South Derbyshire District Council

Treasury Management Report Q1 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: The UK's exit from the European Union took a back seat during the first quarter of 2020/21 as the global economic impact from coronavirus took centre stage. Part of the measures taken to stop the spread of the pandemic included the government implementing a nationwide lockdown in late March which effectively shut down almost the entire UK economy. These measures continued throughout most of the quarter with only some easing of restrictions at the end of May and into June.

Bank Rate was maintained at 0.1% despite some speculation that the Bank of England's Monetary Policy Committee (MPC) might cut further and some MPC members also suggesting that negative rates are part of the Bank's policy tools. In June the Bank increased the asset purchase scheme by £100 billion, taking the recent round of QE to £300bn and total QE to £745 billion.

At the same time, the government also implemented a range of fiscal stimulus measures totalling over £300 billion which had been announced in March and designed to dampen the effect of the pandemic on the labour market.

GDP growth contracted by 2.2% in Q1 (Jan-Mar) 2020 pushing the annual growth rate down to -1.6%. The lockdown only came into force on 23rd March, and the markets are braced for a dire set of growth data for Q2. In April UK GDP fell 20.4% month-on-month. On the back of the 5.8% month-on-month fall in March, this means economic output fell by 25% compared to its pre-coronavirus peak in February 2020.

The headline rate of UK Consumer Price Inflation UK Consumer Price Inflation fell to 1.2% y/y in May, further below the Bank of England's 2% target.

In the three months to June, labour market data remained largely unchanged on the previous quarter. This is likely due to the government's furlough scheme as more than a quarter of the UK workforce was estimated to be supported by it. The ILO unemployment rate remained unchanged at 3.9% while the employment rate fell to 76.4%. However, employers will have to contribute towards furlough payments from August and the scheme is due to stop at the end of October; unemployment is expected to rise as a result.

The US economy contracted at an annualised rate of 5.0% in Q1 2020. The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25% while the US government announced a $2 trillion fiscal stimulus package. Relations between the US and China, which had briefly improved when Phase 1 of the trade agreement was signed in January, deteriorated over the quarter.

With little room to move on interest rates, the European Central Bank maintained interest rates at 0% and the rate on the deposit facility (which banks may use to make overnight deposits with the Euro system) at -0.5% and announced a further huge, open-ended commitment to buy €600bn of bonds under its Pandemic Emergency Purchase Programme (PEPP) which can be reinvested out to 2022. This lifted the ECB's total bond buying support package to €1.35trillion.

Financial markets:

After selling off sharply in March, equity markets started recovering in April and while still down on their pre-crisis levels, the Dow Jones and FTSE 100 and 250 have made up around half of the losses. Measures implemented by central banks and governments continue to maintain some degree of general investor confidence, however volatility remains.

Ultra-low interest rates and the flight to quality continued to keep gilts yields low over the period with the yield on some short-dated government bonds turning negative. The 5-year UK benchmark gilt yield dropped from 0.18% at the beginning of April 2020 to -0.06% on 30th June. The 10-year benchmark gilt yield fell from 0.31% to 0.14% over the same period, and the 20-year from 0.69% to 0.52%. 1-month, 3-month and 12-month bid rates averaged 0.04%, 0.28% and 0.44% respectively over the quarter.

Over the quarter (April–June), the yield on 2-year US treasuries fell from 0.24% to 0.20% while that on yield on 10-year treasuries fell from 0.63% to 0.61%. German bund yields remain negative.

Credit review:

After rising sharply in late March, credit default swap spreads slowly eased over the quarter but remained above their pre-crisis levels.

Fitch downgraded the UK sovereign rating to AA- in March which was followed by a number of actions on UK and also non-UK banks from early April onwards. 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 downgrading Close Brothers' long-term rating to A-. Network Rail Infrastructure and LCR Finance's long-term ratings were downgraded from AA to AA-.

HSBC Bank and HSBC UK Bank were the exceptions however, with Fitch upgrading their long-term ratings to AA-.

Fitch affirmed the ratings of Canadian banks but revised their outlook to negative. The agency also downgraded the long- and short-term ratings of Australia's four largest banking groups. It upgraded the long-term deposit rating of both Bayerische Landesbank and Landesbank Baden-Wuerttemberg (LBBW) but downgraded the viability ratings, and revised outlooks to negative. Fitch later placed three Singapore banks on Rating Watch Negative.

S&P also took action on a range of UK and European banks, affirming their ratings but revising their outlook downwards due to the economic consequences of COVID-19. Moody's downgraded the long-term rating of Nationwide BS from Aa3 to A1 and S&P downgraded the long- and short-term ratings of HSBC Bank PLC and HSBC UK Bank PLC to A+ and A-1 respectively

In May, Fitch and S&P downgraded TfL's long-term rating to A+ from AA- after the 95% reduction in tube and train fares which make up 47% of TfL's revenue. However, the UK government agreed to a £1.6 billion support package which will help ease some of the stress TfL faces.

As the extent of the losses that banks and building societies will suffer due to the impact from the coronavirus epidemic remains uncertain but is expected to be substantial, in early June following Arlingclose's stress testing of the institutions on the counterparty list using bail-in analysis, a number of UK banks and building societies were suspended from the counterparty list for unsecured deposits. Although much better capitalised than before the 2007-09 financial crisis, under the current economic circumstances these entities were suspended for reasons of prudence. For those remaining on the list, the duration advice remains up to 35 days.

Local Context

On 31st March 2020, the Authority had net borrowing of £7.69m arising from its revenue and capital income and expenditure. This fell to £2.59m 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
Housing Revenue Account	
Debt Outstanding	57,423
Capital Financing Requirement (CFR)	61,584
Statutory Debt Cap	66,853
Borrowing Capacity (Cap less Debt Outstanding)	**9,430**

General Fund	
Debt Outstanding	0
Capital Financing Requirement (CFR)	5,653
Borrowing Capacity (Cap less Debt Outstanding)	**5,653**
Total Capital Financing Requirement (CFR)	**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 30th June 2020 and the change during the quarter is shown below.

Treasury Management Summary

	31.3.20 Balance £m	Movement £m	30.06.20 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	4,000	0	4,000	4.01%
Short-term investments	43,371	4,000	47,371	0.84%
Cash and cash equivalents	2,388	1,107	3,495	0.00%
Total investments	**49,759**	**5,107**	**54,866**	
Net borrowing	**7,692**	**5,107**	**2,585**	

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 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 31st July 2020 with implementation of the new lending terms expected in the latter part of this calendar year.

Municipal Bonds Agency (MBA): The MBA has 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 issued its first bond in March 2020 on behalf of Lancashire County Council.

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 30th June 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

On 6th April 2020 the Authority received central government funding to support small and medium businesses during the coronavirus pandemic through grant schemes. £15.2m was received, temporarily invested in short-dated, liquid instruments such as call accounts and Money Market Funds. £14.25m was disbursed by the end of June.

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 £55m 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	**Q1 2020 Movement £'000**	**30.06.20 Balance £'000**	**30.06.20 Rate of Return %**
Banks (unsecured)	2,388	1,107	3,495	0.00
Local Authorities	40,350	(1,000)	39,350	0.69
Money Market Funds	3,000	5,000	8,000	0.15
CCLA Property Fund	4,000	0	4,000	4.01
Total investments	**49,738**	**5,107**	**54,845**	

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 1.

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

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
30.06.2020	3.89	AA-	23%	104	0.22
Similar LAs	4.10	AA-	59%	51	-0.58
All LAs	4.10	AA-	59%	18	-0.30

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.

In a relatively short period since the onset of the COVID-19 pandemic in March and the ensuing enforced lockdown in many jurisdictions, the global economic fallout has been 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, business and individuals.

Similar to many other property funds, dealing (i.e. buying or selling units) in the CCLA Local Authorities Property Fund was suspended by the fund in March 2020. The relative infrequency of property transactions in March as the pandemic intensified meant that it was not possible for valuers to be confident that their valuations correctly reflected prevailing conditions. To avoid material risk of disadvantage to buyers, sellers and holders of units in the property fund, the management company was obliged to suspend transactions until the required level of certainty is re-established. The temporary suspension remained in force on 30th June.

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 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.

The mid-market value of the fund as at the 30th June 2020 is £3,534,233 and the bid market value is £3,479,472. 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

		2019/20	**2020/21**
		Q4	**Q1**
Dividend Received	£	40,484	34,886
Annual Equivalent Interest Rate	%	4.57%	4.01%
Bid (Selling) Price	pence/unit	291.15	279.57

In 2020/21 the Authority expects to receive lower income from its cash and short-dated money market investments and from its externally managed funds than it did in 2019/20 and earlier years. Dividends and income paid will ultimately depend on many factors including but not limited to the duration of COVID-19 and the extent of its economic impact, the fund's sectoral asset allocation, securities held/bought/sold and, in the case of equities, the enforced or voluntary dividend cuts or deferral

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 quarter is shown below.

	As at 31.03.20	As at 30.06.20
Average 7-Day Money Market Rate (Target)	0.42%	0.24%
Average Interest Rate Achieved on Short Term Deposits	0.54%	0.68%

Compliance

The Chief Finance Officer is pleased to report that all treasury management activities undertaken during quarter 1 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 Q1 £m	Maximum Invested per Counterparty £m	Limit	Maximum Term	Complied
Debt Management Office	£15m	£6m	£20m in total	364 days	✓
Other Local Authorities	£45.35m	£5m	£5m per Authority	364 days	✓
Money Market funds	£8m	£2m	£8m total, £2m per fund	60 days	✓
CCLA Property Fund	£4m	£4m	£4m	Indefinite period	✓
Named Counterparties (HSBC/Lloyds/BOS/Santander)	£1.99m	£1.98m	£2m per Bank	35 days	✓
Named Counterparties (Barclays/NatWest/RBS)	£1.49m	£1.49m	£2m 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 until 2021/22.

Outlook for the remainder of 2020/21

The medium-term global economic outlook is very weak. While containment measures taken by national governments in response to coronavirus are being eased, it is likely to be some time before demand recovers to pre-crisis levels due to rises in unemployment, the on-going need for virus control measures and the impact on consumer/business confidence.

The responses from the Bank of England, HM Treasury as well as other central banks and governments have been significant and will act to support the recovery when it occurs, by keeping financial conditions stable and many businesses solvent/employees employed than would otherwise have been the case. There will be an economic bounce in the second half of the year, as businesses currently dormant begin production/supply services once more.

However, the scale of the economic shock to demand and the probable on-going social distancing measures necessary before a vaccine is produced will mean that the subsequent pace of recovery is limited.

Arlingclose expects Bank Rate to remain at the current 0.10% level and additional monetary loosening in the near future through further financial asset purchases (QE). While the Arlingclose central case for Bank Rate is no change, further cuts to Bank Rate to zero or even into negative territory cannot be ruled out.

Downside risks remain in the near term, as households and businesses react to an unprecedented set of economic circumstances.

	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23
Official Bank Rate												
Upside risk	0.00	0.00	0.00	0.00	0.00	0.15	0.15	0.15	0.15	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**
Downside risk	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35

Gilt yields are expected to remain very low in the medium term. Some shorter-term gilt yields will remain around zero until either the Bank expressly rules out negative Bank Rate or growth prospects improve.