NOT CONFIDENTIAL – For public release **Item No. 10**

Governance and Resources
14th January 2021

Report of the Director of Resources

Treasury Management Out turn 2019/20 & Mid-Year Report for 2020/21

PURPOSE OF REPORT

This report seeks approval for the Treasury Management Outturn report for 2019/20 & Mid-Year report for 2020/21

RECOMMENDATION

That the Treasury Management Out turn for 2019/20 and Mid-Year Report for 2020/21 be approved

WARDS AFFECTED

All.

STRATEGIC LINK

The above recommendation contributes to all of the Council's Corporate Plan Priorities

1 BACKGROUND

1.1 This report fulfils the Authority's legal obligation to have regard to the CIPFA Code which requires the Authority to approve Treasury Management semi-annual and annual reports.

- The Treasury Management strategy for 2019/20 was approved at a meeting on 7th March 2019

- The Treasury Management Strategy report for 2020/21 was approved at a meeting on 5th March 2020

- The Authority has 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.

- The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, which is to be a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy for 2019/20 &

2020/21 complying with CIPFA's requirement were approved by Council on 7th March 2019 & 5th March 2020 respectively.

2 REPORT

2.1 The Council is required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals.

2.2 **The Treasury Strategy** – The first, and most important, report covers:

- The treasury management strategy (how the investments and borrowings are to be organised) including treasury indicators); and

- A treasury management investment strategy (the parameters on how investments are to be managed).

2.3 **A mid-year treasury management report –** This updates members with the progress of the capital position, amending prudential indicators as necessary, and whether any policies require revision.

2.4 **An annual treasury report –** This provides details of actual treasury operations compared to the estimates within the strategy.

Scrutiny

2.5 The above reports are adequately scrutinised by the Corporate Leadership Team before being recommended to the Council.

External Context

2.6 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.

2.7 The Bank of England (BoE) maintained Bank Rate at 0.1% and its Quantitative Easing programme at £895 billion having extended it by 150 billion. The potential use of negative interest rates was not ruled in or out by BoE policymaker.

2.8 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.

2.9 **Financial markets:** 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.

2.10 **Credit review: :** After spiking in late March as coronavirus became a global pandemic and then rising again in October/November, credit default swap (CDS) prices for the larger UK banks have steadily fallen back to almost pre-pandemic levels. Although uncertainly around COVID-19 related loan defaults lead to banks provisioning billions for potential losses in the first half of 2020, drastically reducing profits, reported impairments for Q3 were much reduced in some institutions. However, general bank profitability in 2020 and 2021 may be significantly lower than in previous years.

2.11 The credit ratings for many UK institutions were downgraded on the back of downgrades to the sovereign rating. Credit conditions more generally though in banks and building societies have tended to be relatively benign, despite the impact of the pandemic.

2.12 Looking forward, the potential for bank losses to be greater than expected when government and central bank support starts to be removed remains a risk, suggesting a cautious approach to bank deposits in 2021/22 remains advisable.

Local Context

2.13 On 31st March 2020, the Authority had net investments of £19.6m 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 £'000	31.3.20 Actual £'000
General Fund CFR	5,898	5,651
Less: Other debt liabilities *	151	0
Borrowing CFR	5,747	5,651
Actual borrowing	5,540	5,450
Under borrowing	297	201
Usable reserves	(19,311)	(22,862)
Working capital requirement	5,079	3,182
Total Investments	(13,935)	(19,680)

* finance leases that form part of the Authority's total debt

2.14 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 Authority pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk.

2.15 The treasury management position on 31st March 2020 and the change over the six months to 30th September is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.20 £'000	Movement £'000	30.09.20 £'000	30.09.20 Rate %
Total Borrowing	5,450	0	5,450	4.1
Long-term investments	1,000	0	1,000	4.14
Short-term Investments	3,000	10,500	13,500	0.23
Cash & cash equivalents	15,680	(3,249)	12,431	0.23
Total Investments	19,680	7,251	26,931	0.36
Net Investments	14,230	7,251	21,481	

Note: the figures in the table for 31.3.20 are from the balance sheet in the Authority's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments.

Borrowing Update

2.16 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.

2.17 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.

Borrowing Strategy during the period

2.18 At 31st March 2020 the Authority held £5.5m of loans from the Public Works Loan Board, the same as the previous year, as part of its strategy for funding previous years' capital programme.

2.19 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.

2.20 In keeping with these objectives, no new borrowing was undertaken in the period.

2.21 The "cost of carry" analysis performed by the Authority's treasury management advisor Arlingclose did not indicate and value in borrowing in advance for future years' planned expenditure and therefore none was taken.

Treasury Investment Activity

2.22 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.

2.23 Continued downward pressure on short-dated cash rates 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.

2.24 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.

2.25 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.

2.26 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 counterparties and/or Money Market Funds to manage both credit and liquidity risks.

2.27 The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 3 below.

Table 3: Investment Benchmarking – Treasury investments managed in-house

	Credit Score*	Credit Rating	Bail-in Exposure**	Weighted Average Maturity (days)	Rate of Return (Total Portfolio)
31.03.2020	4.17	AA-	73%	5	0.54
30.09.2020	4.11	AA-	48%	45	0.14
Similar LAs	4.15	AA-	65%	51	-0.87
All LAs	4.16	AA-	64%	18	-0.46

* The lower the risk the lower the score

** Banking reform legislation exposes the council to bail-in risk on all unsecured bank deposits. The risk of bail-in is effective at the point when banks are considered to be underperforming rather than once they have failed. With larger entities either exempt or not exposed, local authorities will be one of the primary bail-in targets with a potential loss of 100% of the deposit. The council manages this risk by diversifying its investments over a number of investment vehicles. Secure deposits are longer in duration and an element of the council's investments must remain liquid to fund cash flow requirements, resulting in some bail-in risk being inherent in the Council's investment portfolio.

Externally Managed Pooled Funds:

2.28 £1m 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 dividends of £40,486 in the year to 31st March 20 (4.23%), which is used to support services in year. This fund is intended to be held long term and is subject to capital volatility. The authority invested 1m into the fund. The capital value of the fund at 30th September 2020 is £0.86m

2.29 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.

2.30 The Authority has invested in property funds. The falls in the capital values of the underlying assets, in particular bonds and equities were reflected in the 31st March 2020 fund valuations with 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 3, above.

2.31 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.

2.32 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.

2.33 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

2.34 The definition of investments in CIPFA's revised Treasury Management Code covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. This is replicated in the Investment Guidance issued by the Ministry of Housing, Communities and Local Government (MHCLG) and Welsh Government, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

2.35 The Authority holds such investments in directly owned property, valued at £1.586m at 31 March 2020. These investments generated £101,000 of investment income for the Authority after taking account of direct costs, representing a rate of return of 6.37%.

Estimates for income 2020/21

2.36 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.

2.37 Investment income in the Authority's 2020/21 budget 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 than originally anticipated. 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.

2.38 The Authority will be reviewing its expectations for investment income in 2020/21 and has made an adjustment to the expected income on internally managed funds of £36,000. Further adjustment is needed to reduce investment income expected on the property fund of 20% which equates to a further drop of £8,000.

Compliance

2.39 2019/20: All treasury management activities undertaken during financial year 2019/20 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy

2.40 2020/21: On 1st April 2020 the Authority received central government funding to support small and medium businesses during the coronavirus pandemic through grant schemes. £36.2m was received, and temporarily invested in short-dated, liquid instruments such as Money Market Funds, other Local Authorities and the Debt Management Office.

2.41 The significant amount of funding received (which had not been foreseen when the Treasury Management Strategy was approved by Council on 5 March 2020) and the limits on counterparties deemed by our Treasury Management Strategy caused a breach of up to £8m for a period of 34 days. The excess funds were diversified over a range of money market funds and had a credit rating of AA-, therefore the financial risk was low. This breach was reported to the Council's monitoring office and was rectified on the 5th May 2020. The Grant money was disbursed by the end of September.

2.42 Compliance with specific investment limits is demonstrated in table 4 below.

Table 4: Investment Limits

	31.03.20 £	Limit 2019/20 £	First Half Maximum £	30.09.20 £	Limit 2020/21 £	Complied
Banks (Lloyds)	3.7m	6m	5.3m	2.6m	6m	Yes
UK Government (including Local Authorities)	5m	Unlimited	30m	13.5m	Unlimited	Yes
Certificates of Deposit	1m	3m	1m	0	3m	Yes
Money Market Funds	9m	12m	24m	9.8m	16m	No*
Strategic Funds	1m	5m	1m	1m	5m	Yes

* See paragraph 2.6.2 above.

2.43 Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 5 below.

Table 5: Debt Limits

	31.3.20 Actual £000	30.9.20 Actual £000	Operational Boundary £000	Authorised Limit £000	Complied? Yes/No
Borrowing	5,450	5,450	9,000	11,000	Yes
Total debt	5,450	5,450	9,000	11,000	Yes

Note: 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.

Treasury Management Indicators

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

2.45 **Security:** The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average

	31.3.20	30.9.20 Actual	2020/21 Target	Complied?
Portfolio average credit rating	AA-	AA-	AA-	Yes

2.46 **Liquidity:** The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing / it can borrow each period without giving prior notice.

	31.3.20 Actual	30.9.20 Actual	2020/21 Target	Complied?
Total cash available within 3 months	£15m	£14.8m	£6m	Yes
Total sum borrowed in past 3 months without prior notice	0	0	0	Yes

2.47 **Interest Rate Exposures**: This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on one year's revenue impact of a 1% rise or fall in interest was:

	31.3.20 Actual	2019/20 Limit
Upper limit on one-year revenue impact of a 1% rise in interest rates	10,151	154,500
Upper limit on one-year revenue impact of a 1% fall in interest rates	10,151	110,500

2.48 Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

2.49 **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:

	31.3.20 Actual	30.9.20 Actual	Upper Limit	Complied?
Under 12 months	0	0	50%	Yes
12 months and within 24 months	0	0	50%	Yes
24 months and within 5 years	0	0	50%	Yes
5 years and within 10 years	0	0	75%	Yes
10 years and above (please break this into meaningful periods if required)	100%	100%	100%	Yes

2.50 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.

2.51 **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:

	Actual 31.3.20	2020/21	2021/22	2022/23
Actual principal invested beyond year end	£1m	0	0	0
Limit on principal invested beyond year end	£3m	£3m	£3m	£3m
Complied?	Yes	Yes	Yes	Yes

3 RISK ASSESSMENT

Legal

3.1 This report fulfils the Authority's legal obligation to have regard to the CIPFA Code which requires the Authority to approve Treasury Management semi-annual and annual reports and as such the legal risk is low

Financial

3.2 The 2019/20 accounts have been prepared in accordance with proper practices, and have been audited. There is therefore no financial risk arising from this report in respect of 2019/20.

3.3 For 2020/21, as set out in paragraph 2.5.17 of this report, investment income will be much lower than was anticipated when the budget was set. It is expected that the overall reduction in investment income for 2020/21 could be around £44,000. Investment income is expected to remain low for much of 2021/22. The revised levels of investment income will be built into the revised budget for 2020/21 and the proposed budget for 2021/22, to be considered by Council on 4 March 2021.

3.4 The financial risk is therefore is assessed as medium.

4 OTHER CONSIDERATIONS

In preparing this report, the relevance of the following factors has also been considered: prevention of crime and disorder, equalities, environmental, climate change, health, human rights, personnel and property.

5 CONTACT INFORMATION

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6 BACKGROUND PAPERS

None

7 ATTACHMENTS

Appendix 1 – Arlingclose Economic & Interest Rate Forecast – December 2020

Appendix 1 – Arlingclose Economic & Interest Rate Forecast – December 2020

Underlying assumptions:

- The medium-term global economic outlook has improved with the distribution of vaccines, but the recent upsurge in coronavirus cases has worsened economic prospects over the short term.
- Restrictive measures and further lockdowns are likely to continue in the UK and Europe until the majority of the population is vaccinated by the second half of 2021. The recovery period will be strong thereafter, but potentially longer than previously envisaged.
- Signs of a slowing UK economic recovery were already evident in UK monthly GDP and PMI data, even before the second lockdown and Tier 4 restrictions. Employment is falling despite an extension to support packages.
- The need to support economic recoveries and use up spare capacity will result in central banks maintaining low interest rates for the medium term.
- Brexit will weigh on UK activity. The combined effect of Brexit and the after-effects of the pandemic will dampen growth relative to peers, maintain spare capacity and limit domestically generated inflation. The Bank of England will therefore maintain loose monetary conditions for the foreseeable future.
- Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid longer-term 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 the deployment of vaccines.

Forecast:

- Arlingclose expects Bank Rate to remain at the current 0.10% level.
- Our central case for Bank Rate is no change, but further cuts to zero, or perhaps even into negative territory, cannot be completely ruled out, especially with likely emergency action in response to a no-deal Brexit.
- Gilt yields will remain low in the medium term. Shorter term gilt yields are currently negative and will remain around zero or below until either the Bank expressly rules out negative Bank Rate or growth/inflation prospects improve.
- Downside risks remain, and indeed appear heightened, in the near term, as the government reacts to the escalation in infection rates and the Brexit transition period ends.

	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
Official Bank Rate													
Upside risk	0.00	0.00	0.15	0.15	0.15	0.15	0.30	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	0.30	0.40	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3-month money market r													
Upside risk	0.05	0.05	0.10	0.10	0.15	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	0.10	0.10	0.15	0.15	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
Downside risk	0.30	0.40	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
1yr money market rate													
Upside risk	0.05	0.05	0.10	0.10	0.15	0.20	0.40	0.40	0.40	0.40	0.40	0.40	0.40
Arlingclose Central Case	0.15	0.15	0.25	0.25	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30
Downside risk	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15
5yr gilt yield													
Upside risk	0.40	0.40	0.45	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70	0.70
Arlingclose Central Case	0.00	0.00	0.05	0.10	0.15	0.20	0.20	0.20	0.25	0.25	0.25	0.25	0.25
Downside risk	0.40	0.45	0.50	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60
10yr gilt yield													
Upside risk	0.30	0.35	0.40	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70	0.70
Arlingclose Central Case	0.25	0.30	0.35	0.35	0.40	0.40	0.45	0.45	0.50	0.55	0.55	0.55	0.60
Downside risk	0.50	0.50	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55
20yr gilt yield													
Upside risk	0.40	0.40	0.45	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70	0.70
Arlingclose Central Case	0.70	0.70	0.75	0.75	0.75	0.80	0.80	0.85	0.85	0.85	0.85	0.90	0.90
Downside risk	0.30	0.30	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40
50yr gilt yield													
Upside risk	0.40	0.40	0.45	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70	0.70
Arlingclose Central Case	0.60	0.60	0.65	0.65	0.65	0.70	0.70	0.75	0.75	0.75	0.75	0.80	0.80
Downside risk	0.30	0.30	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40

PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%

PWLB Infrastructure Rate (Maturity Loans) = Gilt yield + 0.60%