South Derbyshire District Council

Treasury Management Report Q3 2020/21

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 2020/21 was approved at a meeting of the Authority on 26th February 2020. 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: Some good news came during the quarter as two COVID-19 vaccines were given approval by the UK Medicines and Healthcare products Regulatory Agency (MHRA). The UK Medicines and Healthcare products Regulatory Agency (MHRA) provided authorisation for emergency supply of two COVID-19 vaccines in December and the rollout to individuals in the highest priority groups began in earnest.

A Brexit trade deal was agreed with only days to spare before the 11pm 31st December 2020 deadline Having been agreed with the European Union (EU) on Christmas Eve, the Brexit trade deal was voted through the House of Commons by 521 votes to 73 and then written into law after passing through the House of Lords and given royal assent.

The Bank of England (BoE) maintained Bank Rate at 0.1% during the quarter but extended its Quantitative Easing programme by £150 billion to £895 billion at its November 2020 meeting. In its December interest rate announcement, the BoE noted that plans to roll out COVID-19 vaccines would reduce some of the downside risks to the economic outlook but that recent rises in the number of infections is likely to lead to weaker GDP growth than had been predicted in its November Monetary Policy Report.

Government initiatives continued to support the economy as the furlough (Coronavirus Job Retention) scheme was extended once again to April 2021, supporting some 10 million jobs, and meaning that by then the Government would have provided taxpayer support to jobs for over a year.

GDP growth rebounded by 16.0% (upwardly revised from first estimate of 15.5%) in Q3 2020 (Jul-Sep) according to the Office for National Statistics (ONS), pulling the annual growth rate up to -8.6% from -20.8% in Q2. Construction rose by a huge 41% over the quarter, services output was up almost 15% as was production output. However, recent monthly estimates of

GDP have shown growth is slowing and only a 1.1% monthly rise was managed in September.

The headline rate of UK Consumer Price Inflation (CPI) rose to 0.3% year/year in November, below expectations (0.6%) and still well below the Bank of England's 2% target. The ONS' preferred measure of CPIH which includes owner-occupied housing was 0.6% year/year (0.8% expected). The weaker-than-expected readings were due to falling prices for clothing as Black Friday deals started earlier than usual and for food and non-alcoholic drinks.

In the three months to October, labour market data showed the unemployment rate increased from 4.3% to 4.9% while wages rose 2.7% for total pay in nominal terms (2.8% for regular pay) and was up 1.9% in real terms (2.1% for regular pay). The employment rate fell to 75.2% from 75.8%. Unemployment is expected to increase strongly once the various government job support schemes come to an end, with the BoE predicting unemployment could peak at almost 8% in the second quarter of 2021.

The US economy rebounded at an annualised rate of 33.4% in Q3 2020 (Jul-Sep), fuelled by more than $3 trillion in pandemic relief. The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25%.

The European Central Bank maintained its base rate at 0% and deposit rate at -0.5% but increased the size of its asset purchase scheme to €1.85 trillion and extended it until March 2022.

Financial markets:

Equity markets continued to rise, and the Dow Jones beat its pre-crisis peak on the back of continued outperformance by a small number of technology stocks. The FTSE indices continued to perform well, with the more internationally focused FTSE 100 getting back to around 60% of its pre-March level while the more UK-focused FTSE 250 was closer to 80% of its previous peak over the same period.

Ultra-low interest rates prevailed through the quarter. Gilt yields remained low but volatile over the period with the yield on some short-dated UK government bonds continuing to remain negative. The 5-year UK benchmark gilt yield started the October–December period at -0.07% and ended at -0.09% (with much volatility in between). The 10-year gilt yield fell from 0.23% to 0.19% over the same period but peaked at 0.40% in November during a volatile quarter. The 20-year fell from 0.76% to 0.69%. 1-month, 3-month and 12-month SONIA bid rates averaged -0.01%, 0.06% and 0.07% respectively over the three months.

At the end of December, the yield on 2-year US treasuries was around 0.12% while for 10-year treasuries the yield was 0.92%. German bund yields remain negative across most maturities.

Credit review: After rising in late October/early November, credit default swap spreads declined over the remaining period of the calendar year to broadly pre-pandemic levels and the gap in spreads between UK ringfenced and non-ringfenced entities remained. At the end of the period Barclays Bank Plc was trading the highest at 57bps and Standard Chartered the lowest at 32bps. The ringfenced banks were trading between 33 and 36bps.

During the period Moody's downgraded the UK sovereign rating to Aa3 with a Stable outlook which then impacted a number of other UK institutions, banks and local government. These included Cornwall Council and Guildford BC which were downgraded to Aa3.Transport for

London, Aberdeen CC, Lancashire CC, Lloyds Bank and HSBC Bank downgraded to A1 and Warrington BC was downgraded to A2.

While the approval of two coronavirus vaccines is a credit positive, there remains much uncertainty around the extent of the losses banks and building societies will suffer due to the economic slowdown which has resulted due to pandemic-related lockdowns and restrictions. 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.

<u>Local Context</u>

On 31st March 2020, the Authority had net borrowing of £7.69m arising from its revenue and capital income and expenditure. This fell to £-15,064 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)

	31.03.20 Actual £,000	**30.06.20 Actual £'000**	**30.09.20 Actual £,000**	**31.12.20 Actual £,000**
<u>Housing Revenue Account</u>				
Debt Outstanding	57,423	57,423	57,423	57,423
Capital Financing Requirement (CFR)	61,584	61,584	61,584	61,584
Statutory Debt Cap	66,853	66,853	66,853	66,853
Borrowing Capacity (Cap less Debt Outstanding)	**9,430**	**9,430**	**9,430**	**9,430**
<u>General Fund</u>				
Debt Outstanding	0	0	0	0
Capital Financing Requirement (CFR)	5,653	5,653	5,653	5,653
Borrowing Capacity (Cap less Debt Outstanding)	**5,653**	**5,653**	**5,653**	**5,653**
Total Capital Financing Requirement (CFR)	**67,237**	**67,237**	**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 2020 and the change during the quarter is shown below.

Treasury Management Summary

	31.03.20 Balance £m	Movement £m	31.12.20 Balance £m	Average Rate %
Long-term borrowing:				
Fixed	47,423	0	47,423	3.19%
Variable	10,000	0	10,000	0.48%
Short-term borrowing	28	0	28	0.00%
Total borrowing	**57,451**	**0**	**57,451**	
Long-term investments	4,000	0	4,000	5.29%
Short-term investments	43,371	19,629	63,000	0.14%
Cash and cash equivalents	2,388	3,127	5,515	0.00%
Total investments	**49,759**	**22,756**	**72,515**	
Net borrowing	**7,692**	**22,756**	**(15,064)**	

Borrowing update

In November 2020 the PWLB published its response to the consultation on 'Future Lending Terms'. From 26th November the margin on PWLB loans above gilt yields was reduced from 1.8% to 0.8% providing that the borrowing authority can confirm that it is not planning to purchase 'investment assets primarily for yield' in the current or next two financial years. Authorities that are purchasing or intending to purchase investment assets primarily for yield will not be able to access the PWLB except to refinance existing loans or externalise internal borrowing. As part of the borrowing process authorities will now be required to submit more detailed capital expenditure plans with confirmation of the purpose of capital expenditure from the Section 151 Officer. The PWLB can now also restrict local authorities from borrowing in unusual or large amounts.

Acceptable use of PWLB borrowing includes service delivery, housing, regeneration, preventative action, refinancing and treasury management. Misuse of PWLB borrowing could result in the PWLB requesting that Authority unwinds problematic transactions, suspending access to the PWLB and repayment of loans with penalties.

Competitive market alternatives may be available for authorities with or without access to the PWLB. However, the financial strength of the individual authority and borrowing purpose will be scrutinised by commercial lenders.

Municipal Bonds Agency (MBA): The MBA revised its standard loan terms and framework agreement. Guarantees for the debt of other borrowers are now proportional and limited and a requirement to make contribution loans in the event of a default by a borrower has been introduced. The agency has issued 5-year floating rate and 40-year fixed rate bonds in 2020, in both instances Lancashire County Council is the sole borrower and guarantor. A planned third bond issuance by Warrington Borough Council was withdrawn in early December after the reduction in PWLB borrowing rates.

If the Authority intends future borrowing through the MBA, it will first ensure that it has thoroughly scrutinised the legal terms and conditions of the arrangement and is satisfied with them.

Borrowing Activity

At 31st December 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 £89k 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		**89**	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

On 13th November the Authority received central government funding to support small and medium businesses during the coronavirus pandemic through grant schemes. £3.2m was received, temporarily invested in short-dated, liquid instruments such as call accounts and Money Market Funds. £700k was disbursed by the end of December.

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 £50m and £72.5m due to timing differences between income and expenditure. The investment position during the quarter is shown in the table below.

Treasury Investment Position

	30.03.20 Balance £'000	Q3 2020 Movement £'000	31.12.20 Balance £'000	31.12.20 Rate of Return %
Banks (unsecured)	2,388	3,127	5,515	0.00
Local Authorities	40,350	11,650	52,000	0.18
Money Market Funds	3,000	8,000	11,000	0.05
CCLA Property Fund	4,000	0	4,000	5.29
Total investments	**49,738**	**22,777**	**72,515**	

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.

Continued downward pressure on short-dated cash rate brought net returns on sterling low volatility net asset value money market funds (LVNAV MMFs) close to zero even after some managers have temporarily lowered their fees. At this stage net negative returns are not the central case of most MMF managers over the short-term, and fee waivers should maintain positive net yields, but the possibility cannot be ruled out.

Deposit rates with the Debt Management Account Deposit Facility (DMADF) have continued to fall and are now largely below zero. Funds invested for 3 weeks earn -0.03% rising to -0.01% for a deposit of 4 months or more. The rate was 0% for up to 3-week deposits.

The net return on Money Market Funds net of fees, which had fallen after Bank Rate was cut to 0.1% in March, are now at or very close to zero; fund management companies have temporarily lowered or waived fees to avoid negative net returns.

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

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

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.12.2020	4.39	AA-	10%	117	0.20
Similar LAs	4.68	A+	65%	41	-0.07
All LAs	4.73	A+	63%	17	0.00

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.

Externally Managed Pooled Funds

£4m of the Authority's investments are invested in externally managed strategic pooled property funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds generated an average total return of £40k (4.58%), its estimated a £160k income return will be achieved this year, which is used to support services in year.

Because the Authority's externally managed funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives are regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three- to five-year period total returns will exceed cash interest rates.

CCLA Property Fund Performance

		2019/20 Q4	2020/21 Q1	2020/21 Q2	2020/21 Q3
Dividend Received	£	40,484	34,886	38,633	46,574
Annual Equivalent Interest Rate	%	4.57%	4.01%	4.44%	5.29%
Bid (Selling) Price	pence/unit	291.15	279.57	283.43	287.50

The mid-market value of the fund as at the 31st December 2020 is £3,578,167 and the bid market value is £3,522,783. This reinforces the notion that the Fund should only be considered for long-term investments.

In 2020/21 the Authority expects to receive significantly lower income from its cash and short-dated money market investments, including money market funds, as rates on cash investments are close to zero percent. Income from most of the Authority's externally managed funds will also be expected to be lower than in 2019/20 and earlier years. Whilst the arrival and approval of vaccines against COVID-19 and the removal of Brexit uncertainty that has weighed on UK equities are encouraging developments, dividends and income distribution will also depend on other factors including but not limited to the length of time economies take to recover from the impact of the pandemic, the fund's sectoral asset allocation, securities held/bought/sold and, in the case of equities, the enforced dividend cuts or deferral required by regulatory authorities or due to corporates reducing dividends to safeguard liquidity during a period of economic uncertainty.

The authority's investment in the CCLA fund has been stable throughout 20/21. The performance of the fund has continued to yield positive dividends with rising rates of interest each quarter.

Performance

Average 7 day Interest Rate

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 second quarter is shown below.

	As at 31.03.20	As at 31.12.20
Average 7-Day Money Market Rate (Target)	0.42%	0.15%
Average Interest Rate Achieved on Short Term Deposits	0.54%	0.58%

Cost of Debt

This indicator shows how much the costs of borrowing impact upon each household (at Band D Council Tax rate) in the District. The impact on Council Tax is positive as the General Fund has no actual debt. The performance for the third quarter is shown below using the current interest received compared to the annual interest received last year.

General Fund Impact per Council Tax Payer	Actual 31.03.2020	As at 31.12.20
	£'000	£'000
Net Interest Received - General Fund	-299,788	-196,905
Band D Properties	33,302	34,474
Cost per Band D Property	**-£9.00**	**-£5.71**

The cost of debt on each council tenant (HRA) is shown below. The performance for the second quarter is the actual costs compared to the estimated costs for the year. The fluctuation in interest paid is the decrease in interest rate of the £10m variable loan and the acquisition of new council houses.

HRA Debt Interest per Dwelling	31.03.20 Actual	31.12.2020 Estimated
HRA Interest Payable	1,595,062	1,553,198
Dwellings	2,970	2,978
Annual Cost per Dwelling	**£537.06**	**£521.56**

Compliance

The Chief Finance Officer reports that during the third quarter treasury management activities have not fully complied with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy.

Throughout the beginning of the third quarter from the 1st October until the 5th October, the balance held in the Council's main bank account, Barclays breached the Counterparty limit of £2m. The reason for the breach is that the cash limits were over the maximum and at the end of the second quarter, as reported on 26th November, the direct debit collections for payment of Council Tax and NNDR exacerbated the situation. The counterparty limit was breached by a maximum of £707,089. The S151 Officer was informed of the potential breach and advised the Finance team to exceed the limit in the current account rather than any other counterparty.

Before the proposal to open additional Money Market accounts, and to increase our limits in Barclays was approved on 26th November, the Council received £600k from the Government to support the Track and Trace payments which forced an overnight breach of £758,735 on the 15th October. Following the announcement of a second lockdown, the Government made a further payment of £3.2m in order to fund the new grant scheme for small and medium sized busines. This created a breach of the Counterparty limit in Barclays on the 16th and 17th of November, the maximum amount of the breach was £109,004. The S151 Officer was informed of the potential breach and advised the Finance team to exceed the limit in the current account rather than any other counterparty.

Non-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	£20m	£3.2m	£20m in total	364 days	✓
Other Local Authorities	£39m	£5m	£5m per Authority	364 days	✓
Money Market funds	£11m	£2m	£14m total, £2m per fund	60 days	✓
CCLA Property Fund	£4m	£4m	£4m	Indefinite period	✓
Named Counterparties (HSBC/Lloyds/BOS/Santander)	£1.99m	£1.99m	£2m per Bank	35 days	✓
Named Counterparties (Barclays/NatWest/RBS)	£3.1m	£3.1m	£3m per Bank	35 days	☒
Named Counterparties (Nationwide)	0	0	5% of total deposits	35 days	✓
Foreign Counterparties	0	0	AAA rated - £1m per Bank		✓
Independent Building Societies	0	0	£1m per Society	35 days	✓

Other

IFRS 16: The implementation of the new IFRS 16 Leases accounting standard has been delayed for a further year until 2022/23.

Arlingclose's Outlook for the remainder of 2020/21

	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
Official Bank Rate													
Upside risk	0.00	0.00	0.15	0.15	0.15	0.15	0.30	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Downside risk	0.30	0.40	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50

The medium-term global economic outlook has improved with the distribution of vaccines, but the recent upsurge in coronavirus cases has worsened economic prospects over the short term.

Restrictive measures and further lockdowns are likely to continue in the UK and Europe until the majority of the population is vaccinated by the second half of 2021. The recovery period will be strong thereafter, but potentially longer than previously envisaged.

Signs of a slowing UK economic recovery were already evident in UK monthly GDP and PMI data, even before the second lockdown and Tier 4 restrictions. Employment is falling despite an extension to support packages.

The need to support economic recoveries and use up spare capacity will result in central banks maintaining low interest rates for the medium term.

Brexit, whatever the outcome of current negotiations, will weigh on UK activity. The combined effect of Brexit and the after-effects of the pandemic will dampen growth relative to peers, maintain spare capacity and limit domestically generated inflation. The Bank of England will therefore maintain loose monetary conditions for the foreseeable future.

Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid longer-term inflation expectations. There is a chance yields may follow a slightly different path in the medium term, depending on investor perceptions of growth and inflation, the deployment of vaccines or if the UK leaves the EU without a deal.

Arlingclose expects Bank Rate to remain at the current 0.10% level. The central case for Bank Rate is no change, but further cuts to zero, or perhaps even into negative territory, cannot be completely ruled out.

Gilt yields will remain low in the medium term. Shorter term gilt yields are currently negative and will remain around zero or below until either the Bank expressly rules out negative Bank Rate or growth/inflation prospects improve.

Downside risks remain, and indeed appear heightened, in the near term, as the government reacts to the escalation in infection rates and the Brexit transition period comes to an end.