Treasury Management Report Q1 2020/21

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 2020/21 was approved at a meeting on 26th February 2020. 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 26th February 2020.

External Context

Economic background: The UK's exit from the European Union took a back seat during the first quarter of 2020/21 as the global economic impact from coronavirus took centre stage. Part of the measures taken to stop the spread of the pandemic included the government implementing a nationwide lockdown in late March which effectively shut down almost the entire UK economy. These measures continued throughout most of the quarter with only some easing of restrictions at the end of May and into June.

Bank Rate was maintained at 0.1% despite some speculation that the Bank of England's Monetary Policy Committee (MPC) might cut further and some MPC members also suggesting that negative rates are part of the Bank's policy tools. In June the Bank increased the asset purchase scheme by £100 billion, taking the recent round of QE to £300bn and total QE to £745 billion.

At the same time, the government also implemented a range of fiscal stimulus measures totalling over £300 billion which had been announced in March and designed to dampen the effect of the pandemic on the labour market.

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.

The headline rate of UK Consumer Price Inflation UK Consumer Price Inflation fell to 1.2% y/y in May, further below the Bank of England's 2% target.

In the three months to June, labour market data remained largely unchanged on the previous quarter. This is likely due to the government's furlough scheme as more than a quarter of the UK workforce was estimated to be supported by it. The ILO unemployment rate remained unchanged at 3.9% while the employment rate fell to 76.4%. However, employers will have to contribute towards furlough payments from August and the scheme is due to stop at the end of October; unemployment is expected to rise as a result.

The US economy contracted at an annualised rate of 5.0% in Q1 2020. The Federal Reserve

maintained the Fed Funds rate at between 0% and 0.25% while the US government announced a $2 trillion fiscal stimulus package. Relations between the US and China, which had briefly improved when Phase 1 of the trade agreement was signed in January, deteriorated over the quarter.

With little room to move on interest rates, the European Central Bank maintained interest rates at 0% and the rate on the deposit facility (which banks may use to make overnight deposits with the Eurosystem) at -0.5% and announced a further huge, open-ended commitment to buy €600bn of bonds under its Pandemic Emergency Purchase Programme (PEPP) which can be reinvested out to 2022. This lifted the ECB's total bond buying support package to €1.35trillion.

Financial markets: After selling off sharply in March, equity markets started recovering in April and while still down on their pre-crisis levels, the Dow Jones and FTSE 100 and 250 have made up around half of the losses. Measures implemented by central banks and governments continue to maintain some degree of general investor confidence, however volatility remains.

Ultra-low interest rates and the flight to quality continued to keep gilts yields low over the period with the yield on some short-dated government bonds turning negative. The 5-year UK benchmark gilt yield dropped from 0.18% at the beginning of April 2020 to -0.06% on 30th June. The 10-year benchmark gilt yield fell from 0.31% to 0.14% over the same period, and the 20-year from 0.69% to 0.52%. 1-month, 3-month and 12-month bid rates averaged 0.04%, 0.28% and 0.44% respectively over the quarter.

Over the quarter (April–June), the yield on 2-year US treasuries fell from 0.24% to 0.20% while that on yield on 10-year treasuries fell from 0.63% to 0.61%. German bund yields remain negative.

Credit review: After rising sharply in late March, credit default swap spreads slowly eased over the quarter but remained above their pre-crisis levels.

Fitch downgraded the UK sovereign rating to AA- in March which was followed by a number of actions on UK and also non-UK banks from early April onwards. 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 downgrading Close Brothers' long-term rating to A-. Network Rail Infrastructure and LCR Finance's long-term ratings were downgraded from AA to AA-. HSBC Bank and HSBC UK Bank were the exceptions however, with Fitch upgrading their long-term ratings to AA-.

Fitch affirmed the ratings of Canadian banks but revised their outlook to negative. The agency also downgraded the long- and short-term ratings of Australia's four largest banking groups. It upgraded the long-term deposit rating of both Bayerische Landesbank and Landesbank Baden-Wuerttemberg (LBBW) but downgraded the viability ratings, and revised outlooks to negative. Fitch later placed three Singapore banks on Rating Watch Negative.

S&P also took action on a range of UK and European banks, affirming their ratings but revising their outlook downwards due to the economic consequences of COVID-19. Moody's downgraded the long-term rating of Nationwide BS from Aa3 to A1 and S&P downgraded the long- and short-term ratings of HSBC Bank PLC and HSBC UK Bank PLC to A+ and A-1 respectively

In May, Fitch and S&P downgraded TfL's long-term rating to A+ from AA- after the 95% reduction in tube and train fares which make up 47% of TfL's revenue. However, the UK government agreed to a £1.6 billion support package which will help ease some of the stress TfL faces.

As the extent of the losses that banks and building societies will suffer due to the impact from the coronavirus epidemic remains uncertain but is expected to be substantial, in early June following Arlingclose's stress testing of the institutions on the counterparty list using bail-in analysis, a number of UK banks and building societies were suspended from the counterparty list for unsecured

deposits. Although much better capitalised than before the 2007-09 financial crisis, under the current economic circumstances these entities were suspended for reasons of prudence. For those remaining on the list, the duration advice remains up to 35 days.

Local Context

On 31st March 2020, the Authority had net borrowing of £51.9m 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

	31.3.20 Actual £000
General Fund CFR	62,506
HRA CFR	69,617
Total CFR	**132,123**
Less: Usable reserves	(71,292)
Less: Working capital	(8,897)
Net borrowing	**51,934**

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

Lower official interest rates have lowered the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The Authority pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk.

The treasury management position on 30th June 2020 and the change during over the quarter is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.20 Balance £000	**Movement £000**	**30.6.20 Balance £000**	**30.6.20 Rate %**
Long-term borrowing	75,632	2,367	77,999	
Short-term borrowing	31,367	(2,367)	29,000	
Total borrowing	**106,999**	**0**	**106,999**	**3.46%**
Long-term investments	45,476	4,524	50,000	
Short-term investments	4	1	5	
Cash and cash equivalents	9,585	12,898	22,483	
Total investments	**55,065**	**17,423**	**72,488**	**3.95%**
Net borrowing	**51,934**		**46,836**	

Significant increase of £12.9m to cash and cash equivalents to the quarter ended 30th June 2020 due to emergency grant funding received in April from central government to support local businesses. £4.5m for the year end fair value adjustments added back to the pooled investments in the quarter.

Borrowing Update

On 9th October 2019 the PWLB raised the cost of certainty rate borrowing to 1.8% above UK gilt yields making it relatively expensive. Market alternatives are available, 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 Housing Revenue Account (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). £1.15bn of additional "infrastructure rate" funding at gilt yields plus 0.60% was made available 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" allows stakeholders to contribute to developing a system whereby PWLB loans can be made available at improved margins to support qualifying projects. It contains proposals to allow 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. The consultation also broaches the possibility of slowing, or stopping, individual authorities from borrowing large sums in specific circumstances.

The consultation deadline was extended and now closes on 31st July 2020 with implementation of the new lending terms expected in the latter part of this calendar year.

Municipal Bonds Agency (MBA): The MBA has revised its standard loan terms and framework agreement. Guarantees for the debt of other borrowers are now proportional and limited and a requirement to make contribution loans in the event of a default by a borrower has been introduced. The agency issued its first bond in March 2020 on behalf of Lancashire County Council.

If the Authority intends future borrowing through the MBA, it will first ensure that it has thoroughly scrutinised the legal terms and conditions of the arrangement and is satisfied with them.

Borrowing Strategy during the period

At 30th June 2020 the Authority held £107m of loans, similar position to 31st March 2020, as part of its strategy for funding previous years' capital programmes. Outstanding loans on 30th June are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.20 Balance £000	**Net Movement £000**	**30.6.20 Balance £000**	**30.6.20 Weighted Average Rate %**
Public Works Loan Boar	77,999	0	77,999	3.46%
Local authorities (short-term)	29,000	0	29,000	0.40%
Total borrowing	**106,999**		**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 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 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

On 1st April 2020 the Authority received central government funding to support small and medium businesses during the coronavirus pandemic through grant schemes. £27.6m was received, temporarily invested in short-dated, liquid instruments such as call accounts and Money Market Funds.

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 £69.9 and £72.5 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.20 Balance £000	Net Movement £000	30.6.20 Balance £000	30.6.20 Income Return %
Banks & building societies (unsecured)	5,055	7,918	9,515	0.01%
Money Market Funds	4,534	4,981	12,973	0.15%
Other Pooled Funds:				
- Short-dated bond funds	7,861	139	8,000	0.76%
- Strategic bond funds	7,474	526	8,000	3.57%
- Property funds	5,625	375	6,000	3.63%
- Multi asset income funds	24,516	3,484	28,000	4.71%
Other Pooled Funds Sub-Total	45,476	4,524	50,000	
Total investments	**55,065**	**17,423**	**72,788**	

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.

The balance of the pooled funds as at 31.3.20 includes accounting adjustments of £4.5m for unrealised losses, which were included at year-end for statutory reporting purposes (and separately reversed out through a non-useable reserve, as permitted). The high value of the unrealised losses is due to the impact of the pandemic on the underlying assets in the funds, most of the funds have recouped some of their value in the quarter ended 30.06.20.

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 %
31.03.2020	4.88	A+	100%	1	2.75
30.06.2020	4.70	A+	100%	1	2.20
Similar LAs	4.10	AA-	59%	51	1.23
All LAs	4.10	AA-	59%	18	0.96

Externally Managed Pooled Funds: £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 -1.36%, comprising a 3.18% income return which is used to support services in year, and -4.54%of unrealised capital loss.

In a relatively short period since the onset of the COVID-19 pandemic in March and the ensuing enforced lockdown in many jurisdictions, the global economic fallout has been 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, business and individuals.

The Authority is invested in bond, multi-asset and property funds. The falls in the capital values of the underlying assets, in particular bonds and equities were reflected in the 31st March 2020 fund valuations with every fund registering negative capital returns over a 12-month period. Since March there here has been some improvement in market sentiment which is reflected in an increase in capital values of the short-dated, strategic bond, and multi-asset income funds in the Authority's portfolio. The capital value of the property fund is below that at 31st March.

Dealing (i.e. buying or selling units) in the CCLA Local Authorities Property Fund was suspended by the fund in March 2020. The relative infrequency of property transactions in March as the pandemic intensified meant that it was not possible for valuers to be confident that their valuations correctly reflected prevailing conditions. To avoid material risk of disadvantage to buyers, sellers and holders of units in the property fund, the management company was obliged to suspend transactions until the required level of certainty is re-established. The temporary suspension remained in force on 30th June.

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

In 2020/21 the Authority expects to receive lower income from its cash and short-dated money market investments and from its externally managed funds than it did in 2019/20 and earlier years. Dividends and income paid will ultimately depend on many factors including but not limited to the duration of COVID-19 and the extent of its economic impact, the fund's sectoral asset allocation, securities held/bought/sold and, in the case of equities, the enforced or voluntary dividend cuts or deferral.

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 the Ministry of Housing, Communities and Local Government (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.

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	1,621	1,750	(129)	2.50%	0.29%	2.21%
Interest payable	2,596	2,596	0	3.46%	3.46%	0

Estimates for income 2020/21

The corporate world is still adjusting to the economic shock, with probably more to come, and it is still too early to tell which companies will withstand the economic damage in the short- to medium-term or which will choose to conserve cash in very difficult economic conditions simply to survive.

Investment income in the Authority's 2020/21 was set against a very different economic backdrop. Bank Rate, which was 0.75% in January/February 2020 was 0.75%, it now stands at 0.1%. Interest earned from short-dated money market investments will be significantly lower. In relation to income from the Authority's externally managed strategic funds, dividends and income distributions will ultimately depend on many factors including but not limited to the duration of COVID-19 and

the extent of its economic impact, the fund's sectoral asset allocation, securities held/bought/sold and, in the case of equities, the enforced or voluntary dividend cuts or deferral.

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

	30.6.20 Actual £m	**2020/21 Operational Boundary £m**	**2020/21 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

	30.6.20 Actual	**2020/21 Limit**	**Complied?**
Any single organisation, except the UK Government	£4.9m	£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	✓
Money Market Funds	£12.9m	£10m per fund	✓
Operational bank	£4.5m	£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.

	30.6.20 Actual	2020/21 Target	Complied?
Portfolio average credit rating	4.70	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.

	30.6.20 Actual	2020/21 Target	Complied?
Total cash available within 3 months	£22.5m	£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	30.6.20 Actual	2020/21 Limit	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	728	550	x
Upper limit on one-year revenue impact of a 1% fall in interest rates	728	550	x

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

Due to additional funding received from central government in April the cash balances up until the 30th June 2020 were higher than anticipated at the time the 20/21 limits were set in December 2019. It is expected that the balances will have returned to their normal levels by the end of the next quarter as most of the funding will have been paid out in business support grants.

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:

	30.6.20 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	31,367	25%	0%	✓
12 months and within 24 months	3,694	50%	0%	✓
24 months and within 5 years	7,934	50%	0%	✓
5 years and within 10 years	16,012	100%	0%	✓
10 years and above	47,992	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:

	2020/21	2021/22	2022/23
Actual principal invested beyond year end	0	0	0
Limit on principal invested beyond year end	£30m	£30m	£30m
Complied?	✓	✓	✓

Other

IFRS 16: The implementation of the new IFRS 16 Leases accounting standard has been delayed until 2021/22.

Outlook for the remainder of 2020/21

The medium-term global economic outlook is very weak. While containment measures taken by national governments in response to coronavirus are being eased, it is likely to be some time before demand recovers to pre-crisis levels due to rises in unemployment, the on-going need for virus control measures and the impact on consumer/business confidence.

The responses from the Bank of England, HM Treasury as well as other central banks and governments have been significant and will act to support the recovery when it occurs, by keeping financial conditions stable and many businesses solvent/employees employed than would otherwise have been the case. There will be an economic bounce in the second half of the year, as businesses currently dormant begin production/supply services once more.

However, the scale of the economic shock to demand and the probable on-going social distancing measures necessary before a vaccine is produced will mean that the subsequent pace of recovery is limited.

Arlingclose expects Bank Rate to remain at the current 0.10% level and additional monetary loosening in the near future through further financial asset purchases (QE). While the Arlingclose central case for Bank Rate is no change, further cuts to Bank Rate to zero or even into negative territory cannot be ruled out.

Downside risks remain in the near term, as households and businesses react to an unprecedented set of economic circumstances.

	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23
Official Bank Rate												
Upside risk	0.00	0.00	0.00	0.00	0.00	0.15	0.15	0.15	0.15	0.30	0.30	0.30
Arlingclose Central Case	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Downside risk	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35

Gilt yields are expected to remain very low in the medium term. Some shorter-term gilt yields will remain around zero until either the Bank expressly rules out negative Bank Rate or growth prospects improve.