

Treasury Management Six Month Performance Review

1.0 Introduction

The Council 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 Council to approve treasury management semi-annual and annual reports.

The Council's treasury management strategy for 2020/21 was approved at a meeting on 26th February 2020. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk remain central to the Council's treasury management strategy.

The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Council's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 26th February 2020.

2.0 External Context

2.1 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 and the government came under fire, both at home and abroad, as it tried to pass the Internal Market Bill which could override the agreed Brexit deal, potentially breaking international law.

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.

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 EOH scheme. The Office for National Statistics' preferred measure of CPIH which includes owner-occupied housing was 0.5% y/y.

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%.

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

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

Credit review: Credit default swap spreads eased over most of the period but then started to tick up again through September. In the UK, the spreads between 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.

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

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.

Interest Rates Forecast

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.

The historical low level of interest rates has made it difficult to achieve a higher rates returns on investment.

2.2 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.

At the end of September, the yield on 2-year US treasuries was around 0.13% while that on 10-year treasuries was 0.69%. German bund yields remain negative across most maturities.

3.0 Local Context

On 31st March 2020, the Council had net borrowing of £21.37m arising from its revenue income 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 | 71.3 |
| Less: *Other debt liabilities | 0.5 |
| Total CFR | 71.8 |
| External borrowing | 43.9 |
| Internal borrowing | 27.8 |
| Less: Usable reserves | 55.5 |
| Less: Working capital | 15.3 |
| Net (Investing) or New Borrowing | (43.0) |

The Council pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, to reduce risk and keep interest costs low.

The treasury management position as at 30th September 2020 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

| | 31.3.20 Balance £m | Movement £m | 30.9.20 Balance £m | 30.9.20 Rate % |
|---------------------------|-----------------------------------|------------------------|-----------------------------------|-------------------------------|
| Long-term borrowing | 39.96 | -0.27 | 39.69 | 2.76 |
| Short-term borrowing | 4.00 | (4.00) | 0.00 | 0.00 |
| Total borrowing | 43.96 | | 39.69 | |
| Long-term investments | 10.46 | (0.83) | 9.63 | (0.08) |
| Short-term investments | 0.00 | 4.00 | 4.00 | |
| Cash and cash equivalents | 12.13 | 6.43 | 18.56 | 53.0% |
| Total investments | 22.59 | | 32.18 | |
| Net borrowing | 21.37 | | 7.51 | |

The movement in short-term borrowing was as a result of maintaining cash balances over £10m to comply with the Markets in Financial Instruments Directive (MiFID), that allows the council access to investment instruments as a professional client rather than a retail client, such Money Market Funds (MMF).

The movement in the cash and cash equivalent has been as result of council tax and NNDR receipts and Government cash funding for Covid 19 (reduction of payments to Central Government and increased S31 Grant income); these funds were invested in bank deposits and Money Market Funds for easy access and liquidity reasons.

3.1 Borrowing Strategy during the period

At 30th September 2020, the Council held £39.69m of loans, a decrease of £4.27m from 31st March 2020. Outstanding loans on 30th September are summarised in Table 3 below.

Table 3: Borrowing Position

| | 31.3.20 | Net | 30.9.20 | 30.9.20 | 30.9.20 |
|-----------------------------------|----------------|-----------------|----------------|-----------------|-----------------|
| | Balance | Movement | Balance | Weighted | Weighted |
| | £m | £m | £m | Average | Average |
| | | | | Rate | Maturity |
| | | | | % | (years) |
| Public Works Loan Board | 39.96 | -0.27 | 39.69 | 2.76% | 22.9 |
| Local authorities (short-term) | 4.00 | -4.00 | 0.00 | 0.73% | 0.0 |
| Total borrowing | 43.96 | -4.27 | 39.69 | | 22.9 |

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.

With short-term interest rates remaining much lower than long-term rates, the Council considered it to be more cost effective in the near term to use internal resources or short-term loans instead. The Council had not used short-term loans facility so far in this financial year.

Although it was anticipated that the Council's CFR would increase due to the capital programme, delays in the capital programme due to the pandemic no new loans have been taken out.

| Long-dated Loans borrowed | PWLB Reference | Amount £ | Rate % | Period (Years) |
|---------------------------|----------------|-------------------|-------------|----------------|
| PWLB 1 | 495152 | 5,000,000 | 3.91 | 38.0 |
| PWLB 2 | 495153 | 5,000,000 | 3.90 | 37.0 |
| PWLB 3 | 502463 | 485,575 | 2.24 | 2.5 |
| PWLB 4 | 504487 | 682,106 | 3.28 | 26.0 |
| PWLB 5 | 504598 | 906,922 | 3.10 | 26.0 |
| PWLB 6 | 504810 | 458,870 | 2.91 | 26.0 |
| PWLB 7 | 504922 | 367,164 | 3.10 | 26.5 |
| PWLB 8 | 504993 | 297,665 | 2.92 | 26.5 |
| PWLB 9 | 505255 | 589,748 | 2.31 | 26.5 |
| PWLB 10 | 505372 | 452,086 | 2.18 | 26.5 |
| PWLB 11 | 505649 | 808,570 | 2.67 | 27.0 |
| PWLB 12 | 506436 | 5,000,000 | 2.78 | 17.0 |
| PWLB 13 | 508696 | 7,285,550 | 2.49 | 18.0 |
| PWLB 14 | 508931 | 400,000 | 1.48 | 1.0 |
| PWLB 15 | 509389 | 11,963,000 | 2.18 | 18.5 |
| Total borrowing | | 39,697,256 | 2.76 | 22.9 |

The Council's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short- and long-term borrowing was maintained.

3.2 Treasury Investment Activity

The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

The weighted average rate for the investment portfolio up to 30.09.2020 was 1.81%.

| | 31.3.20 Balance £ | Net Movement £m | 30.9.20 Balance £m | 30.9.20 Income Return % | 30.9.20 Weighted Average Maturity days |
|--|-------------------------|-----------------------|--------------------------|----------------------------------|--|
| Banks & building societies (unsecured) | 4,980,000 | 2,375,000 | 7,355,000 | 0.03% | 1 |
| Government (incl. local authorities) | 0 | 4,000,000 | 4,000,000 | 0.04% | 12.5 |
| Money Market Funds | 7,150,000 | 4,050,000 | 11,200,000 | 0.18% | 1 |
| Loans to other organisation | 6,262,000 | -456,004 | 5,805,996 | 3.23% | >365 |
| Other Pooled Funds . | | | | | |
| - <i>Property funds</i> | 3,823,829 | 0 | 3,823,829 | 4.37% | >365 |
| Total investments | 22,215,829 | 9,968,996 | 32,184,825 | | |

3.3 Risk Management

Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum 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.

Given the increasing risk and low returns from short-term unsecured bank investments, the Council has maintained a diversified portfolio of asset classes as shown in table 4 above.

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 | Weighted Average Maturity (days) | Rate of Return |
|-------------|---------------------|----------------------|-------------------------|---|-----------------------|
| | | | % | | % |
| 31.03.2020 | 4.49 | AA- | 100 | 1 | 1.35 |
| 30.09.2020 | 4.54 | A+ | 82 | 3 | 0.63 |
| Similar LAs | 4.15 | AA- | 65 | 51 | 1.83 |
| All LAs | 4.16 | AA- | 64 | 18 | 0.9 |

*Weighted average maturity

£3.84m of the Council's investments are held in externally managed strategic pooled property funds – CCLA Property Fund where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. This fund generated an average total return of £76,422 (4.37%), for period of 1st April to 30th September 2020 which is 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 Council's investment objectives are regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three- to five-year period total returns will exceed cash interest rates. In light of their performance over the medium-term and the Council's latest cash flow forecasts, investment in these funds has been maintained.

3.4 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 Authority 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 Authority also held £55.04m of such investments in:

- directly owned property £54.9m
- shareholding in subsidiaries £0.1m

Table 6: Property held for investment purposes in £'000

| Property | Actual | 31.3.2020 | actual |
|--|---------------|-------------------|-------------------|
| | Purchase cost | Gains or (losses) | Value in accounts |
| Existing Portfolio | 19,644 | 1,581 | 21,225 |
| 2 Stonehill | 1,400 | 400 | 1,800 |
| 80 Wilbury Way | 2,200 | (330) | 1,870 |
| Shawlands Retail Park | 6,500 | (2,000) | 4,500 |
| 1400 & 1500 Parkway | 5,425 | (1,025) | 4,400 |
| Units 21a, 21b,23a,b,c Little End Road, St Neots | 3,200 | (300) | 2,900 |
| Rowley Centre, St Neots | 7,600 | (1,850) | 5,750 |
| Tri-link, Wakefield | 13,750 | (1,250) | 12,500 |
| TOTAL | 59,719 | (4,774) | 54,945 |

These investments generated £1.3m of investment income for the Authority from April to September 2020 after taking account of direct costs.

The Authority is dependent on profit generating investment activity to achieve a balanced revenue budget. The table below shows the extent to which the expenditure planned to meet the service delivery objectives and/or place making role of the Authority is dependent on achieving the expected net profit from investments over the lifecycle of the Medium Term Financial Plan. Current forecast is showing a

shortfall of expected net investment income of £975k due to the impact of the Covid 19 pandemic. Therefore, the Authority's contingency plans for continuing to provide these services, are to use reserves where necessary to offset any negative variances in the final outturn. Unallocated general fund balances and budget surplus reserve can be used in case of a downturn in investment income to meet any detrimental effect.

Table 7: Proportionality of Investments in £'000

| | 2018/19 Actual | 2019/20 Actual | 2020/21 Budget | 2021/22 Budget | 2022/23 Budget |
|---------------------------|---------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
| Gross service expenditure | 75,729 | 77,760 | 72,303 | 69,710 | 58,836 |
| Investment income | 2,753 | 3,283 | 5,654 | 5,290 | 5,345 |
| Proportion | 3.6% | 4.22% | 7.82% | 7.59% | 9.1% |

4.0 Compliance

The Chief Finance Officer (s151 officer) reports that all treasury management activities undertaken during the first half year complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 9 below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 8 below.

Table 8: Debt Limits

| | 30.9.30 Actual £m | 2019/20 Operational Boundary £m | 2019/20 Authorised Limit £m | Complied? |
|-------------------|----------------------------------|--|--|------------------|
| General | 10.00 | 70.00 | 80.00 | Yes |
| Loans | 5.44 | 15.00 | 20.00 | Yes |
| CIS | 24.25 | 30.00 | 30.00 | Yes |
| Total debt | 39.69 | 115.00 | 130.00 | |

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 below the operational boundary all through the quarter.

Table 9: Investment Limits

| | 30.9.20 Actual £m | 2020/21 Limit £m | Complied? |
|---|----------------------|---------------------|-----------|
| Deposit Accounts | | | |
| NatWest | 3.35 | unlimited | Yes |
| Debt Management Office (DMO) | 2.00 | unlimited | Yes |
| Barclays | 4.00 | 4.00 | Yes |
| Thurrock Council | 2.00 | | |
| Money Market Funds | | | |
| Aberdeen Liquidity Fund | 4.00 | 5.00 | Yes |
| BlackRock Institutional sterling liquidity Fund | 0.00 | 5.00 | Yes |
| CCLA Public Sector Deposit Fund | 4.00 | 5.00 | Yes |
| Federated Short Term Prime Fund | 2.50 | 5.00 | Yes |
| Insight Liquidity Funds | 0.00 | 5.00 | Yes |
| Invesco | 0.00 | 5.00 | Yes |
| Legal & General Sterling Liquidity Fund | 0.70 | 5.00 | Yes |

5.0 Treasury Management Indicators

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

Security

The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

| | 30.9.20 Actual | 2020/21 Target | Complied? |
|---------------------------------|----------------|----------------|-----------|
| Portfolio average credit rating | A+ | A- | Yes |

Liquidity

The Council 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.

| | 30.9.20 Actual £m | 2020/21 Target £m | Complied? |
|--------------------------------------|----------------------|----------------------|-----------|
| Total cash available within 3 months | 22.56 | 2 | Yes |

Interest Rate Exposures

This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interests was:

| Interest rate risk indicator | 30.9.20 Actual | 2020/21 Limit | Complied? |
|--|----------------|---------------|-----------|
| Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates | 0* | £128,000 | Yes |
| Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates | 0* | £128,000 | Yes |

*no impact as borrowing is fixed rate

The impact of a change in interest rates is calculated on the assumption that maturing loans and investment will be replaced at current rates.

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:

| | 30.9.20 Actual | Upper Limit | Lower Limit | Complied? |
|--------------------------------|----------------|-------------|-------------|-----------|
| Under 12 months | 0% | 80% | 0% | Yes |
| 12 months and within 24 months | 2.74% | 80% | 0% | Yes |
| 24 months and within 5 years | 0.00% | 80% | 0% | Yes |
| 5 years and within 10 years | 0% | 100% | 0% | Yes |
| 10 years and above | 97.26% | 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.

| | 2020/21 | 2021/22 | 2022/23 |
|---|---------|---------|---------|
| Actual principal invested beyond year end | £7.79m | £7.08m | £6.80m |
| Limit on principal invested beyond year end | £10.00m | £10.00m | £10.00m |
| Complied? | Yes | Yes | Yes |

6.0 Outlook for 2020/21

The medium-term global economic outlook is weak. While the strict initial lockdown restrictions have eased, coronavirus has not been suppressed 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 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.