assessing the potential cashflow impact of the Coronavirus lockdown.

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?	✓	✓	✓

Other

IFRS 16: CIPFA/LASAAC has proposed delaying the implementation of the new IFRS 16 Leases accounting standard for a further year to 2021/22.