

Treasury Management Outturn Report 2019/20

1. Introduction

In February 2011 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 a treasury management annual report after the end of each financial year.

The Authority's treasury management strategy for 2019/20 was approved at a meeting on 25th 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 are therefore 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.

2. Economic background

The UK's exit from the European Union and its 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 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%.

3. 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.

4. Credit background

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-.sg54ukh98

5. Local Context

On 31st March 2020, the Authority had net borrowing of £151.358m arising from its revenue and capital income and expenditure, an increase on 2018/19 of £49.833m. 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 and the year-on-year change are summarised in table 1 below.

Table 1: Balance Sheet Summary

	31.3.19 Actual £m	2018/19 Movement £m	31.3.19 Actual £m
General Fund CFR	90.475	26.138	116.613
HRA CFR	44.750	11.496	56.246
Total CFR	135.225	37.634	172.859
Less: Usable reserves	28.712	(12.461)	16.251
Less: Working capital	5.454	0.238	5.692
Net borrowing	101.059	49.857	150.916

The Council's strategy was to maintain 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 as at 31st March 2020 and the year-on-year change in show in table 2 below.

Table 2: Treasury Management Summary

	31.3.19 Balance £m	2019/20 Movement £m	31.3.20 Balance £m	31.3.20 Rate %
Long-term borrowing	112.595	3.356	115.951	3.22
Short-term borrowing	8.000	61.000	69.000	0.92
Total borrowing	120.595	64.356	184.951	2.36
Long-term investments	8.000	(1.000)	7.043	3.87
Short-term investments	8.325	7.275	15.600	1.20
Cash and cash equivalents	2.745	8.245	10.991	0.25
Icelandic	0.466	(0.065)	0.401	-
Total investments	19.536	1.019	34.035	1.58
Net borrowing	53.569	47.490	150.916	

Borrowing Activity

At 31st March 2020, the Authority held £184.951m of loans, an increase of £64.356m on the previous year, as part of its strategy for funding the current years' capital programme and maintaining cashflow. The year-end borrowing position and the year-on-year change in show in table 3 below.

Table 3: Borrowing Position

	31.3.19 Balance £m	2019/20 Movement £m	31.3.20 Balance £m	31.3.20 Rate %
Public Works Loan Board	96.695	3.356	100.051	3.09
Banks (LOBO)	7.000	0	7.000	4.24
Banks (fixed-term)	8.900	0	8.900	3.82
Local authorities (short-term)	8.000	61.000	69.000	0.92
Total borrowing	120.595	64.356	184.951	2.36

The council'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.

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 31st July 2020 with implementation of the new lending terms expected in the latter part of this calendar year or financial year beginning 2021/22, and the Authority is in the process to respond to the consultation.

The Council's current strategy has been to fund a number of capital asset purchases with the use of temporary borrowing and then take long term borrowing from the Public Works Loan Board (PWLB). Towards the end of March 2020 the Council took out a loan for £4m in relation to new HRA houses built and completed in 2019/20. The 40 year annuity loan was taken at the fixed rate of 1.77%. The Authority continues to hold £7m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during 2019/20.

8. Investment Activity

The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2018/19, the Authority's investment balance ranged between £16.625m and £65.510m due to timing differences between income and expenditure. The year-end investment position and the year-on-year change in show in table 4 below.

Table 4: Investment Position (Treasury Investments)

	31.3.19 Balance £m	2019.20 Movement £m	31.3.20 Balance £m	31.3.20 Rate %
Banks & building societies (unsecured)	6.424		5.401	0.87
Government (incl. local authorities)	3.000		10.000	0.84
Money Market Funds/Call Accounts	2.745		10.990	0.25
Pooled Funds	7.000	-	7.000	4.66
Other	0.371		0.643	3.05
Total investments	19.540	1.799	34.034	1.58

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 investments before seeking the highest 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.

£7m of the Authority's investments are held in externally managed strategic pooled (bond, equity, multi-asset and property) 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 a total return of £325,622 ([4.66%]), however capital reduced by £872,633 for reasons noted below, which are treated as an 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.

Table 5: Current Pooled Funds

Fund Manager	Investment	Capital Value as at 31 st March 2019	Capital Value as at 31 st March 2020	Dividends Received 2019/20	2019/20 Gain/(Loss)	Gain/(Loss) v Original Investment
	£	£	£	£	£	£
CCLA Property Fund	3,000,000	2,877,602	2,774,677	124,412	(102,925)	(225,323)
Schroders Income Maximiser Fund	2,000,000	1,774,692	1,184,864	135,355	(589,828)	(815,136)
CCLA Diversified Income Fund	2,000,000	2,003,727	1,823,816	65,855	(179,911)	(176,184)
Total –current Funds	7,000,000	6,656,021	5,783,357	325,622	(872,664)	(1,216,643)

The Pooled Funds' have performed well in producing dividends amounting to £326,020 against a budgeted figure of £329,700 returning 4.65% for the year on the original £7m invested. The total funds value is now £344k less than the initial investments made (£7m) and £873k down from this time last year. Due to the effect of COV-19 the markets took a hiding in March with funds values losing £505k. At the time of this report the funds capital value's as at the end of May 2020 have improved by over £100k to date.

The nature of these funds is that values can fluctuate from one year to another. Their performance and suitability in meeting the Authority's investment objectives are monitored and discussed with Arlingclose on a regular basis. 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.

9. Financial Implications

The outturn for debt interest paid in 2019/20 was £3.878 million (2.64%) on an average debt portfolio of £149.506 million against a budgeted £3.889 million. A surplus of £11k was recorded for the financial year. The HRA reimbursed the General Fund £1.748m for the debt associated to the HRA for 2019/20.

The outturn for investment income received in 2019/20 was £459.097k which equates to a 2.17% return (18/19 – 1.85%) on an average investment portfolio of £21.151 million against a budgeted £471.909k on an average investment portfolio of £23 million at an average interest rate of 2.05%. The General Fund reimbursed the HRA £107k for revenue balances held within investment balances during 2019/20.

Net loans and investments budget for 2019/20 which also includes leasing and third party loans repayments, was a budgeted cost of £1.473m but made an actual cost return of £1.457m, a surplus of £16k.

11. Compliance Report

The Council can confirm that it has complied with its Prudential Indicators for 2019/20, which was set in February 2019 as part of the Council's Treasury Management Strategy and Capital Strategy. In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2019/20. None of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

The Prudential Indicators include:

- Authorised and Operational Boundary for External Debt
- Average Credit rating
- Upper limits for fixed interest rate exposure and variable interest rate exposure
- Upper limit for total principal sums invested over 364 days.

Table 6: Debt Limits

	2019/20 Maximum £m	31.3.20 Actual £m	2019/20 Operational Boundary £m	2019/20 Authorised Limit £m	Complied
Borrowing	188	185	288	298	✓

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. Total debt was never above the operational boundary during 2019/20.

11. Treasury Management Indicators

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

11.1 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.

	31.3.19 Actual	2018/19 Target	Complied
Portfolio average credit rating	A+	A	✓

11.2 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 fixed rate borrowing were:

	31.3.20 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	37.63%	50%	0%	✓
12 months and within 24 months	1.51%	50%	0%	✓
24 months and within 5 years	3.88%	100%	0%	✓
5 years and within 10 years	2.88%	100%	0%	✓
10 years and above	54.10%	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.

11.3 Principal Sums Invested for Periods Longer than 364 days

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	7m	7m	7m
Limit on principal invested beyond year end	10m	10m	10m
Complied	✓	✓	✓