Cheltenham Borough Council
Council – 7 December 2020
Treasury Mid-Term Report 2020/21

Accountable member	**Cabinet Member for Finance, Councillor Rowena Hay**
Accountable officer	**Executive Director Finance and Assets (Section 151 Officer), Paul Jones**
Accountable scrutiny	**Treasury Management Panel**
Ward(s) affected	**All**
Key Decision	**Yes**
Executive summary	The Treasury Management Strategy for 20/21 has been determined by the adoption of the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the council to approve treasury management semi-annual and annual reports.
Recommendations	The Treasury Management Panel considered this report on the 26th November 2020 and has recommended that Council **:** **1. Note the contents of the summary report of the treasury management activity during the first six months of 2020/21.**

Financial implications	All financial implications are detailed throughout the report **Contact officer: Andrew Sherbourne, andrew.sherbourne@cheltenham.gov.uk, 01242 264337**
Legal implications	The Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) requires the authority to approve a Treasury Management Strategy before the start of each financial year and to keep it updated throughout the year. The report fulfils the authority's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code. **Contact officer: Shirin Wotherspoon, shirin.wotherspoon@tewkesbury.gov.uk, 01684 272696**
HR implications (including learning and organisational development)	None arising directly from this report **Contact officer: Julie McCarthy, julie.mccarthy@cheltenham.gov.uk. 01242 264355**

Key risks	As noted in Appendix 1
Corporate and community plan Implications	The purpose of the report is to improve corporate governance, a key objective for the Council
Environmental and climate change implications	None arising directly from this report

1. Background

1.1 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 members to approve the treasury management semi-annual and annual reports.

1.2 The Council's treasury management strategy for 202/21 was approved at a meeting on 23rd March 2020. The Council 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 remain central to the council's treasury management strategy.

1.3 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 23rd March 2020.

Economic update for the first six months

2.1 The spread of the coronavirus pandemic dominated during the period as countries around the world tried to manage the delicate balancing act of containing transmission of the virus while easing lockdown measures and getting their populations and economies working again. After a relatively quiet few months of Brexit news it was back in the headlines towards the end of the period as agreement between the UK and EU on a trade deal was looking difficult and the government came under fire, both at home and abroad, as it tried to pass the Internal Market Bill which could override the agreed Brexit deal, potentially breaking international law.

2.2 The Bank of England (BoE) maintained Bank Rate at 0.1% and its Quantitative Easing programme at £745 billion. The potential use of negative interest rates was not ruled in or out by BoE policymakers, but then a comment in the September Monetary Policy Committee meeting minutes that the central bank was having a harder look at its potential impact than was previously suggested took financial markets by surprise.

2.3 Government initiatives continued to support the economy, with the furlough (Coronavirus Job Retention) scheme keeping almost 10 million workers in jobs, grants and loans to businesses and 100 million discounted meals being claimed during the 'Eat Out to Help Out' (EOHO) offer.

2.4 GDP growth contracted by a massive 19.8% (revised from first estimate -20.4%) in Q2 2020 (Apr-Jun) according to the Office for National Statistics, pushing the annual growth rate down to -21.5% (first estimate -21.7%). Construction output fell by 35% over the quarter, services output by almost 20% and production by 16%. Recent monthly estimates of GDP have shown growth recovering, with the latest rise of almost 7% in July, but even with the two previous monthly gains this still only makes up half of the lost output. The headline rate of UK Consumer Price Inflation (CPI) fell to 0.2% year/year in August, further below the Bank of England's 2% target, with the largest downward contribution coming from restaurants and hotels influenced by the EOHO scheme.

2.5 The US economy contracted at an annualised rate of 31.7% in Q2 2020 (Apr-Jun). The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25% but announced a change to its inflation targeting regime. The move is to a more flexible form of average targeting which will allow the central bank to maintain interest rates at low levels for an extended period to support the economy even when inflation is 'moderately' above the 2% average target, particularly given it has been below target for most of the last.

2.6 The European Central Bank maintained its base rate at 0% and deposit rate at -0.5

3. Financial Markets

3.1 Equity markets continued their recovery, with the Dow Jones climbing to not far off its pre-crisis peak, albeit that performance being driven by a handful of technology stocks including Apple and Microsoft, with the former up 75% in 2020. The FTSE 100 and 250 have made up around half of their losses at the height of the pandemic in March. Central bank and government stimulus packages continue to support asset prices, but volatility remains.

3.2 Ultra-low interest rates and the flight to quality continued, keeping gilts yields low but volatile over the period with the yield on some short-dated UK government bonds remaining negative. The 5-year UK benchmark gilt yield started and ended the June–September period at -0.06% (with much volatility in between). The 10-year gilt yield also bounced around, starting at 0.21% and ending at 0.23% over the same period, while the 20-year rose from 0.56% to 0.74%. 1-month, 3-month and 12-month bid rates averaged 0.02%, 0.06% and 0.23% respectively over the period.

3.3 Credit default swap spreads eased over most of the period but then started to tick up again through September. In the UK, the spreads between ring-fenced and non-ring-fenced entities remains, except for retail bank Santander UK whose CDS spread remained elevated and the highest of those we monitor at 85bps while Standard Chartered was the lowest at 41bps. The ring-fenced banks are currently trading between 45 and 50bps**.**

3.4 After a busy second quarter of the calendar year, the subsequent period has been relatively quiet for credit changes for the names on our counterparty list. Fitch assigned a AA- deposit rating to Netherlands lender Rabobank with a negative outlook and prior to that, while not related to our counterparty list but quite significant, revised the outlook on the US economy to Negative from Stable while also affirming its AAA.

3.5 There continues to remain much uncertainty around the extent of the losses banks and building societies will suffer due to the impact from the coronavirus pandemic and for the UK institutions on our list there is the added complication of the end of the Brexit transition period on 31st December and what a trade deal may or may not look like. The institutions on Arlingclose's counterparty list and recommended duration remain under constant review, but at the end of the period no changes had been made to the names on the list or the recommended maximum duration of 35 days.

4. Treasury Management Summary position 1/4/2020 to 30/9/2020

4.1 On the 31st March 2020, the Council had net borrowing of £150.959m 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 £m
General Fund CFR	120.452
HRA CFR	56.246
Total CFR	**176.698**
Less: Usable reserves	16.251
Less: Working capital	9.488
Net borrowing	**150.959**

4.2 The Council 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 30th September 2020 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.20 Balance £m	**Movement £m**	**30.9.20 Balance £m**	**30.9.20 Rate %**
Long-term borrowing	115.951	(0.363)	115.588	3.22
Short-term borrowing	69.000	(11.500)	57.500	0.23
Total borrowing	**184.951**	**(11.863)**	**173.088**	**2.23**
Long-term investments	7.000	-	7.000	4.11
Short-term investments	15.600	(12.500)	3.100	1.56
Cash and cash equivalents	10.991	(9.876)	1.115	0.21
Icelandic	0.401	(0.006)	0.395	-
Total investments	**33.992**	**(22.382)**	**11.610**	**1.77**
Net borrowing	**150.959**	**10.519**	**161.478**	

4.3 Lower official interest rates have reduced the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The Council pursued its strategy in funding the £39m capital asset purchase made in August 2019 with the use of temporary borrowing and then either take long term borrowing or use future capital receipts to repay it. Currently interest rates for this borrowing are around

0.10% to 0.15% which is much cheaper than fixing it to a long term loan.

4.4 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).

4.5 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 closed on 31st July 2020 with the announcement and implementation of the revised lending terms expected in the latter part of this calendar year or early next year.

4.6 As at 31st March 2020 the Council held loans of £184.951m and has reduced the amount of temporary borrowing by using cash investments which were earning very little interest. The balance as can be seen in Table 3 below shows a reduced figure of £173.088m as at 30th September 2020. The weighted average interest rate on these loans is 2.23% down from 2.36% in March 2020. Borrowing costs are expected to be £125,000 lower than forecasted with the budget at the end of the 2020/210 financial year.

Outstanding loans on 30th September are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.20 Balance £m	**2020/21 Movement £m**	**30.9.20 Balance £m**	**30.9.20 Rate %**
Public Works Loan Board	100.051	(0.363)	99.688	3.10
Banks (LOBO)	7.000	0	7.000	4.24
Banks (fixed-term)	8.900	0	8.900	3.82
Local authorities (short-term)	69.000	(11.500)	57.500	0.23
Total borrowing	**184.951**	**(11.863)**	**173.088**	**2.23**

5. Investments

5.1 The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the six month period the council's investment balance ranged between £11.614m and £56.988m 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 £m	Net Movement £m	30.9.20 Balance £m	30.9.20 Rate of Return %
Banks & Building Societies (unsecured)	5.401	(5.401)	-	-
Local Authorities	10.000	(9.000)	1.000	1.00
Money Market Funds/ Call Accounts	10.990	(9.875)	1.115	0.20
CCLA Property Fund	3.000	-	3.000	3.76
Schroders Maximiser Fund	2.000	-	2.000	4.83
CCLA Diversified Income Fund	2.000	-	2.000	3.98
Gloucestershire Airport Loan	0.643	0.457	1.100	3.10
Total Investments	**34.034**	**(23.819)**	**10.215**	**1.77**

5.2 Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking optimum rate of return, or yield. All investments made to date in this financial year have been in line with the approved lending list set in February 2020.

5.3 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 Council's 2020/21 budget was set against a very different economic backdrop. Bank Rate, which was 0.75% in January 2020, now stands at 0.10%. 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.

5.4 In February 2020 the Council's Investment income for 2020/21 was budgeted to be £436,500. The average cash balances representing the council's reserves and working balances, was £19.968m during the period this report covers, which is a reduction of over £3m compared with last year. The Council anticipates an investment outturn of around £309,000 at a rate of return of 1.70% for this financial year. Estimated deficit for investment income is likely to be around £127,500 for the financial year.

5.5 £7m of the Authority's investments are held in externally managed strategic pooled 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 an average total return of 4.13% for the first 6 months of this financial year which is used to support services in year. Because the Council's externally managed funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council'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 rate.

5.6 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. Table 5 below shows the current valuations of the Pooled Funds portfolio at the end of September 2020 compared with the opening balances of 2020/21.

Table 5: Pooled Funds

FUND NAME	Initial Investment	1 April 2020 Fund Value	30th Sept 20 Fund Value	Dividends paid out in 2020/21 as at 30 Sept	Gain / (Loss) for 2020/21	Gain / (Loss) to Initial Principal
	£	£	£	£	£	£
CCLA Property Fund	3,000,000	2,774,677	2,659,258	56,324	(115,419)	(340,323)
Schroders Income Maximiser Fund	2,000,000	1,184,864	1,135,220	45,246	(49,644)	(864,780)
CCLA Diversified Income Fund	2,000,000	1,823,816	1,949,232	19,836	125,416	(50,768)
Total	**7,000,000**	**5,783,357**	**5,743,710**	**121,406**	**(39,647)**	**(1,255,871)**

5.7 Net loan costs and investment interest should hopefully balance each other off at year end based on current predictions as reported.

5.8 The Housing Revenue Account (HRA) has kept its revenue reserves and balances close to what was estimated for 2020/21 budget and is expected to come in on budget for interest payable on these.

6. Outlook for the remainder of 2020/21

6.1 The medium-term global economic outlook is weak. While the strict initial lockdown restrictions have eased, coronavirus has not been supressed and second waves have prompted more restrictive measures on a regional and national basis. This ebb and flow of restrictions on normal activity will continue for the foreseeable future, at least until an effective vaccine is produced and importantly, distributed**.**

6.2 The global central banks and government responses have been significant and are in many cases on-going, maintaining more stable financial, economic and social conditions than otherwise. This has supported a sizeable economic recovery in Q3. However, the scale of the economic shock to demand, on-going social distancing measures, regional lock downs and reduced fiscal support will mean that the subsequent pace of recovery is limited. Early signs of this are already evident in UK monthly GDP and PMI data, even before the latest restrictions.

6.3 This situation will result in central banks maintaining low interest rates for the medium term. In the UK, Brexit is a further complication. Bank Rate is therefore likely to remain at low levels for a very long time, with a distinct possibility of being cut to zero. Money markets have priced in a chance of negative Bank Rate. Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid inflation expectations. There is a chance yields may follow a slightly different path in the medium term, depending on investor perceptions of growth and inflation, or if the UK leaves the EU without a deal.

6.4 Our treasury advisors Arlingclose expects Bank Rate to remain at the current 0.10% level and additional monetary loosening in the future most likely through further financial asset purchases (QE). While Arlingclose's central case for Bank Rate is no change from the current level of 0.10%, further cuts to Bank Rate to zero or even into negative territory cannot be completely ruled out. See Arlingclose's interest rate forecast for the next three years in table 6.

Table 6: Interest rate forecast

	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.15	0.15	0.15	0.15	0.30	0.30	0.30	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	0.10
Downside risk	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50

6.5 Compliance

The Chief Finance Officer reports that all treasury management activities undertaken during the first six months 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.

Table 7: Debt Limits

	30.9.20 Actual £m	2020/21 Operational Boundary	2020/21 Authorised Limit	Complied? Yes/No
Borrowing	173.088	310.000	320.000	Yes
Total debt	**173.088**	***310.000***	**320.000**	

Council approved on 23rd March 2020 the authorised borrowing limit and operational boundary limit are increased to the new levels as shown above in table 7.

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.

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Appendices	Risk Assessment – Appendix 1
Background information	Treasury Management Strategy & Capital Strategy, Council 23rd March 2020