South Derbyshire District Council

Treasury Management Strategy Statement 2020/21

February 2020

Introduction

Treasury management is the management of the Authority’s cash flows, borrowing and investments, and the associated risks. 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 financial risk are therefore central to the Authority’s prudent financial management.

Treasury risk management at the Authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy’s Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year. This report fulfils the Authority’s legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

Updates on treasury activity are reported to the Finance and Management Committee on a quarterly basis. A further annual report is produced alongside the final accounts each July to detail all activity for the year.

Responsibility for Treasury Management

The Finance and Management Committee is responsible for setting and monitoring treasury activity at the Council. Under its terms of reference, this includes ensuring that the Council does not breach its borrowing limit.

The Committee is advised by its Section 151 (Chief Finance) Officer who is the Strategic Director (Corporate Resources). This Officer is responsible for the oversight of activity and to ensure that treasury strategy and associated policies are met.

The day-to-day operational activity is undertaken within the Financial Services Unit at the Council. The main officers who have responsibility for daily transactions are the Senior Accountant and the Service Accountants.

The Authorising Officers for transactions are the Chief Executive, Strategic Director (Corporate Resources), Head of Finance. Any new borrowing or investment has to have the prior approval of the Strategic Director (Corporate Resources).

External Support for Treasury Activity

All designated officers involved in treasury activity are covered under the Council’s Fidelity Guarantee insurance. Officers are also supported by external treasury advisors who provide research material, news bulletins, together with general advice and guidance.

Audit Arrangements

The Council's Internal Audit function audits treasury policies and procedures, together with treasury activity and transactions at least once per year. This is a requirement of External Audit. Any matters raised concerning any governance or control matters, are considered and monitored by the Council's Audit Sub-Committee.

Scrutiny and Training

Scrutiny is undertaken by the Finance and Management Committee as part of their role of agreeing policy and monitoring performance. The Audit Sub-Committee review internal audit reports regarding any procedural or wider control matters.

The Elected Members involved in reviewing Treasury Management have previously received training outside of formal reports and briefing papers. To strengthen the role of Members and to supplement their understanding, it is planned to deliver a further briefing/training session during 2020.

The Strategy

This strategy covers:

- The management of debt
- The Council's debt and investment projections
- The expected movement in interest rates
- The Council's borrowing and investment strategies
- Treasury performance indicators
- Specific limits on treasury activities
- Any local treasury issues

External Context

Economic background: The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Authority's treasury management strategy for 2020/21.

UK Consumer Price Inflation (CPI) for September 2019 registered 1.7% year on year, unchanged from the previous month. Core inflation, which excludes the more volatile components, rose to 1.7% from 1.5% in August. The most recent labour market data for the three months to August 2019 showed the unemployment rate ticked back up to 3.9% while the employment rate was 75.9%, just below recent record-breaking highs. The headline 3-month average annual growth rate for pay was 3.8% in August 2019 as wages continue to rise steadily. In real terms, after adjusting for inflation, pay growth increased 1.9%.

GDP growth rose by 0.3% in the third quarter of 2019 from -0.2% in the previous three months with the annual rate falling further below its trend rate to 1.0% from 1.2%. Services and construction added positively to growth, by 0.6% and 0.4% respectively, while production was flat and agriculture recorded a fall of 0.2%. Looking ahead, the Bank of England's Monetary Policy Report (formerly the Quarterly Inflation Report) forecasts economic growth to pick up during 2020 as Brexit-related uncertainties dissipate and provide a boost to business investment helping GDP reach 1.6% in Q4 2020, 1.8% in Q4 2021 and 2.1% in Q4 2022.

The Bank of England maintained the Bank Base Rate at 0.75% in November 2019 following a 7-2 vote by the Monetary Policy Committee. Despite keeping rates on hold, MPC members did confirm that if Brexit uncertainty drags on or global growth fails to recover, they are prepared to cut interest rates as required. Moreover, the downward revisions to some of the growth projections in the Monetary Policy Report suggest the Committee may now be less convinced of the need to increase rates even if there is a Brexit deal.

Growth in Europe remains soft, driven by a weakening German economy which saw GDP fall -0.1% in Q2 and is expected to slip into a technical recession in Q3. Euro zone inflation was 0.8% year on year in September, well below the European Central Bank's target of 'below, but close to 2%' and leading to the central bank holding its main interest rate at 0% while cutting the deposit facility rate to -0.5%. In addition to maintaining interest rates at ultra-low levels, the ECB announced it would recommence its quantitative easing programme from November.

In the US, the Federal Reserve began easing monetary policy again in 2019 as a pre-emptive strike against slowing global and US economic growth on the back on of the ongoing trade war with China. At its last meeting the Fed cut rates to the range of 1.50-1.75% and financial markets expect further loosening of monetary policy in 2020. US GDP growth slowed to 1.9% annualised in Q3 from 2.0% in Q2.

Credit Outlook

Credit conditions for larger UK banks have remained relatively benign over the past year. The UK's departure from the European Union was delayed three times in 2019 and while there remains some concern over a global economic slowdown, this has yet to manifest in any credit issues for banks. Meanwhile, the post financial crisis banking reform is now largely complete, with the new ringfenced banks embedded in the market.

Challenger banks hit the news headlines in 2019 with Metro Bank and TSB Bank both suffering adverse publicity and falling customer numbers.

Looking forward, a global recession remains the major risk facing banks and building societies in 2020/21 and a cautious approach to bank deposits remains advisable.

Interest Rate Forecast

The Authority's treasury management adviser Arlingclose is forecasting that the Bank Base Rate will remain at 0.75% until the end of 2022. The risks to this forecast are deemed to be significantly weighted to the downside. The Bank of England, having previously indicated interest rates may need to rise if a Brexit agreement was reached, stated in its November Monetary Policy Report and its Bank Rate decision (7-2 vote to hold rates) that the MPC now believe this is less likely even in the event of a deal.

Gilt yields have risen but remain at low levels and only some very modest upward movement from current levels are expected based on Arlingclose's interest rate projections. The central case is for 10-year and 20-year gilt yields to rise to around 1.00% and 1.40% respectively over the time horizon, with broadly balanced risks to both the upside and downside. However, short-term volatility arising from both economic and political events over the period is a near certainty.

<u>Effect on the Council</u>

Interest rates currently pose a low risk for the Council. Clearly, given a positive cash and reserves situation, with interest rates so low, returns on deposits are limited. However, the Council's MTFP is not based on interest rates rising to generate income to help ensure a balanced budget. Therefore, if rates do rise, this should generate extra revenue in addition to that budgeted.

The Council's current long-term borrowing is fixed at relatively low rates, with the variable element of the debt currently costing 0.92% per year. The HRA's Financial Plan allows for this to rise to 3% to its repayment date in 2021/22.

<u>Debt and Investment Projections</u>

The table below shows the expected debt position of the Council's HRA over the Medium Term Financial Planning (MTFP) period.

External Debt	**2019/20 £'000**	**2020/21 £'000**	**2021/22 £'000**	**2022/23 £'000**	**2023/24 £'000**	**2024/25 £'000**
Debt 1st April	57,423	57,423	57,423	57,423	47,423	47,423
New Debt	0	0	0	0	0	0
Maturing Debt	0	0	-10,000	0	-10,0000	0
Debt 31st March	**57,423**	**57,423**	**47,423**	**47,423**	**37,423**	**37,423**
Annual Change in Debt	0	0	-10,000	0	-10,000	0
Long-term Investments	4,000	4,000	4,000	4,000	4,000	4,000
Short-term Investments	50,000	47,000	45,000	32,000	23,000	15,000

A comparison of this estimated debt position with the various borrowing limits is shown below:

Limits compared to Actual Debt	**2019/20 £'000**	**2020/21 £'000**	**2021/22 £'000**	**2022/23 £'000**	**2023/24 £'000**	**2024/25 £'000**
Authorised Limit - General Fund	4,988	4,667	4,409	4,214	4,026	3,871
Authorised Limit - HRA	66,853	66,853	66,853	66,853	66,853	66,853
Financing Requirement	66,572	66,251	55,993	55,798	45,610	45,455
Operational Boundary	62,423	62,423	52,423	52,423	42,423	42,423
Gross Debt	57,423	57,423	47,423	47,423	37,423	37,423
Debt Less Short-term Investments	45,423	52,423	43,423	45,423	35,423	35,423

The debt cap for HRA (i.e. the Authorised Limit) self-financing was removed by the Government from October 2018. Borrowing is therefore no longer restricted but it must remain affordable over the plan. To ensure affordability, the Chief Finance Officer has retained the former limit.

The above table shows that (gross) debt outstanding is expected to be comfortably below the Financing or underlying Borrowing Requirement (CFR) and well within the Authorised Limit (Debt Cap).

The Operational Boundary allows a temporary borrowing requirement of £5m.
However, it is expected that the Council will continue to be a net lender of funds on a day-to-day basis.

Management of Debt

As approved by the Council, treasury activities are accounted within two separate pools. This involves splitting borrowing between the General Fund and the HRA and then allocating new loans to each pool as required. This has been adopted for clarity and transparency and ensured there was no detriment to the General Fund on transition to HRA self-financing in 2012.

Treasury Management decisions on the structure and timing of borrowing is made separately for the General Fund and HRA.

Interest on loans is calculated in accordance with proper accounting practice and allocated to either pool accordingly. It is not anticipated that there will be a requirement to transfer loans between the two pools. Any proposals to do this will be considered and approved separately.

Internal Borrowing – Cash Management

Both the HRA and General Fund are likely to have surplus cash balances which will allow either account to have external borrowing below its Capital Financing Requirement.

The interest earned on all deposits is initially allocated to the General Fund with a proportion allocated to the HRA based on the average rate of interest earned on the average cash balances during the year.

Use of Financial Instruments

The Council does not use any type of derivative instruments, such as interest rate swaps or hedge accounting, to manage the risk of borrowing.

General Fund Debt

The General Fund does not currently have any actual debt outstanding and its underlying borrowing requirement is financed from reserves and balances as shown in the following table.

General Fund - Net Indebtedness	**2019/20 £'000**	**2020/21 £'000**	**2021/22 £'000**	**2022/23 £'000**	**2023/24 £'000**	**2024/25 £'000**
CFR / Borrowing Requirement	4,988	4,667	4,409	4,214	4,026	3,871
Estimated Reserves	8,951	8,838	8,016	6,911	5,328	2,839
Net Indebtedness	**-3,963**	**-4,171**	**-3,607**	**-2,697**	**-1,302**	**-1,032**

The 2020/21 Financial Plan outlines the balanced approach needed to address the projected deficit on the General Fund, through a combination of utilising reserves and identifying budget savings.

Although in budgeting terms expenditure is still greater than income over the medium-term, the Council does have a history of under spending on its General Fund. This is reviewed each year and budgets adjusted accordingly. However, if the net indebtedness does become positive, this may require some temporary borrowing at an additional cost, although this is not expected to occur until at least 2022/23 and indeed if ever over the life of the current MTFP due to the current level of Reserves.

HRA and Limit on Indebtedness

As previously mentioned, the debt cap for HRA self-financing was removed by the Government during 2018/19, but to ensure affordability the Chief Finance Officer has retained the former limit.
The Cap is shown in the following table with a comparison to the CFR and expected level of actual debt on the HRA.

HRA Limit on Indebtedness	2019/20 £'000	2020/21 £'000	2021/22 £'000	2022/23 £'000	2023/24 £'000	2024/24 £'000
HRA Debt Cap	66,853	66,853	66,853	66,853	66,853	66,853
HRA CFR	61,584	61,584	51,584	51,584	41,584	41,584
Difference	5,269	5,269	15,269	15,269	25,269	25,269
HRA Debt	57,423	57,423	47,423	47,423	37,423	37,423
Borrowing Headroom (Debt Cap minus Debt)	**9,430**	**9,430**	**19,430**	**19,430**	**29,430**	**29,430**

The next debt repayment is a variable rate loan of £10m in 2021/2022 and a fixed rate loan of £10m in 2023/24. The HRA's Financial Plan allows for sums to be set aside from its revenue account, as a provision to repay these and future loans, in accordance with the debt maturity profile.

Revenue Implications

The Financial implications of the Council's expected debt management transactions have been included in the MTFP and are summarised in the following table.

Interest Payable and Receivable	2019/20 £'000	2020/21 £'000	2021/22 £'000	2022/23 £'000	2023/24 £'000	2024/25 £'000
General Fund						
Interest Payable	0	0	0	0	0	0
Interest Received	-180	-180	-150	-129	-99	-82
HRA						
Interest Payable	1,793	1,793	1,793	1,493	1,493	1,493
Interest Received	-90	-90	-65	-47	-22	-5

Borrowing Strategy

The Authority currently holds £57.423m of loans. This relates wholly to the HRA. For many years, the Council has not entered into any other long-term borrowing arrangements and has managed new prudential borrowing internally through its cash reserves and balances. This has proved to be a cheaper form of borrowing compared to the interest earned by having those reserves on deposit.

The maturity analysis of the HRA debt portfolio is as follows:

	Current Rate	Balance as at 29.1.20 £'000
Less than one year		0
Between one and two years	0.79% Variable	10,000
Between two and five years	2.70% Fixed	10,000
Between five and ten years	3.01% Fixed	10,000
More than ten years	3.30% Fixed 3.44% Fixed 3.50% Fixed	10,000 10,000 7,423
TOTAL		**57,423**

The HRA's Financial Plan allows for these repayments by setting-aside resources from HRA surpluses.

The HRA debt will be reviewed regularly with the Council's treasury advisors to ensure that the portfolio continues to suit the Council. It is possible that the Council will be in a position to repay debt earlier or may opt to reschedule some longer-term debt depending on prevailing interest rates. Although this is not anticipated over the current MTFP it will be kept under review. Any early repayment or rescheduling decision will be based on a Net Present Value calculation taking into account the relevant premium or discount of repaying debt early.

As some of the debt is being borrowed at variable rates, this will be kept under closer scrutiny. The cost of this proportion of the portfolio (£10m) is currently contained within the resources of the HRA's Financial Plan. The Plan assumes that the rate on this debt will rise from its current level of 0.92% up to 3% in 2020/21 through to maturity in 2021/22.

Additional Borrowing

The Prudential System for Capital Finance provides flexibility for local authorities to borrow within their overall limit. Effectively, councils can borrow money as long as they are able to demonstrate that the associated interest and principal repayments are affordable and sustainable within their longer-term financial resources. Additional borrowing can also be undertaken on an "invest to save" basis, i.e. the cost of loan finance is met from the payback of the investment (efficiencies or additional income, etc.).

The Council has used the prudential system to finance two capital projects in 2013/14 (extending the Kerbside Recycling Scheme) and in 2015/16 for the development of the Extreme Sports Facility in the Grove Hall, Swadlincote. The costs and payback of this borrowing are included in the treasury indicators and the MTFP.

Borrowing in Advance

The Council will only borrow in advance of need if it is felt that the benefits of borrowing at interest rates now, compared to where they are expected to be in the future, outweighs the current cost and risks associated with investing the proceeds until the borrowing was actually required. Any accounting matters and the general legality will also be considered on a case-by-case basis.

Sources of Borrowing

Previously Authorities main source of borrowing was the PWLB but the government increased PWLB rates by 1% in October 2019 making it now a relatively expensive option. The Authority would look to borrow any long-term loans from other sources including banks, pensions and local authorities, and will investigate the possibility of issuing bonds and similar instruments, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA Code.

Alternatively, the Authority may arrange forward starting loans, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

The approved sources of long-term and short-term borrowing are:

- Public Works Loan Board (PWLB) and any successor body
- any institution approved for investments (as per Counterparty List)
- any other bank or building society authorised to operate in the UK

In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- operating and finance leases
- hire purchase
- Private Finance Initiative
- sale and leaseback

In summary, the key matters in the borrowing strategy for 2020/21 are as follows:

• Meeting the Council's cash flow requirements through the Investment Strategy
• Keeping under review the HRA debt pool and in particular the variable rate of borrowing.

Investment Strategy

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Authority's investment balance has ranged between £38 million and £59 million.

The approved investment policy is based on a counterparty list that has been carefully considered to select those institutions with the best financial structure and the ability to incur losses before a depositor bail-in. This is based on economic data, together with analysis and advice from the Council's treasury advisors. The list is kept under review and updated depending on the changing circumstances of selected counterparties.

The approved lending list and policy is detailed in the Counterparty List. In accordance with regulations, it sets out where the Council will invest surplus funds and places limits upon the various institutions.

The proposed lending list has been updated based on information from the Council's treasury advisors and is relevant as at 27th January 2020. Any proposed changes are reported to the Finance and Management Committee on a quarterly basis

General Lending Policy

Priority is given to specified investments in any investment decision. The length of investment is made in accordance with overall cash flow requirements. The policy focuses on the credit quality of investment counterparties rather than amounts invested and returns.

Where regular investments are made with named financial institutions, this is generally undertaken via instant access accounts. This allows funds to be withdrawn at short notice if the financial situation of these institutions was to change. All other deposits, such as those with the Debt Management Office and other local authorities, tend to be on a fixed and longer-term basis.

Investment Counterparty and Liquidity Framework

The CIPFA Code requires the Authority 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. , Therefore, the primary principle governing the Council's investment criteria is the security and liquidity of its investments. Once that principle is achieved, then yield and length of investment are considered. The Council will also ensure that:

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment sections below.

Specified Investments

The purpose of specified investments is to identify investments offering high security and high liquidity. These investments should be in pounds sterling and with a maturity of no more than a year. They are intended to be used with minimal procedural formalities. Any investments made with the UK Government, another local authority or parish council automatically qualify as specified investments.

In addition, short-term investments with institutions having "high credit ratings" will count as specified investments. The Guidance allows each council to determine these institutions and they must determine locally, investment limits, maximum periods and monitoring arrangements.

Non-Specified Investments

These are all other investments not meeting the criteria of specified investments. Due to the fact that these investments could carry more risk than specified ones, the Council needs to set stricter limits on these investments and determine guidelines on when they should be used.

The Guidance makes it clear that it does not wish to discourage authorities from using non-specified investments. The aim is to ensure that proper procedures are in place for undertaking risk assessments of investments made for longer periods or with bodies that do not carry such a high credit rating.

Credit Quality

The creditworthiness of counterparties remains paramount in any investment decision and this is reflected in the approved lending policy and counterparty list.

In 2014/15, the Council approved a fundamental shift in its lending policy. This moved away from a traditional model based solely on credit ratings, to that based on an assessment of a financial institutions' ability to incur losses before a depositor bail-in.

Besides this, the Council refers to the financial press, any implied Government support for banks and other market data. This is supplemented by information and advice from the Council's retained treasury advisors.

Negative interest rates

If the UK enters into a recession in 2020/21, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

Performance Indicators

The main indicator the Council uses to measure its return on short-term investments to average over the year, is the Average 7-Day Money Market Rate. This is a standard measure of performance. Performance in recent years is shown in the following table.

	2013/14	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**
7-Day Rate (target)	0.47%	0.50%	0.50%	0.36%	0.35%	0.65%
Actual Rate	0.33%	0.31%	0.32%	0.25%	0.39%	0.66%

As at 29th January 2020, the Council's investment portfolio is as follows:

	Current Rate(s)	Balance at 27.01.20 £000
Local Authorities	0.70% - 0.90%	37,850
DMO	0.50%	5,000
Money Market Funds	0.70%	10,000
CCLA Property Funds	3.53%	4,000
Banks	0.50% - 0.65%	3,020
TOTAL		59,870

Treasury Management Prudential Indicators and Limits on Activity

The purpose of these additional indicators is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates.

However, if these are set too restrictively, they could impede the opportunity to reduce debt costs. The indicators are detailed in the following sections.

Upper Limits on Variable Interest Rate Exposure

This indicator identifies a maximum limit for variable interest rates based upon the debt position net of investments. This is set at **5%** and is based on the affordability in the HRA Business Plan. This remains unchanged from that previously adopted.

Upper Limits on Fixed Interest Rate Exposure

This is set at **4.5%** and again is based on the affordability of the HRA Business Plan. This also remains unchanged from that previously adopted.

Maturity Structure of Fixed Rate Borrowing

The current maturity structure of the HRA debt portfolio is as follows:

Less than one year	0%
Between one and two years	17%
Between two and five years	21%
Between five and ten years	35%
More than ten years	48%

Total Principal Funds Invested for Greater Than 364 Days

In October 2019 the Council invested a further £2m in the CCLA Property Fund, bringing its total investment in the fund to £4m. This is for an indefinite period, subject to quarterly review and reported to Members within the Quarterly Monitoring Reports.

Other Options Considered

The DCLG Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The Strategic Director (Corporate Resources), having consulted the Finance and Management Committee, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller
Borrow additional sums at	Debt interest costs will	Higher investment balance

long-term fixed interest rates	rise; this is unlikely to be offset by higher investment income	leading to a higher impact in the event of a default; however long-term interest costs may be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long term costs may be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain