Cabinet **Agenda Item**
29 October 2020

Treasury Management Strategy Mid-Year Review Report 2020/21

Cabinet Member: Councillor Andrew Moore
Responsible Officer: Andrew Jarrett, Deputy Chief Executive (S151).

Reason for Report: To inform the Cabinet of the treasury performance during the first six months of 2020/21, to agree the ongoing deposit strategy for the remainder of 2020/21 and a review of compliance with Treasury and Prudential Limits for 2020/21.

Recommendation(s):

1. **That Cabinet recommends to Council that a continuation of the current policy outlined at paragraphs 6.0 - 6.5 be agreed.**
2. **That Cabinet recommends that Council approves the changes to the Capital Financing Requirement, Operation Boundaries and Authorised Limits for the current year at paragraphs 4.4 - 4.5.**

Relationship to Corporate Plan: Maximising investment return whilst minimising risk of credit default enables the Council to finance the delivery of its Corporate Plan objectives.

Financial Implications: Good financial management and administration underpins the entire strategy. The Council's Treasury Management Strategy should attempt to maximise investment return commensurate with minimum risk to the principal sums invested.

Legal Implications: The Council is under a statutory duty to "have regard" to the 2011 CIPFA Treasury Management Code of Practice. The Council's own Financial Regulations include requirements as to the reporting of treasury management information.

Risk Assessment: The Council considers deposit security as the paramount function in any treasury dealings or activities. It should be noted that any investment decisions will always be subject to a degree of risk. However, in complying with an agreed Treasury Management Strategy, these risks would be kept to an acceptable level.

Equality Impact Assessment: It is considered that the impact of this report on equality related issues will be nil.

Climate Change Assessment: No implications relating this report.

1.0 Introduction

1.1 CIPFA's Code of Practice for Treasury Management recommends the annual setting of a Treasury Management Strategy and best practice dictates a half yearly update of treasury performance. This report will not only update Members on the treasury performance over the first six months of 2020/21, but will also seek approval for the ongoing deposit strategy.

2.0 Treasury Performance 01/04/2020 to 30/09/2020

2.1 The table below shows the Council's overall treasury management position for the first six months of 2020/21.

Treasury Position	Average Interest	Total Interest as at 30/09/2020	Forecast Year-End Position
Temporary Investments and Deposits	0.42%	£92k	£122k
CCLA Dividends	3.67%	£91k	£183k
Commercial Activities / Non-Financial Investments	5.00%	£261k	£518k
Total		**£444k**	**£823k**

2.2 The General Fund 2020/21 budget for all investment activity is £568k and for the Housing Revenue Account is £53k.

2.3 The coronavirus outbreak has done huge economic damage to the UK and around the world over the first half of 2020/21. After the Bank of England took emergency action in March to cut Bank Rate to first 0.25%, and then to 0.10%, it left Bank Rate unchanged at its last meeting on 6th August, although some forecasters had suggested that a cut into negative territory could happen. However, the Governor of the Bank of England has made it clear that he currently thinks that such a move would do more damage than good and that more quantitative easing is the favoured tool if further action becomes necessary. No increase in Bank Rate is expected within the forecast horizon ending on 31st March 2023 as economic recovery is expected to be only gradual and, therefore, prolonged.

2.4 The Bank of England's Monetary Policy Committee kept the level of quantitative easing unchanged at £745bn at its last meeting on 6th August. Its forecasts were optimistic in terms of three areas:

- The fall in **GDP** in the first half of 2020 was revised from 28% to 23%. This is still one of the largest falls in output of any developed nation. However, it is only to be expected as the UK economy is heavily skewed towards consumer-facing services – an area which was particularly vulnerable to being damaged by lockdown.
- The peak in the **unemployment rate** was revised down from 9% in Q2 to 7½% by Q4 2020.
- It forecast that there would be excess demand in the economy by Q3 2022 causing CPI **inflation** to rise above the 2% target in Q3 2022, (based on market interest rate expectations for a further loosening in policy). Nevertheless, even if the Bank were to leave policy unchanged, inflation was still projected to be above 2% in 2023.

2.5 One key addition to **forward guidance** was a new phrase in the policy statement, namely that “it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably”. That seems designed to say, in effect, that even if inflation rises to 2% in a couple of years’ time, do not expect any action from the MPC to raise Bank Rate – until they can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate.

2.6 The **Financial Policy Committee** (FPC) report on 6th August revised down their expected credit losses for the banking sector to “somewhat less than £80bn”. It stated that in its assessment “banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC’s central projection”. The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC’s projection, with unemployment rising to above 15%.

2.7 Overall, it is expected that there has been a strong pickup in economic growth during the back-end of quarter 2 of 2020. However, that pace is likely to fade as the furlough scheme ending in October will lead to many job losses during the second half of the year. Consumers will also probably remain cautious in spending and this will dampen growth. Uncertainty over the outcome of the UK/EU trade negotiations concluding at the end of the year will also be a headwind.

2.8 Interest rate forecasts:

- The Council’s treasury advisor, Link Group, has provided the following forecasts (PWLB rates are certainty rates):

Link Group Interest Rate View 11.8.20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Bank Rate View	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 Month average earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	-	-	-	-
6 Month LIBID	0.10	0.10	0.10	0.10	0.10	0.10	0.10	-	-	-	-
12 Month LIBID	0.20	0.20	0.20	0.20	0.20	0.20	0.20	-	-	-	-
5yr PWLB Rate	1.90	1.90	2.00	2.00	2.00	2.00	2.00	2.10	2.10	2.10	2.10
10yr PWLB Rate	2.10	2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30
25yr PWLB Rate	2.50	2.50	2.50	2.50	2.60	2.60	2.60	2.70	2.70	2.70	2.70
50yr PWLB Rate	2.30	2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50	2.50	2.50

2.9 From the local authority borrowing perspective, HM Treasury imposed **two changes of margins over gilt yields for PWLB rates** in 2019-20 without any prior warning. The first took place on 9th October 2019, adding an additional 1% margin over gilts to all PWLB period rates. That increase was then at least partially reversed for some forms of borrowing on 11th March 2020, but not for mainstream General Fund capital schemes, at the same time as the Government announced in the Budget a programme of increased infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins; this was to end on 4th June, but that date was subsequently put back to 31st July. It is clear that the Treasury will no longer allow local authorities to borrow money from the PWLB to purchase commercial property if the aim is solely to generate an income stream (assets for yield).

2.10 Following the changes on 11th March 2020 in margins over gilt yields, the current situation is as follows:

- **PWLB Standard Rate** is gilt plus 200 basis points (G+200bps)
- **PWLB Certainty Rate** is gilt plus 180 basis points (G+180bps)
- **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
- **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
- **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

2.11 It is possible that the non-HRA Certainty Rate will be subject to revision downwards after the conclusion of the PWLB consultation; however, the timing of such a change is currently an unknown, although it would be likely to be within the current financial year

2.12 As the interest forecast table for PWLB certainty rates (gilts plus 180bps) above shows, there is likely to be little upward movement in PWLB rates over the next two years as it will take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down period. Inflation is also likely to be very low during this period and could even turn negative in some major western economies during 2020/21.

3.0 Investment Portfolio

3.1 In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. Due to the current economic climate and reductions to the Base Rate, it is now impossible to earn the level of interest rates commonly seen in previous decades as investment rates up to 12 months are barely above zero, with DMO rates even turning negative for maturities up to 2 weeks. Given this risk environment and the fact that increases in the Base Rate are unlikely to occur before the end of the current forecast horizon of 31st March 2023, investment returns are expected to remain low.

3.2 Towards the end of March 2020, approval was given by the Deputy Chief Executive (S151) and the Cabinet lead for Finance to breach the £5m counterparty limit with the Council's banking provider, NatWest, for an initial period of three months. This was to allow the administration of the business grant schemes announced by Government as part of the Covid-19 response, and to ensure sufficient funds were held whilst cash flows remained volatile. The Council received £22.732m on 1 April 2020 to fund these schemes, which ended on 28 August 2020 leaving £2.548m unspent. This is to be held in the Council's NatWest account until repayment is required.

3.3 Further approval was given at the end of June for a temporary counterparty limit of £10m with NatWest for 3 months, which was then extended at the start of October for a further 3 months. This limit is to be kept under review and will return to the £5m limit once conditions allow.

3.4 The Council's investment portfolio as at 30 September 2020 was made up of short term investments/deposits to the value of £28.17m, comprising of £20.50m in fixed term investments and £7.67m in NatWest call accounts. In addition to this, the Council also holds £5.00m in the CCLA commercial property fund.

3.5 Short term investments/deposits held as at 30 September 2020 are as follows:

Institution	Principal (£)	Rate	Start Date	Maturity Date
Rugby Borough Council	1,000,000	0.90%	09/10/2019	07/10/2020
City of Liverpool	2,000,000	1.00%	15/04/2020	15/10/2020
Leeds Building Society	2,000,000	0.06%	17/09/2020	19/10/2020
Highlands Council	1,000,000	0.92%	27/11/2019	25/11/2020
Aberdeenshire Council	5,000,000	0.50%	26/05/2020	26/11/2020
Lloyds	2,000,000	1.10%	30/12/2019	30/12/2020
Blackpool Borough Council	2,000,000	0.23%	22/09/2020	06/04/2021
Salford City Council	2,000,000	0.20%	14/09/2020	14/06/2021
Spelthorne Borough Council	1,500,000	0.42%	27/07/2020	26/07/2021
Broxbourne Borough Council	2,000,000	0.40%	02/09/2020	01/09/2021

3.6 The Council received an average return of 0.42% on investments during the first six months of 2020/21, down from 0.75% at the same point in the previous year. This reduction is down to the drop in the base rate to 0.1% in March 2020, and fewer Local Authorities looking to borrow in the short term resulting in a more competitive market for those looking to lend. The return on investments is likely to reduce further in the second half of 2020/21 as maturing investments made prior to the drop in interest rates are replaced with lower yielding investments.

3.7 The Council currently has £5m deposited with the CCLA (Churches, Charities and Local Authorities) commercial property fund, which pays dividends quarterly. For the first two quarters of 2020/21, dividends of 3.67% were received, down from 4.5% for the same period in 2019/20. The dividend payout remained consistent from Q1 to Q2, and there has been a small increase in fund value in September 2020 after reductions seen in previous months due to the Covid-19 pandemic.

4.0 Borrowing Requirements and Prudential Indicators

4.1 The Council has no short term borrowing but has existing PWLB loans of £38.027m as at 30 September 2020, in addition to £2.160m in finance leases.

4.2 The Council's revised capital financing requirement (CFR) for 2020/21 is £62.699m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Table 4.5 shows the Council has borrowings of £47.527m and has utilised £15.172m of cash flow funds in lieu of borrowing.

4.3 There has so far been no new borrowing in 2020/21, however there is expected to be a need to borrow up to £8m before the end of the financial year to finance planned capital spend and to replace some internal borrowing as cash balances naturally reduce towards the end of the year. This is a reduction in the level of borrowing forecast at the start of the year, which originally stood at £16.11m, and could reduce further as the impact of Covid-19 on the deliverable capital programme continues to be assessed. Further funding from Government in response to Covid-19 could also reduce the need for new borrowing.

4.4 The Treasury Management Strategy Statement (TMSS) for 2020/21 was approved by Cabinet on 13 February 2020. The underlying TMSS approved previously requires revision in light of delayed 3 Rivers Developments Limited projects and a revised deliverable capital programme for 2020/21. The proposed changes are set out below:

Prudential Indicator 2020/21	Original £000	Revised Prudential Indicator £000
Authorised Limit	95,000	76,000
Operational Boundary	86,000	67,000
Capital Financing Requirement	81,686	62,699

4.5 The table below shows a breakdown of the revised CFR. It also shows the expected debt position over the period, which determines the Operational Boundary and Authorised Limit shown in the above table.

	2020/21 Original Estimate £000	2020/21 Revised Estimate £000
Prudential Indicator – Capital Financing Requirement		
CFR – Non Housing	19,034	12,756
CFR – Housing	41,957	39,611
CFR – Commercial Activities / Non-Financial Investments	20,695	10,332
Total CFR	**81,686**	**62,699**
Prudential Indicator – External Debt		
Borrowing	53,212	45,104
Other Long Term Liabilities*	2,872	2,423
Total Debt (Year End Position)	**56,084**	**47,527**

** Includes finance leases*

5.0 Annual Investment Strategy

5.1 Any fixed term investments in the market place (except Debt Management Office [DMO]) are restricted to a maximum term of two years (previously one year). The Council's substantial commitments (particularly the monthly precepts to Devon County Council, the Police and Fire Authority) constrain the term of investments. The Cabinet of 7 February 2019 resolved to diversify the investment portfolio to include non-UK banks with a minimum Sovereign Fitch rating of AAA (highest possible rating).

5.2 The Council will continue to have regard to the MHCLG's Guidance on Local Government Investments ("the Guidance") issued in April 2018 (3rd Edition) and

CIPFA's Treasury Management in Public Services Code of Practice and Cross Sectorial Guidance Notes ("the CIPFA Treasury Management Code").

6.0 Lending Criteria and Counterparty Limits

6.1 The current policy allows the lending of funds to be deposited with major UK banks and building societies with an investment period no longer than two years and where the counterparty is required to meet the following ratings requirements: Banks (Fitch F1, F1+) and for building societies based upon a minimum Fitch rating of F1 and an asset base level of at least £1bn. The maximum lending limit to any group counterparty is £5m. The policy includes investments with CCLA property fund and money market funds with a limit of £2m on this option. Note that delegation was provided to the S151 officer and Finance Portfolio Holder in 2011/12 to make reactive decisions when market conditions changed due to volatility in rating changes when our own bankers, NatWest, were downgraded, along with other part nationalised banks. We do not invest any term deposits with the Royal Bank of Scotland Group and only have our call accounts with them.

6.2 Officers would recommend a continuation of the existing policy for investments with banks and building societies, property funds and money market funds.

6.3 In addition to these fixed term deposits, the Council also uses an instant access liquidity account with NatWest (the Council's banker) to sweep any small surplus funds which cannot be placed by our brokers. Again, this account will be subject to the same £5m maximum deposit level (£10m whilst temporary approval remains in place).

6.4 The Council will also continue to lend to:

- Local Authorities, Police, Fire & Rescue, Parish Councils and other Public Bodies
- UK Government (including gilts, Treasury Bills and the DMADF)
- Other Bodies.

6.5 The investments that can be made to the organisations stated in paragraph 6.4, will not be constrained to a maximum deposit of £5m due to their lower level of risk. However, other bodies have a monetary limit of £3m.

7.0 Conclusion

7.1 The first half year performance has been affected by falling interest rates, however the impact has been mitigated to some degree by short term investments placed before rates started to fall in March. Investment income has also been bolstered by the interest received from 3 Rivers Developments Limited being largely unaffected by the reduction in interest rates. Investment income is likely to fall further in the second half of 2020/21 as maturing investments are replaced with new investments yielding far lower returns.

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