AGENDA ITEM:

REPORT TO AUDIT & GOVERNANCE COMMITTEE

REPORT OF DIRECTOR OF FINANCE, DEVELOPMENT & BUSINESS SERVICES

30 NOVEMBER 2020

TREASURY MANAGEMENT STRATEGY MID YEAR REPORT 2020/21

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 2020.

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 2020/21 was approved by Council 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.

External Context

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

Economic background: 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.

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.

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 Eat Out Help Out scheme. The Office for National Statistics' preferred measure of CPIH which includes owner-occupied housing was 0.5%.

In the three months to July, labour market data showed the unemployment rate increased from 3.9% to 4.1% while wages fell 1% for total pay in nominal terms (0.2% regular pay) and was down 1.8% in real terms (-0.7% regular pay). Despite only a modest rise in unemployment over the period, the rate is expected to pick up sharply in the coming months as the furlough scheme ends in October. On the back of this, the BoE has forecast unemployment could hit a peak of between 8% and 9%.

Financial markets: 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.

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.

Credit review: Credit default swap spreads eased over most of the period but then started to pick up again through September. In the UK, the spreads between ringfenced and non-ringfenced 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 ringfenced banks are currently trading between 45 and 50bps.

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.

<u>Local Context</u>

On 31st March 2020, the Authority 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

	31.3.20 Actual £m
General Fund CFR	170.58
Less: Other debt liabilities	-6.14
Borrowing CFR	**164.44**
Less: Usable reserves	-101.52
Less: Working capital	-0.3
Net Borrowing / (Investments)	**62.62**

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 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
Long-term borrowing	73.87	0.44	74.31
Short-term borrowing	27.88	-10.87	17.01
Total borrowing	**101.75**	**-10.43**	**91.32**
Long-term investments	-14.28	0.57	-13.71
Short-term investments	0.00	0.00	0.00
Cash and cash equivalents	-24.85	-11.39	-36.24
Total investments	**-39.13**	**-10.82**	**-49.95**
Net Borrowing	**62.62**	**-21.25**	**41.37**

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.

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. Stockton responded to the consultation.

Municipal Bonds Agency (MBA): The MBA 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 has issued 5-year floating rate and 40-year fixed rate bonds in 2020, in both instances Lancashire County Council is the sole borrower and guarantor.

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 September 2020 the Authority held £91.32m of loans, a decrease of £10.4m since 31st March 2020. This is due to the repayment of various short term loans that have not been replaced. Outstanding loans on 30th September 2020 are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.20 Balance £m	Q2 Net Movement £m	30.9.20 Balance £m	30.9.20 Weighted Average Rate %	30.9.20 Weighted Average Maturity (years)
Public Works Loan Board	33.75	-0.43	33.32	2.18	23.19
Banks (LOBO)	37.00	0.00	37.00	4.79	39.70
Local Authorities	25.00	-10.00	15.00	1.70	1.00
Banks (fixed-term)	6.00	0.00	6.00	9.83	1.67
Total borrowing	**101.75**	**-10.43**	**91.32**	**3.67**	**24.82**

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 and in keeping with these objectives, only £5m of short term borrowing was entered into during the first six month of the year while £15.4m of existing loans allowed to mature without replacement.

This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

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.

Treasury Investment Activity

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. During the current financial year the Authority has received central government funding to support small and medium businesses during the coronavirus pandemic through grant schemes. These funds were temporarily invested in short-dated, liquid instruments such as call accounts and Money Market Funds until they were dispersed. The investment position at the end of September is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.20 Balance £m	**Net Movement £m**	**30.9.20 Balance £m**
Banks & building societies (unsecured)	-1.78	1.10	-0.68
Government (incl. local authorities)	-5.00	5.00	0.00
Property Fund	-13.91	0.58	-13.33
Shares / Cash	-0.44	0.00	-0.44
Money Market Funds	-18.00	-17.50	-35.50
Total investments	**-39.13**	**-10.82**	**-49.95**

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.

Continued downward pressure on short-dated cash rate brought net returns on sterling low volatility net asset value money market funds (LVNAV MMFs) close to zero even after some managers have temporarily lowered their fees. At this stage net negative returns are not the central case of most MMF managers over the short-term, and fee waivers should maintain positive net yields, but the possibility cannot be ruled out.

On 25th September the overnight, 1- and 2-week deposit rates on Debt Management Account Deposit Facility (DMADF) deposits dropped below zero percent to -0.03%, the rate was 0% for 3-week deposits and 0.01% for longer maturities.

The return on Money Market Funds net of fees also fell over the six months and for many funds net returns range between 0% and 0.1%. In many instances, the fund management companies have temporarily lowered or waived fees to maintain a positive net return.

In the light of the pandemic crisis and the likelihood of unexpected calls on cash flow, the Authority kept more cash available at very short notice than is normal. Liquid cash was diversified over several Money Market Funds to manage both credit and liquidity risks.

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 %**
31.03.2020	4.09	AA-	80%	1	0.43%
30.06.2020	4.05	AA-	73%	2	-0.52%
30.09.2020	4.25	AA-	100%	1	-0.66%
Similar LAs	4.32	AA-	72%	31	-0.63%
All LAs	4.61	AA-	64%	18	-0.46%

*Weighted average maturity

£13.33m of the Authority's investments are held in an externally managed strategic pooled property fund where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. The fund generated a return of £0.624m (4.1%) during 2019/20, and has generated £0.282m in dividend payments for the first six months of the year. This income is being used to support the medium term financial plan.

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 property funds and the falls in the capital values of the underlying assets, were reflected in the 31st March 2020 fund valuations with most funds registering negative capital returns over a 12-month period. The capital value of the property fund is below that at 31st March. Market values at 31st March and 30th September 2020 are as shown in Table 4, above.

Similar to many other property funds, 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 dealing suspension was lifted in September

2020. There has also been a change to redemption terms for the CCLA Local Authorities Property Fund; from September 2020 investors are required to give at least 90 calendar days' notice for redemptions.

Because the Authority'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 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 2020/21 the Authority expects to receive significantly 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.

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%.

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, 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.

The Authority has reviewed its expectations for investment income against its property fund in 2020/21 and has made downward adjustments of approximately 10% against dividend income received compared to the previous year, down from £624k in 2019/20 to £564k.

Compliance

The Director of Finance, Development 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	**30.9.20 Actual**	**2020/21 Operational Boundary**	**2020/21 Authorised Limit**	**Complied? Yes/No**
Borrowing	£106.602m	£91.318m	£186.200m	£206.200m	Yes
PFI and Finance Leases	£4.650m	£4.650m	£4.650m	£4.650m	Yes
Total debt	**£111.252m**	**£95.968m**	**£190.850m**	**£210.850m**	

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	**30.9.20 Actual**	**2020/21 Limit**	**Complied? Yes/No**
Any single organisation, except the UK Central Government	£2.6m	£0.680m	£15m per organisation	Yes
UK Central Government	£32.5m	£0m	Unlimited	Yes
Any group of organisations under the same ownership	£0m	£0m	£15m per group	Yes
Any group of pooled funds under the same management	£13.9m	£13.3m	£20m per fund manager	Yes
Negotiable instruments held in a broker's nominee account	£0m	£0m	£12.5m per Broker	Yes
Foreign countries	£0m	£0m	£5m per country	Yes
Registered providers and registered social landlords	£0m	£0m	£12.5m in total	Yes
Unsecured investments with building societies	£0m	£0m	£5m in total	Yes
Loans to unrated corporates	£0m	£0m	£5m in total	Yes
Money Market Funds	£37.5m	£35.5m	£37.5m in total	Yes
Real estate investment trusts	£0m	£0m	£12.5m in total	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:

	30.9.20 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	18.63%	25%	0%	Yes
12 months and within 24 months	0.05%	40%	0%	Yes
24 months and within 5 years	4.40%	60%	0%	Yes
5 years and within 10 years	5.79%	80%	0%	Yes
10 years and above	71.14%	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:

	2020/21	2021/22	2022/23
Actual principal invested beyond year end	£15m	£15m	£15m
Limit on principal invested beyond year end	£60m	£40m	£20m
Complied?	Yes	Yes	Yes

Arlingclose's Outlook for the remainder of 2020/21

	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

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.

The global central bank 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 and national 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.

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.

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 0.1%, further cuts to Bank Rate to zero or even into negative territory cannot be completely ruled out.

Gilt yields are expected to remain very low in the medium term. Shorter-term gilt yields are currently negative and will remain around zero or below until either the Bank of England expressly rules out negative Bank Rate or growth/inflation prospects improve.

Downside risks remain in the near term, as the government dials down its fiscal support measures, reacts to the risk of a further escalation in infection rates and the Brexit transition period comes to an end.

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