AGENDA ITEM:

REPORT TO AUDIT & GOVERNANCE COMMITTEE

REPORT OF DIRECTOR OF FINANCE & BUSINESS SERVICES

25 NOVEMBER 2019

TREASURY MANAGEMENT STRATEGY MID YEAR REPORT 2019/20

SUMMARY

This report informs Members of the performance against the treasury management and prudential indicators set in the Treasury Management Strategy approved by Council in February 2019.

Introduction

The Authority has 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 by Council on 27th February 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.

External Context

Arlingclose Stockton's Treasury Management advisors have provided us with the following commentary on the external environment.

Economic background: UK Consumer Price Inflation (CPIH) fell to 1.7% year/year in August 2019 from 2.0% in July, weaker than the consensus forecast of 1.9% and below the Bank of England's target. The most recent labour market data for the three months to July 2019 showed the unemployment rate edged back down to 3.8% while the employment rate remained at 76.1%, the joint highest since records began in 1971.

The Quarterly National Accounts for Q2 GDP confirmed the UK economy contracted by 0.2% following the 0.5% gain in Q1. Only the services sector registered an increase in growth, a very modest 0.1%, with both production and construction falling and the former registering its largest drop since Q4 2012.

Tensions continued between the US and China with no trade agreement in sight and both countries imposing further tariffs on each other's goods. The US Federal Reserve cut its target Federal Funds rates by 0.25% in September to a range of 1.75% - 2%, a pre-emptive move to maintain economic growth amid escalating concerns over the trade war and a weaker economic environment leading to more pronounced global slowdown. The euro area Purchasing Manager Indices (PMIs) pointed to a deepening slowdown in the Eurozone.

These elevated concerns have caused key government yield curves to invert, something seen by many commentators as a predictor of a global recession. Market expectations are for further interest rate cuts from the Fed and in September the European Central Bank reduced its deposit rate to -0.5% and announced the recommencement of quantitative easing from 1st November.

The Bank of England maintained Bank Rate at 0.75% and in its August Inflation Report noted the deterioration in global activity and sentiment and confirmed that monetary policy decisions related to Brexit could be in either direction depending on whether or not a deal is ultimately reached.

Financial markets: After rallying early in 2019, financial markets have been adopting a more risk-off approach in the following period as equities saw greater volatility and bonds rallied (prices up, yields down) in a flight to quality and anticipation of more monetary stimulus from central banks. The Dow Jones, FTSE 100 and FTSE 250 are broadly back at the same levels seen in March/April.

Gilt yields remained volatile over the period on the back of ongoing economic and political uncertainty. From a yield of 0.63% at the end of June, the 5-year benchmark gilt yield fell to 0.32% by the end of September.

Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth remains a global risk. The US yield curve remains inverted with 10-year Treasury yields lower than US 3-month bills. History has shown that a recession hasn't been far behind a yield curve inversion. Following the sale of 10-year Bunds at -0.24% in June, yields on German government securities continue to remain negative in the secondary market with 2 and 5-year securities currently both trading around -0.77%.

Credit background: Credit Default Swap (CDS) spreads rose and then fell again during the quarter, continuing to remain low in historical terms. After rising to almost 120bps in May, the spread on non-ring fenced bank NatWest Markets plc fell back to around 80bps by the end of September, while for the ring fenced entity, National Westminster Bank plc, the spread remained around 40bps. The other main UK banks, as yet not separated into ring fenced and non-ring fenced from a CDS perspective, traded between 34 and 76bps at the end of the period.

Local Context

On 31st March 2019, the Authority had net borrowing of £18.81m 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 £m
General Fund CFR	136.10
Less: Other debt liabilities	-6.58
Borrowing CFR	**129.52**

Less: Usable reserves	-107.89
Less: Working capital	-2.82
Net Borrowing	**18.81**

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 30th September 2019 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.19 Balance £m	**Movement £m**	**30.9.19 Balance £m**
Long-term borrowing	47.19	30.00	77.19
Short-term borrowing	0.07	-0.07	0.00
Total borrowing	**47.26**	**29.93**	**77.19**
Long-term investments	-14.80	0.13	-14.67
Short-term investments	0.00	0.00	0.00
Cash and cash equivalents	-13.65	-9.88	-23.53
Total investments	**-28.45**	**-9.75**	**-38.20**
Net Borrowing	**18.81**	**20.18**	**38.99**

Borrowing Strategy during the period

At 30th September 2019 the Authority held £77.19m of loans, an increase of £30m since 31st March 2019, which was required as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30th September are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.19 Balance £m	**Q2 Net Movement £m**	**30.9.19 Balance £m**	**30.9.19 Weighted Average Rate %**	**30.9.19 Weighted Average Maturity (years)**
Public Works Loan Board	4.26	29.93	34.19	2.18	24.17
Banks (LOBO)	37.00	0.00	37.00	4.79	40.70
Banks (fixed-term)	6.00	0.00	6.00	9.83	2.67
Total borrowing	**47.26**	**29.93**	**77.19**	**4.03**	**30.42**

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.

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. Having considered the appropriate duration and structure of the Authority's borrowing need based on realistic projections, the Authority decided to take advantage of the fall in external borrowing rates and borrowed a total of £30m in longer-term fixed rate loans, details of which are below.

Long-dated Loans borrowed	**Amount £m**	**Rate %**	**Period (Years)**
PWLB Maturity Loan 1	2.5	1.44	15
PWLB Maturity Loan 2	2.5	1.66	20
PWLB EIP Loan 1	5	1.15	20
PWLB Annuity Loan 1	10	2.21	25
PWLB Annuity Loan 2	10	1.93	25
Total borrowing	**30**		

LOBO loans: The Authority continues to hold £37m 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 the year.

In early October HM Treasury increased Public Works Loan Board interest rates by 100bps (one percentage point). The main reasons are covered in the HM Treasury letter issued on the 9th October which is attached at **Appendix A**.

<u>Treasury Investment Activity</u>

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 fluctuated due to timing differences between income and expenditure. The investment position at the end of September is shown in table 4 below.

<u>Table 4: Treasury Investment Position</u>

	31.3.19 Balance £m	**Net Movement £m**	**30.9.19 Balance £m**
Banks & building societies (unsecured)	-1.07	0.12	-0.95
Government (incl. local authorities)	0.00	0.00	0.00
Property Fund	-14.42	0.13	-14.29
Shares / Cash	-0.46	0.00	-0.46
Money Market Funds	-12.50	-10.00	-22.50
Total investments	**-28.45**	**-9.75**	**-38.20**

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.

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**	**WAM* (days)**	**Rate of Return %**
31.03.2019	4.66	A+	100%	1	2.57%
30.06.2019	4.61	A+	100%	1	2.16%
30.09.2019	4.36	AA-	100%	1	2.08%
Similar LAs	4.32	AA-	74%	41	1.19%
All LAs	4.28	AA-	62%	28	1.22%

*Weighted average maturity

£14.29m of the Authority's investments are held in externally managed strategic pooled 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 return of £0.608m (4.1%) during 2018/19, and has generated £0.315m in dividend payments for the first six months of the year. This income is being used to support services in year.

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 should exceed cash interest rates.

To generate additional income, diversify the Councils investments and to reduce its volatility on its investment portfolio the authority is considering an option to invest up to £10m in multi asset pooled funds. Multi asset funds are made up of a combination of asset classes, including equities, bonds and cash, and are designed with different asset allocations to create a range of low-to-high risk offerings.

We currently have funds invested in the CCLA Local Authorities Property Fund. The authority's portfolio risk is currently 100% to the property sector, as well as concentration risk to one fund. By diversifying the portfolio into multi-asset funds, this will give strategic investment portfolio exposure to other asset classes as detailed above.

An additional benefit would be to diversify exposure to multi-asset funds by investing in more than one multi-asset fund. Each multi-asset fund is slightly different in its asset allocation, with some more weighted towards equity, while others have a higher weighting to bonds. By investing in different funds that are not highly correlated, we can potentially reduce the volatility (risk) of the authority's portfolio even if the funds' individual volatility is high, the movements in capital value being partially offset.

As a larger proportion of the fund's portfolio will be in strategic pooled funds, this has the potential to increase the overall return of the portfolio, in particular the income earned from longer-dated strategic funds than what the authority would earn from cash instruments.

Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

The Council also held £19.863m of such investments at the end of 2018/19 in;

- directly owned property £18.749m
- loans to local businesses £0.110m
- loans to subsidiaries £0.800m
- other £0.204m

These investments generated £0.410m of investment income for the Council after taking account of direct costs in 2018/19 representing a rate of return of 2%.

Compliance

The Director of Finance and Business Services reports that all treasury management activities undertaken during complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 6 below.

Table 6: Debt Limits

	Maximum in Year	30.9.19 Actual	2019/20 Operational Boundary	2019/20 Authorised Limit	Complied? Yes/No
Borrowing	£77.19m	£77.19m	£153.5m	£171.5m	Yes
PFI and Finance Leases	£5.2m	£5.2m	£5.2m	£5.2m	Yes
Total debt	**£82.39m**	**£82.39m**	**£158.7m**	**£176.7m**	

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. Compliance with specific investment limits is demonstrated in table 7 below.

Table 7: Investment Limits

	Maximum in Year	30.9.19 Actual	2019/20 Limit	Complied? Yes/No
Any single organisation, except the UK Central Government	£6.960m	£0.95m	£20m per organisation	Yes
UK Central Government	£0m	£0m	Unlimited	Yes
Any group of organisations under the same ownership	£0m	£0m	£20m per organisation	Yes
Any group of pooled funds under the same management	£15m	£15m	£25m	Yes
Negotiable instruments held in a broker's nominee account	£0m	£0m	£25m	Yes
Foreign countries	£0m	£0m	£10m	Yes
Registered providers and registered social landlords	£0m	£0m	£25m	Yes
Unsecured investments with building societies	£0m	£0m	£10m	Yes
Loans to unrated corporates	£0m	£0m	£10m	Yes
Money Market Funds	£50m	£22.5m	£50m	Yes
Real estate investment trusts	£0m	£0m	£25m	Yes

Treasury Management Indicators

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

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:

	30.9.19 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	0.00%	25%	0%	Yes
12 months and within 24 months	0.03%	40%	0%	Yes
24 months and within 5 years	7.81%	60%	0%	Yes
5 years and within 10 years	6.87%	80%	0%	Yes
10 years and above	85.29%	100%	0%	Yes

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than a year: The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2019/20	2020/21	2021/22
Actual principal invested beyond year end	£15m	£15m	£15m
Limit on principal invested beyond year end	£60m	£40m	£20m
Complied?	Yes	Yes	Yes

Outlook for the remainder of 2019/20

The global economy is entering a period of slower growth in response to political issues, primarily the trade policy stance of the US. The UK economy has displayed a marked slowdown in growth due to both Brexit uncertainty and the downturn in global activity. In response, global and UK interest rate expectations have eased dramatically.

There appears no near-term resolution to the trade dispute between China and the US, a dispute that the US appears comfortable exacerbating further. With the 2020 presidential election a year away, Donald Trump is unlikely to change his stance.

Central bank actions and geopolitical risks will continue to produce significant volatility in financial markets, including bond markets.

Our treasury advisor Arlingclose expects Bank Rate to remain at 0.75% for the foreseeable future but there remain substantial risks to this forecast, dependant on Brexit outcomes and the evolution of the global economy. Arlingclose also expects gilt yields to remain at low levels for the foreseeable future and judge the risks to be weighted to the downside and that volatility will continue to offer longer-term borrowing opportunities

	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Cas	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Downside risk	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75

Name of Contact Officer: Garry Cummings
Post Title: Director of Finance and Business Services
Telephone No. 01642 527011
Email Address: garry.cummings@stockton.gov.uk