South Derbyshire District Council

Treasury Management Report Q3 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

Having now left the EU and free to set up new trade deals, it has been reported that the UK will be hoping to secure an early trade pact with Australia as part of the "first wave" of agreements the government seeks to secure according to Foreign Secretary. At the moment the UK's trade deal with Australia is worth around 17 billion, a timetable, however, for starting the talks has not been given.

Britain plans to develop a new tariff schedule which will come into force in 2021 and apply to goods from countries around the world where no trade agreements are in place It will be called the UK Global Tariff and it is hoped it will simplify tariffs and remove them completely on goods where Britain has no domestic production.

The UK services sector PMI survey came in better than expected in January as the flash estimate was revised up to 53 9 from 52 9 beating the consensus forecast for a no change. This result gives a clear signal the economy is improving and is consistent with growth in official services output of around 0 5 in Q 1 comfortably ahead of the 0 1 3 m/ 3 m gain in November. The manufacturing and construction sector PMIs also rebounded in January, pushing the all sector number to 52 8 from 48 9 a level consistent with Q 1 GDP of around 0 3 q/q. This is slightly ahead of the Bank of England's forecast of 0 2 for Q 1 but either way the strength of these numbers is consistent with our interest rate view of Bank Rate of 0 75 remaining on hold.

Despite inflation in the euro zone remaining stubbornly below the 2 target for almost seven years, European Central Bank chief economist Philip Lane stated this week that pressures are building slowly, but in line with the Bank's forecast The deflationary drag from the shift to a digital economy is expected not to be permanent according to Mr Lane, who is expecting wage pressures in the services sector to increase steadily, but conceded that it will take some time before inflation gets anywhere close to target.

Also speaking this week, ECB President Christine Lagarde warned that the coronavirus is adding to global economic uncertainty and will likely exacerbate widespread concerns over the impact of trade protectionism having only recently receded following the signing of the Phase 1 trade deal between the US and China.

Update on the financial impact of Coronavirus

Investors had previously taken a relatively sanguine view of coronavirus, but this has quickly changed as the geographic reach of virus has escalated and with it the impact on activity and the consequences for corporate earnings.

The geographic reach of the Coronavirus (2019-nCoV) outbreak is rapidly expanding and, whilst secondary to the impact on health, is having significant and adverse economic consequences. Central banks stand ready to support the global financial system in a coordinated way not seen since the financial crisis in 2008. The US Federal Reserve announced a surprise 50bp cut in US official interest rates on 3rd March.

The uncertainty surrounding 2019-nCoV is resulting in volatile financial markets with a strong bias towards flows into safe haven assets that include UK government gilts. Longer term market rates have declined to new lows. Long-term alternatives to the PWLB exist but involve a lead time and careful analysis. Lower official interest rates are increasingly likely and could lead to near zero or negative money market rate.

Financial markets:

Financial markets adopted a more risk-on approach over the quarter as equities rallied in expectation of ongoing monetary stimulus from central banks. The Dow Jones ended the 2019 calendar year up 22%, while the FTSE 100 and FTSE 250 jumped on the UK general election result with the former gaining 12% during 2019 and the latter around 25%.

Gilt yields remained volatile over the period. From 0.28% at the end of September, the 5-year benchmark gilt rose to 0.60% by the end of December. There were rises in the 10-year and 20-year gilts over the same period, with the former climbing from 0.48% to 0.82% and the latter from 0.88% to 1.24%. 1-month, 3-month and 12-month SONIA (Sterling Overnight Index Average) bid rates averaged 0.63%, 0.76% and 0.93% respectively over the period.

The US yield curve returned to ‘normal’ over the period with 2-year ending 2019 at 1.56% and the 10-year at 1.91%. German bunds continued to remain firmly negative with the 10-year ending 2019 at -0.19% with 2 and 5-year securities ending at -0.61% and -0.46% respectively.

Credit background: Credit Default Swap (CDS) spreads fell over the quarter. Non-ringfenced bank NatWest Markets plc CDS fell to 50 basis points at the end of December from over 80bp in September, while for the ringfenced entity, National Westminster Bank plc, the spread fell to around 30bp. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 29 and 50bp at the end of the quarter.

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.

Moody's revised HSBC Bank's outlook to negative from stable as it expects restructuring costs to negatively impact net income over the next year or two.

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.

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 £1.8M 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	**31.12.19 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 December 2019 and the change during the year is shown below.

Treasury Management Summary

	31.3.19 Balance £m	Movement £m	31.12.19 Balance £m	Average Rate %
Long-term borrowing:				
Fixed	47,423	0	47,423	3.19%
Variable	10,000	0	10,000	0.86%
Short-term borrowing	28	0	28	0.00%
Total borrowing	**57,451**	**0**	**57,451**	
Long-term investments	2,000	0	4,000	3.53%
Short-term investments	33,500	18,871	52,371	0.77%
Cash and cash equivalents	2,500	355	2,855	0.41%
Total investments	**38,000**	**19,226**	**59,226**	
Net borrowing	**19,451**	**19,226**	**1,775**	

Borrowing Activity

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.

Short-term "local to local" funding is available at around Bank Rate of 0.75% and 1-year money around 1.1%.

At 31st December 2019 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 £51 and £59m 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	Q3 2019 Movement £'000	31.12.19 Balance £'000	31.12.19 Rate of Return %
Banks (unsecured)	2,500	355	2,855	0.41
Local Authorities	25,000	17,350	42,350	0.85
Money Market Funds	8,500	1,500	10,000	0.71
CCLA Property Fund	2,000	2,000	4,000	3.53
Total investments	**38,000**	**12,853**	**59,205**	

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 3.

<u>Investment Benchmarking – Treasury investments managed in-house (excludes CCLA)</u>

	Credit Score	**Credit Rating**	**Bail-in Exposure**	**Weighted Average Maturity (days)**	**Rate of Return %**
31.12.2019	3.80	AA-	23%	132	0.71
Similar LAs	4.11	AA-	63%	80	1.58
All LAs	4.11	AA-	60%	28	1.22

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, with the investment purchasing 317,985 units at an offer price of 314.48p per unit. Following member approval, the Authority subsequently deposited a further £1m in the fund on 28th August 2018, with this investment purchasing 308,261 units at an offer price of 324.40p per unit. 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 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	**2019/20**
		Q4	**Q3**
Dividend Received	£	20,736	33,184
Annual Equivalent Interest Rate	%	4.26	3.53%
Bid (Selling) Price	pence/unit	301.95	297.61

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 3 31.12.19**
Average 7-Day Money Market Rate (Target)	0.65%	0.67%
Average Interest Rate Achieved on Short Term Deposits	0.66%	0.72%

Compliance

The Chief Finance Officer is pleased to report that all treasury management activities undertaken during quarter 3 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	£1.95m	£2m per Bank	6 months	✓
Named Counterparties (Barclays/Goldman Sachs/NatWest/RBS)	£3.7m	£2.m	£2m per Bank	100 days	✓
Named Counterparties (Nationwide/Coventry)	0	0	5% of total deposits	6 months	✓
Named Counterparties (Leeds Building Society)	0	0	5% of total deposits	100 days	✓
Foreign Counterparties	0	0	AAA rated - £1m per Bank	1 month	✓
Independent Building Societies	0	0	£1m per Society	100 days	✓

Outlook for the remainder of 2019/20

Our treasury advisor Arlingclose expects Bank Rate to remain at 0.75% for the foreseeable future but there remain substantial risks to this forecast, dependant on Brexit/trade deal outcomes as well as the evolution of the global economy. Arlingclose also expects gilt yields to remain at low levels for the foreseeable future and judges the risks to be weighted to the downside.

	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Case	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Downside risk	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75