Treasury Management Report Q4 2019/20

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 2019/20 was approved at a meeting of the Authority on 14th February 2019. 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 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, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 17th January 2019.
The detail that follows is in accordance with the CIPFA Code and is written with support from the Council's Treasury Advisor, Arlingclose.

External Context

Economic background: The UK's exit from the European Union and future trading arrangements, had remained one of major influences on the UK economy and sentiment during 2019/20. The 29th March 2019 Brexit deadline was extended to 12th April, then to 31st October and finally to 31st January 2020. Politics played a major role in financial markets over the period as the UK's tenuous progress negotiating its exit from the European Union together with its future trading arrangements drove volatility, particularly in foreign exchange markets. The outcome of December's General Election removed a lot of the uncertainty and looked set to provide a 'bounce' to confidence and activity.

The headline rate of UK Consumer Price Inflation UK Consumer Price Inflation fell to 1.7% y/y in February, below the Bank of England's target of 2%. Labour market data remained positive. The ILO unemployment rate was 3.9% in the three months to January 2020 while the employment rate hit a record high of 76.5%. The average annual growth rate for pay excluding bonuses was 3.1% in January 2020 and the same when bonuses were included, providing some evidence that a shortage of labour had been supporting wages.

GDP growth in Q4 2019 was reported as flat by the Office for National Statistics and service sector growth slowed and production and construction activity contracted on the back of what at the time were concerns over the impact of global trade tensions on economic activity. The annual rate of GDP growth remained below-trend at 1.1%.

Then coronavirus swiftly changed everything. COVID-19, which had first appeared in China in December 2019, started spreading across the globe causing plummeting sentiment and falls in financial markets not seen since the Global Financial Crisis as part of a flight to quality into sovereign debt and other perceived 'safe' assets.

In response to the spread of the virus and sharp increase in those infected, the government enforced lockdowns, central banks and governments around the world cut interest rates and introduced massive stimulus packages in an attempt to reduce some of the negative economic impact to domestic and global growth.

The Bank of England, which had held policy rates steady at 0.75% through most of 2019/20, moved in March to cut rates to 0.25% from 0.75% and then swiftly thereafter brought them down further to the record low of 0.1%. In conjunction with these cuts, the UK government introduced a number of measures to help businesses and households impacted by a series of ever-tightening social restrictions, culminating in pretty much the entire lockdown of the UK.

The US economy grew at an annualised rate of 2.1% in Q4 2019. After escalating trade wars and a protracted standoff, the signing of Phase 1 of the trade agreement between the US and China in January was initially positive for both economies, but COVID-19 severely impacted sentiment and production in both countries. Against a slowing economic outlook, the US Federal Reserve began cutting rates in August. Following a series of five cuts, the largest of which were in March 2020, the Fed Funds rate fell from of 2.5% to range of 0% - 0.25%. The US government also unleashed a raft of COVID-19 related measures and support for its economy including a $2 trillion fiscal stimulus package. With interest rates already on (or below) the floor, the European Central Bank held its base rate at 0% and deposit rate at -0.5%.

Financial markets: Financial markets sold off sharply as the impact from the coronavirus worsened. After starting positively in 2020, the FTSE 100 fell over 30% at its worst point with stock markets in other countries seeing similar huge falls. In March sterling touch its lowest level against the dollar since 1985. The measures implemented by central banks and governments helped restore some confidence and financial markets have rebounded in recent weeks but remain extremely volatile. The flight to quality caused gilts yields to fall substantially. The 5-year benchmark falling from 0.75% in April 2019 to 0.26% on 31st March. The 10-year benchmark yield fell from 1% to 0.4%, the 20-year benchmark yield from 1.47% to 0.76% over the same period. 1-month, 3-month and 12-month bid rates averaged 0.61%, 0.72% and 0.88% respectively over the period.

Since the start of the calendar 2020, the yield on 2-year US treasuries had fallen from 1.573% to 0.20% and from 1.877% to 0.61% for 10-year treasuries. German bund yields remain negative.

Credit review: In Q4 2019 Fitch affirmed the UK's AA sovereign rating, removed it from Rating Watch Negative (RWN) and assigned a negative outlook. Fitch then affirmed UK banks' long-term ratings, removed the RWN and assigned a stable outlook. Standard & Poor's also affirmed the UK sovereign AA rating and revised the outlook to stable from negative. The Bank of England announced its latest stress tests results for the main seven UK banking groups. All seven passed on both a common equity Tier 1 (CET1) ratio and a leverage ratio basis. Under the test scenario the banks' aggregate level of CET1 capital would remain twice their level before the 2008 financial crisis.

After remaining flat in January and February and between a range of 30-55bps, Credit Default Swap spreads rose sharply in March as the potential impact of the coronavirus on bank balance sheets gave cause for concern. Spreads declined in late March and through to mid-April but remain above their initial 2020 levels. NatWest Markets Plc (non-ringfenced) remains the highest at 128bps and National Westminster Bank Plc (ringfenced) still the lowest at 56bps. The other main UK banks are between 65bps and 123bps, with the latter being the thinly traded and volatile Santander UK CDS.

While the UK and Non-UK banks on the Arlingclose counterparty list remain in a strong and well-capitalised position, the duration advice on all these banks was cut to 35 days in mid-March.

Fitch downgraded the UK sovereign rating to AA- in March which was followed by a number of actions on UK and Non-UK banks. This included revising the outlook on all banks on the counterparty list to negative, with the exception of Barclays Bank, Rabobank, Handelsbanken and Nordea Bank which were placed on Rating Watch Negative, as well as cutting Close Brothers long-term rating to A-. Having revised their outlooks to negative, Fitch upgraded the long-term ratings on Canadian and German banks but downgraded the long-term ratings for Australian banks. HSBC Bank and HSBC UK Bank, however, had their long-term ratings increased by Fitch to AA-.

Local Context

On 31st March 2019, the Authority had net borrowing of £19.45m arising from its revenue and capital income and expenditure. This fell to £7.69m by the end of the quarter. 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 below.

Capital Financing Requirement (CFR)

	31.3.19 Actual £'000	**31.03.20 Actual £,000**
Housing Revenue Account		
Debt Outstanding	57,423	57,423
Capital Financing Requirement (CFR)	61,584	61,584
Statutory Debt Cap	66,853	66,853
Borrowing Capacity (Cap less Debt Outstanding)	**9,430**	**9,430**
General Fund		
Debt Outstanding	0	0
Capital Financing Requirement (CFR)	5,653	5,653
Borrowing Capacity (Cap less Debt Outstanding)	**5,653**	**5,653**
Total Capital Financing Requirement (CFR)	**67,237**	**67,237**

The Authority’s current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

The overall treasury management position at 31st March 2020 and the change during the year is shown below.

Treasury Management Summary

	31.3.19 Balance £m	Movement £m	31.03.20 Balance £m	Average Rate %
Long-term borrowing:				
Fixed	47,423	0	47,423	3.19%
Variable	10,000	0	10,000	0.88%
Short-term borrowing	28	0	28	0.00%
Total borrowing	**57,451**	**0**	**57,451**	
Long-term investments	2,000	0	4,000	4.57%
Short-term investments	33,500	18,871	43,371	0.81%
Cash and cash equivalents	2,500	355	2,388	0.41%
Total investments	**38,000**	**19,226**	**49,759**	
Net borrowing	**19,451**	**19,226**	**7,692**	

Borrowing update

On 9th October 2019 the PWLB raised the cost of certainty rate borrowing by 1% to 1.8% above UK gilt yields as HM Treasury was concerned about the overall level of local authority debt. PWLB borrowing remains available but the margin of 180bp above gilt yields appears relatively very expensive. Market alternatives are currently available and new products will be developed; however, the financial strength of individual authorities will be scrutinised by investors and commercial lenders.

The Chancellor’s March 2020 Budget statement included significant changes to Public Works Loan Board (PWLB) policy and launched a wide-ranging consultation on the PWLB’s future direction. Announcements included a reduction in the margin on new HRA loans to 0.80% above equivalent gilt yields. The value of this discount is 1% below the rate at which the authority usually borrows from the PWLB), available from 12th March 2020 and £1.15bn of additional “infrastructure rate” funding at gilt yields plus 0.60% to support specific local authority infrastructure projects for England, Scotland and Wales for which there is a bidding process.

The consultation titled “Future Lending Terms” represents a frank, open and inclusive invitation, allowing key stakeholders to contribute to developing a system whereby PWLB loans can be made available at improved margins to support qualifying projects. It contains proposals on allowing authorities that are not involved in “debt for yield” activity to borrow at lower rates as well as stopping local authorities using PWLB loans to buy commercial assets primarily for yield without impeding their ability to pursue their core policy objectives of service delivery, housing, and regeneration. The consultation also broaches the possibility of slowing, or stopping, individual authorities from borrowing large sums in specific circumstances.

The consultation closes on 4th June 2020 with implementation of the new lending terms expected in the latter part of this calendar year or financial year beginning 2021/22.

Borrowing Activity

At 31st March 2020 the Authority held £57.4m of loans. These loans were taken out by the Authority in 2011/12 for the purpose of HRA self-financing. The principal element of these loans is repayable in full on maturity, with interest being paid each March and September.

The short-term borrowing of £28k relates to deposits received from two Parish Councils within the District. These loans can be recalled on immediate notice. Interest is calculated at the Bank of England Base Rate, less 1%. No interest is currently being paid due to the Base Rate being less than 1%.

The following table shows the maturity dates of the loans and rate of interest payable.

Borrowing Position

Loan Profile	Type	Value £'000	Rate %	Maturity
Public Works Loan Board	Variable	10,000	0.92	2021/22
Public Works Loan Board	Fixed	10,000	2.70	2023/24
Public Works Loan Board	Fixed	10,000	3.01	2026/27
Public Works Loan Board	Fixed	10,000	3.30	2031/32
Public Works Loan Board	Fixed	10,000	3.44	2036/37
Public Works Loan Board	Fixed	7,423	3.50	2041/42
Total Long-term borrowing		**57,423**		
Short-term Parish Council Loans		**28**	0.00	
Total borrowing		**57,451**		

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.

Treasury Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the quarter, the Authority's investment balance ranged between £59 and £50m due to timing differences between income and expenditure. The investment position during the quarter is shown in the table below.

Treasury Investment Position

	31.03.19 Balance £'000	Q4 2020 Movement £'000	31.03.20 Balance £'000	31.03.20 Rate of Return %
Banks (unsecured)	2,500	(112)	2,388	0.41
Local Authorities	25,000	15,350	40,350	0.91
Money Market Funds	8,500	(5,000)	3,000	0.57
CCLA Property Fund	2,000	2,000	4,000	4.57
Total investments	**38,000**	**12,238**	**49,738**	

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.

In furtherance of these objectives, and given the increasing risk and falling returns from short-term unsecured bank investments, the Authority has undertaken greater detailed cash flow forecasting which has enabled it to enter into longer-term deposits with other Local Authorities, therefore securing a higher rate of return.

The Authority participates in the Arlingclose quarterly investment benchmarking exercises. This enables us to measure our investment portfolio against other similar Local Authorities. The progression of risk and return are shown in the extracts from Arlingclose's quarterly benchmarking in the table below at the end of quarter 4.

Investment Benchmarking – Treasury investments managed in-house (excludes CCLA)

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2020	3.78	AA-	12%	126	0.57
Similar LAs	3.95	AA-	59%	53	-0.79
All LAs	4.03	AA-	56%	20	-0.34

In a relatively short period since the onset of the COVID-19 pandemic, the global economic fallout was sharp and large. Market reaction was extreme with large falls in equities, corporate bond markets and, to some extent, real estate echoing lockdown-induced paralysis and the uncharted challenges for governments, businesses and individuals. Volatility measured by the VIX index was almost as high as during the global financial crisis of 2008/9 and evidenced in plummeting equity prices and the widening of corporate bond spreads, very close to rivalling those twelve years ago. Gilt yields fell but credit spreads widened markedly reflecting the sharp deterioration in economic and credit conditions associated with a sudden stagnation in economies, so corporate bonds yields (comprised of the gilt yield plus the credit spread) rose and prices therefore fell.

Credit Score:	This is a value-weighted average score calculated by weighting the credit score of each investment by its value. A higher number indicates a higher risk.
Credit Rating:	This is based on the long-term rating assigned to each institution in the portfolio, by ratings agencies Fitch, Moody's and Standard & Poor's. Ratings rang from AAA to D, and can be modified by +/-
Bail-in Exposure:	The adoption of a bail-in regime for failed banks results in a potential increased risk of loss of funds for local authority should this need to be implemented. Therefore a lower exposure to bail-in investments reduces this risk.
Weighted Average Maturity:	This is an indicator of the average duration of the internally-managed investments. Similar authorities have a similar profile to South Derbyshire; other larger authorities tend to hold a greater proportion of fund in money markets than fixed-term deposits with other LAs, due to their cash flow requirements.
Rate of Return:	This is the average rate received on internally managed investments. At the quarter-end we had a few lower rate investments that were secured prior to the base rate rise in August 2018, which reduced the average rate of return compared to other authorities.

The Authority deposited £1m in the CCLA Property Fund on 28th September 2017; the Authority subsequently deposited a further £1m in the fund on 28th August 2018. Following a review on the performance of the CCLA Property Fund an additional £2m investment was approved by Members to purchase 618,334 units at an offer price of 323.45p per unit on the 31st October 2019.

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 Authority's investment objectives is regularly reviewed. The mid-market value of the fund as at the 31st March 2020 is £3,680,720 and the bid market value is £3,623,594. This reinforces the notion that the Fund should only be considered for long-term investments.

The performance of the investment over the last quarter is shown in the table below. Although past performance is no guarantee of future returns, the movement in the bid (selling) price so far shows how the value of the investment is moving closer to the original purchase price. This reinforces the notion that the Fund should only be considered for long-term investments.

CCLA Property Fund Performance

		2018/19 Q4	2019/20 Q4
Dividend Received	£	20,736	40,484
Annual Equivalent Interest Rate	%	4.26	4.57%
Bid (Selling) Price	pence/unit	301.95	291.15

Covid-19 Impact on performance - At the start of the year, consensus expectations were that property sector returns in 2020 would be broadly flat. The contribution from income would continue to be important – property is the highest yielding of the major asset classes but this positive would be offset by a decline in capital values.

The immediate impact of Covid-19 amplified pressures already existing for valuers. Dealing volumes, already depressed, fell further, leaving valuers short of data at a time when valuations were clearly changing. The result was that the fund valuations they provided were ‘qualified’; that is issued but without the expected confidence in their accuracy.

The CCLA funds position was to suspend dealing in funds. This is expected to remain necessary for a few more months until confidence that the valuations truly reflect market conditions.

Looking forward, CCLA funds expect a period of economic recovery next year and for this to be reflected in positive returns from the sector; the recession has been a shock to values, but it should be a passing one. In particular, the excess supply and distressed selling that undermined values in the previous recession isn’t present today.

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 for the first three quarters is shown below.

	As at 31.03.19	As at 31.03.20
Average 7-Day Money Market Rate (Target)	0.65%	42%
Average Interest Rate Achieved on Short Term Deposits	0.66%	54%

Compliance

The Chief Finance Officer is pleased to report that all treasury management activities undertaken during quarter 4 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy.

Compliance with specific investment limits is demonstrated in the table below:

Investment Limits

	Maximum Investment during Q3 £m	**Maximum Invested per Counterparty £m**	**Limit**	**Maximum Term**	**Complied**
Debt Management Office	£5m	£5m	£20m in total	364 days	✓
Other Local Authorities	£37.8m	£5m	£5m per Authority	364 days	✓
Money Market funds	£10m	£2m	£10m total, £2m per fund	60 days	✓
CCLA Property Fund	£4m	£4m	£4m	Indefinite period	✓
Named Counterparties (HSBC/Lloyds/BOS/Close Bros/Santander)	£3.46m	£1.96m	£2m per Bank	35 days	✓
Named Counterparties (Barclays/Goldman Sachs/NatWest/RBS)	£3.7m	£2.m	£2m per Bank	35 days	✓
Named Counterparties (Nationwide/Coventry)	0	0	5% of total deposits	35 days	✓
Named Counterparties (Leeds Building Society)	0	0	5% of total deposits	35 days	✓
Foreign Counterparties	0	0	AAA rated - £1m per Bank	35 days	✓
Independent Building Societies	0	0	£1m per Society	35 days	✓

Arlingclose reduced the limits in UK banks and Building Societies to 35 days from 27th March 2020 until this point we have them listed at 100 days and 6 months on our Counterparty list.

Other

IFRS 16: CIPFA/LASAAC has proposed delaying the implementation of the new IFRS 16 Leases accounting standard for a further year to 2021/22.