AGENDA ITEM.

REPORT TO AUDIT & GOVERNANCE COMMITTEE

28 SEPTEMBER 2020

REPORT OF DIRECTOR OF FINANCE, DEVELOPMENT & BUSINESS SERVICES

TREASURY MANAGEMENT STRATEGY – ANNUAL 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.

REASONS FOR PRODUCING THIS REPORT

The Council operates under 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 a treasury management annual report after the end of each financial year.

This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

Introduction

The Council's treasury management strategy for 2019/20 was approved at Council on the 27th February 2019. 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 remains central to the Council's Treasury Management Strategy.

External Context

The Councils treasury management advisors Arlingclose have provided the following commentary on the 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 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% in February, below the Bank of England's target of 2%. Labour market data remained positive. The 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.

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.

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.

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.

Local Context

On 31st March 2020, the Council had net borrowing of £62.62m 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	**2019/20 Movement £m**	**31.3.20 Actual £m**
General Fund CFR	136.11	34.47	170.58
Less: Other debt liabilities	(6.59)	0.45	(6.14)
Borrowing CFR	**129.52**	**34.92**	**164.44**
Less: Usable reserves	(107.89)	6.37	(101.52)
Less: Working capital	(2.82)	2.52	(0.30)
Net Borrowing / (Investments)	**18.81**	**43.81**	**62.62**

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 31st March 2020 and the change during the year is shown 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	47.19	26.68	73.87	
Short-term borrowing	0.07	27.81	27.88	
Total borrowing	**47.26**	**54.49**	**101.75**	**4.96%**
Long-term investments	14.80	(0.52)	14.29	
Short-term investments	0.00	0.00	0.00	
Cash and cash equivalents	13.65	11.20	24.85	
Total investments	**28.45**	**10.69**	**39.14**	
Net Borrowing / (Investments)	**18.81**	**43.81**	**62.62**	

As you are aware the Council had not undertaken any borrowing since 2008 deciding instead to internally borrow as it was more economical to do so. Due to major capital purchases and other capital expenditure during 2019/20 the Council had to enter the borrowing market taking out a number of long term and short term loans. Also due to the Covid 19 pandemic the Council at the end of March 2020 needed to make sure that it had sufficient cash resources to cover the expected increased expenditure / loss of income during the first part of 2020/21. Therefore the Council agreed a short term loan with another authority so cash resources were available during the uncertain times. As a result the Council increased its borrowing by £54.49m up to £101.75m during 2019/20. This borrowing was a mixture of short term and long term as detailed in table 3a below.

Total investment also increased during the year rising £10.69m up to £39.14m. The main reason for this increase is due to additional Government Grants received at year end to deal with the Covid 19 pandemic and the short-term loan that the Council entered into as detailed above.

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.

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 closed at the end of July 2020 with implementation of the new lending terms expected in the latter part of this calendar year or financial year beginning 2021/22. The Council responded to this consultation.

Borrowing Strategy during the year

At 31st March 2020 the Council held £101.75m of loans, an increase of £54.49m from the previous year. The year-end borrowing position and the year-on-year change is shown in Table 3 below.

Table 3: Borrowing Position

	31.3.19 Balance £m	2019/20 Movement £m	31.3.20 Balance £m	Average Rate %	31.3.20 WAM* years
Public Works Loan Board	4.26	29.49	33.75	5.21%	8.1
Banks (LOBO)	37.00	0.00	37.00	4.83%	39.9
Local Authorities	0.00	25.00	25.00	1.11%	0.0
Banks (fixed-term)	6.00	0.00	6.00	10.24%	2.0
Total borrowing	**47.26**	**54.49**	**101.75**	**4.96%**	**17.3**

**Weighted average maturity*

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 Council'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 borrowing need based on realistic projections, it was decided to take a combination of short-term borrowing and longer-term loans. The Authority borrowed £30m longer-term fixed rate loans and £25m in short term fixed rate loans, details of which are shown below in table 3a below. These loans provide some longer-term certainty and stability to the debt portfolio.

Table 3a

Long-dated Loans borrowed	Amount £m	Rate %	Period (Years)
PWLB Maturity Loan - Sept 2019	2.5	1.44	15
PWLB Maturity Loan - Sept 2019	2.5	1.66	20
PWLB EIP Loan - Sept 2019	5.0	1.15	20
PWLB Annuity Loan - April 2019	10.0	2.21	25
PWLB Annuity Loan - May 2019	10.0	1.93	25
Local Authority Loan - Jan 2020	5.0	0.90	0.5
Local Authority Loan - Feb 2020	5.0	0.90	0.5
Local Authority Loan - March 2020	10.0	1.80	0.8
Local Authority Loan - Jan 2020	5.0	0.83	0.5
Total borrowing	**55.0**		

The Council continues to holds £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 Council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during 2019/2020.

Treasury Investment Activity

The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Council's investment balances fluctuated due to timing differences between income and expenditure. The year-end investment position is show in Table 4 below.

Table 4: Treasury Investment Position

Counterparty	Amount £	Rate %	Maturity Date
Nat West SIBA	1,780,000	0.30%	Call Account
Debt Management Office	5,000,000	0.09%	Deposit Fund
Blackrock	4,000,000	0.37%	Money Market Fund
Aberdeen	4,000,000	0.48%	Money Market Fund
Federated	4,000,000	0.41%	Money Market Fund
Legal & General	2,500,000	0.31%	Money Market Fund
Insight	2,500,000	0.31%	Money Market Fund
CCLA Deposit Fund	1,000,000	0.48%	Money Market Fund
CCLA Property Fund	13,908,401	4.15%	Property Fund
	38,688,401		

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 investments before seeking the highest rate of return, or yield. The Council'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 credit risk and return metrics for the Council's investments managed in-house 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	4.61	A+	100%	1	1.97%
30.06.2019	4.61	A+	100%	1	2.16%
30.09.2019	4.36	AA-	100%	1	2.08%
31.12.2019	4.09	AA-	100%	1	1.67%
31.03.2020	4.09	AA-	80%	1	0.43%
Similar LAs	4.26	AA-	62%	52	-0.32%
All LAs	4.03	AA-	56%	20	-0.34%

*Weighted average maturity

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.

£15m of the Council's investments are held in an 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 £0.624m (4.1%) which is used to support services in year. The falls in the capital value of the underlying assets were reflected in the 31st March fund valuations with the CCLA property fund registering negative capital returns over 12 months to March 2020 of £0.515m. Dividend yields remained relatively high as detailed above and due to decent income returns in 2019-20, this fund still posted a positive total return over the one-year period.

The Authority is using the alternative fair value through profit and loss (FVPL) accounting and must defer the funds' fair value losses (capital value reduction) 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 Council'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.

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 £18.254m of such investments in;

- directly owned property £16.267m
- loans to local businesses £1.069m
- loans to subsidiaries £0.714m
- other £0.204m

These investments generated £0.633m of investment income for the Council after taking account of direct costs in 2019/20 representing a rate of return of 3.5%.

Compliance

The Director of Finance, Development and Business Services reports that all treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in Table 6 below.

Table 6: Debt Limits

	2019/120 Maximum	**31.3.20 Actual**	**2019/20 Operational Boundary £m**	**2019/20 Authorised Limit £m**	**Complied**
Borrowing	47.26	101.75	152.5	170.5	✓
PFI & finance leases	6.59	6.14	6.2	6.2	✓
Total debt	**53.85**	**107.89**	**158.7**	**176.7**	✓

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. Total debt was above the operational boundary for 0 days during 2019/20.

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

Table 7: Investment Limits

	2019/20 Maximum	**31.3.20 Actual**	**2019/20 Limit**	**Complied**
Any single organisation, except the UK Central Government	£6.7m	£1.78m	£20m each	✓
UK Central Government	£5m	£5m	unlimited	✓
Any group of organisations under the same ownership	£0m	£0m	£20m per group	✓
Any group of pooled funds under the same management	£14.4m	£13.9m	£25m per fund manager	✓
Negotiable instruments held in a broker's nominee account	£0m	£0m	£25m per broker	✓
Foreign countries	£0m	£0m	£10m per country	✓
Registered Providers	£0m	£0m	£25m in total	✓
Unsecured investments with Building Societies	£0m	£0m	£10m in total	✓
Loans to unrated corporates	£0m	£0m	£10m in total	✓
Money Market Funds	£50.00	£18m	£50m in total	✓
Real estate investment trusts	£0m	£0m	£25m in total	✓

** see table 4 above for actual values with individual counterparties as at 31st March 2020.*

Treasury Management Indicators

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

Maturity Structure of Borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	31.3.20 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	25%	25%	0%	✓
12 months and within 24 months	3%	40%	0%	✓
24 months and within 5 years	7%	60%	0%	✓
5 years and within 10 years	10%	80%	0%	✓
10 years and above	55%	100%	0%	✓

Principal Sums Invested for Periods Longer than 365 days: The purpose of this indicator is to control the Council'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	£60m	£60m
Complied	✓	✓	✓

PRUDENTIAL INDICATORS 2018/19

Introduction: The Local Government Act 2003 requires the Council to have regard to the Chartered Institute of Public Finance and Accountancy's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code is to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

This report compares the approved indicators with the outturn position for 2019/20. Actual figures have been taken from or prepared on a basis consistent with, the Council's Statement of Accounts.

Capital Expenditure: The Council's capital expenditure and financing is summarised as follows.

Capital Expenditure and Financing	**2019/20 Estimate £m**	**2019/20 Actual £m**	**Difference £m**
Total Expenditure	**61.6**	**63.2**	**1.6**
Capital Receipts	10.1	3.9	**-6.2**

Grants & Contributions	23.4	22.2	**-1.2**
Revenue	4.8	1.8	**-3.0**
Borrowing	23.3	35.3	**12.0**
Total Financing	**61.6**	**63.2**	**1.6**

Capital Financing Requirement: The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose.

Capital Financing Requirement	**31.03.20 Estimate £m**	**31.03.20 Actual £m**	**Difference £m**
General Fund	158.7	170.6	**11.9**
Total CFR	**158.7**	**170.6**	**11.9**

There was a difference of £11.9m on the CFR from the original estimate due increase approved spend within the capital programme.

Actual Debt: The Council's actual debt at 31st March 2020 was as follows:

Debt	**31.03.20 Estimate £m**	**31.03.20 Actual £m**	**Difference £m**
Borrowing	91.2	101.8	**10.6**
Finance leases	1.5	1.5	**0.0**
PFI liabilities	4.7	4.7	**0.0**
Total Debt	**97.4**	**107.9**	**10.5**

During 2019/20 the council as part of its treasury management strategy took out various external loans to fund the capital programme.

Gross Debt and the Capital Financing Requirement: In order to ensure that over the medium term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence. The table below shows the position as at 31st March 2020;

Debt and CFR	**31.03.20 Estimate £m**	**31.03.20 Actual £m**	**Difference £m**
Total debt	97.4	107.9	**10.5**
Capital financing requirement	158.7	170.6	**11.9**
Headroom / Under Borrowed	**-61.3**	**-62.7**	**-1.4**

Total debt during the year remained below the CFR. At the 31st March the Council was under borrowed by £62.7m.

Operational Boundary for External Debt: The operational boundary is based on the Council's estimate of most likely (i.e. prudent but not worst case) scenario for external debt.

It links directly to the Council's estimates of capital expenditure, the capital financing requirement and cash flow requirements, and is a key management tool for in-year monitoring. Other long-term liabilities comprise finance lease, Private Finance Initiative and other liabilities that are not borrowing but form part of the Council's debt.

Operational Boundary and Total Debt	**31.03.20 Boundary £m**	**31.03.20 Actual Debt £m**	**Complied**
Borrowing	152.5	101.8	✓
Other long-term liabilities	6.2	6.1	✓
Total Debt	**158.7**	**107.9**	✓

Authorised Limit for External Debt: The authorised limit is the affordable borrowing limit determined in compliance with the *Local Government Act 2003.* It's the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit and Total Debt	**31.03.20 Limit £m**	**31.03.20 Actual Debt £m**	**Complied**
Borrowing	170.5	101.8	✓
Other long-term liabilities	6.2	6.1	✓
Total Debt	**176.7**	**107.9**	✓

Ratio of Financing Costs to Net Revenue Stream: This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income. The table below shows the position as at 31st March 2020

Ratio of Financing Costs to Net Revenue Stream	**31.03.20 Estimate %**	**31.03.20 Actual %**	**Difference %**
General Fund	1.5%	1.4%	-0.1%

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