

Cabinet

15 July 2020



Title	Treasury Management Annual Report 2019-20		
Purpose of the report	To note		
Report Author	Anna Russell, Deputy Chief Accountant		
Cabinet Member	Councillor S. Buttar	Confidential	No
Corporate Priority	Financial Sustainability		
Recommendations	Cabinet is asked to note the treasury outturn position for 2019-20 and the financial environment in global markets.		
Reason for Recommendation	Not applicable.		

1. Key issues

- 1.1 This report provides outturn details on treasury outturn for 2019-20 (section 3), initially giving external background (section 2). In the context of £77m additional capital investment (Table 1), borrowing has increased by £60m to £1,110m (Table 2). The scale of capital investment has decreased by £305m compared to last year, reflecting the shift in the council's strategy from acquisition of investment properties to focusing on schemes to facilitate regeneration and support housing needs of the borough.
- 1.2 The overall return on £88.2m investments was 2.07% on average for 2019-20, with 3.97% average return on £28.2m pooled funds (3.16, Appendix A). The impact of COVID-19 on investment yield has been low, because of the timing at year end after the majority of dividends had been distributed. However, capital values as at the end of March have decreased significantly, by £4.3m, as a consequence of the COVID-19 crisis.
- 1.3 The Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA TM Code, edition 2017) requires that authorities report on the performance of the treasury management function at least twice a year (mid-year and at year-end). This report fulfils the Council's legal obligation to have regard to the CIPFA TM Code.
- 1.4 The Council's Treasury Management Strategy for 2019-20 was approved by Cabinet on 30 January 2019 and then by full Council on 21 February 2019.

- 1.5 This report is an outturn statement of treasury management activities for the financial year 2019-20. The Council has invested and borrowed 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 Council's treasury management strategy.
- 1.6 CIPFA's 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 Council's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 21 February 2019.

2. External Context provided by Arlingclose

- 2.1 The narrative for external context is provided by the Council's treasury advisers, Arlingclose, with minor revisions by council officers reflecting for example the timing of this report compared to the Arlingclose draft.

Economic background

- 2.2 The UK's exit from the European Union and future trading arrangements remained one of major influences on the UK economy and sentiment during 2019/20. The Brexit deadline of 29 March 2019 was extended to 12 April, then to 31 October and finally to 31 January 2020. Politics played a major role in financial markets over the period as the UK's protracted negotiations over 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 much of the uncertainty and looked set to provide a 'bounce' to confidence and activity.
- 2.3 The headline rate of UK Consumer Price Inflation year on year fell to 1.7% in February, below the Bank of England's target of 2%. Labour market data remained positive. The ILO (International Labour Organization) 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.
- 2.4 GDP growth in Q4 2019 was reported as flat by the Office for National Statistics, 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%.
- 2.5 The coronavirus crisis quickly changed everything. COVID-19 had first appeared in China in December 2019 and started spreading across the globe causing plummeting sentiment and falls in financial markets not seen since the 2008 Global Financial Crisis, as part of a flight to quality into sovereign debt and other perceived 'safe' assets.

- 2.6 In response to the spread of the virus and the sharp increases in those infected, governments enforced lockdowns, central banks and governments around the world cut interest rates and introduced massive stimulus packages in attempts to reduce the negative economic impact on domestic and global growth.
- 2.7 In March, the Bank of England, which had held policy rates steady at 0.75% through most of 2019-20, moved to cut rates, first to 0.25% and then within days 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 a lockdown across the UK.
- 2.8 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. COVID-19 severely affected sentiment and production in both countries. Against a slowing economic outlook, the US Federal Reserve had begun cutting rates on 31 July 2019. Following a series of five rates cuts, the largest of which were in March 2020, the Federal Funds Rate fell to a range of 0% - 0.25% (down from 2.25% - 2.5% 30 July 2019). The US government also unleashed a raft of COVID-19 related measures and support for its economy, including a \$2 trillion fiscal stimulus package.
- 2.9 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

- 2.10 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 reached 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, though remaining extremely volatile.
- 2.11 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 31 March 2020. Over the same comparison period, the 10-year benchmark yield fell from 1% to 0.4%, and the 20-year benchmark yield from 1.47% to 0.76%. One-month, 3-month and 12-month bid rates averaged 0.61%, 0.72% and 0.88% respectively over the period.
- 2.12 Since January 2020, the yield on 2-year US treasuries has fallen from 1.58% to 0.23% end March, and from 1.92% to 0.70% for 10-year treasuries. German bund yields remain negative.
- 2.13 Into the new financial year towards the end of May 2020, UK gilts were sold with a negative yield, for the first time in history. Interest rates on loans through the Public Works Loan Board (PWLb) are based on gilts +1.80%.

Credit review

- 2.14 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 the basis of a Common Equity Tier 1 (CET1) ratio and of a leverage ratio. Under the test scenario, the banks' aggregate level of CET1 capital would remain twice their level before the 2008 financial crisis.
- 2.15 After remaining flat in January and February and within a range of 30-55 bps (bps = basis points; 30 bps = 0.30%), Credit Default Swap spreads rose sharply in March as the potential impact of COVID-19 on bank balance sheets gave cause for concern. Spreads came down in late March and through to mid-April, but remain above their initial 2020 levels. NatWest Markets Plc (non-ring-fenced) remains the highest at 128 bps and National Westminster Bank Plc (ring-fenced) still the lowest at 56 bps. The other main UK banks are between 65 and 123 bps, with the latter being the thinly traded and volatile Santander UK CDS.
- 2.16 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.
- 2.17 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-.

3. Local Context

Overview

- 3.1 With the purchase of commercial properties generating sustainable income streams starting with the BP international campus site in Sunbury during 2016-17, the Council now has significant levels of long-term borrowing secured at low fixed rates to fund property acquisitions.
- 3.2 The Council's strategy when making strategic asset acquisitions has been to take advantage of the cheap borrowing rates available and fix at those rates to provide long-term funding certainty, while maintaining, and supplementing when possible, the investment portfolio that has been built up.

- 3.3 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. The CFR, and resources applied, are summarised in Table 1. This shows that capital investment for 2019-20 was £77m, which increased the CFR, offset by capital inflows and contribution from revenue, resulting in a closing CFR of £1,115m.

Table 1: Balance Sheet Summary as at 31 March 2020

	Actual 31/03/2019 £m	Movement 2019-20 £m	Actual 31/03/2020 £m
Opening Capital Financing Requirement	678	373	1,051
Capital investment	382	(305)	77
<i>Less:</i>			
Capital Receipts, Grants & Contributions	(1)	(1)	(2)
Minimum Revenue Provision (MRP)	(7)	(4)	(11)
Revenue Contributions (above MRP)	(1)	1	0
Closing Capital Financing Requirement	1,051	64	1,115

- 3.4 Borrowing does not affect the CFR. However, Council does borrow to finance capital spend. On 31 March 2020, the Council had net borrowing of £1,021m (shown at Table 2 below) arising from its revenue and capital income and expenditure, an increase on 2018-19 of £51m.
- 3.5 The Council's current strategy is to maintain borrowing at levels that minimise risk and keep interest costs low. The Council also continues to consider alternative funding to assess availability of funders at rates cheaper than the PWLB. The treasury management position as at 31 March 2020 and the change over the period is show in Table 2.

Table 2: Treasury Management Summary

	Balance 31/03/2019 £m	Movement £m	Balance 31/03/2020 £m	Rate 31/03/2020 %
Long-term borrowing	(1,039)	(8)	(1,047)	2.27%
Short-term borrowing *	(11)	(52)	(63)	0.97%
Total borrowing	(1,050)	(60)	(1,110)	
Long-term investments	36	(7)	29	3.95%
Short-term investments	30	12	42	1.00%
Cash and cash equivalents	14	4	18	0.72%
Total investments	80	9	89	2.07%
Net borrowing	(970)	(51)	(1,021)	

* Short term borrowing includes £10m relating to PWLB.

- 3.6 The Council continued the move away from investment property acquisitions and towards strengthening its strategic policy objectives such as on housing and regeneration.

- 3.7 Available funds were held in short-term funds and as cash as far as possible during 2019-20. This approach was based on Arlingclose advice in the context of the low rates available through local authorities, and also as a holding position while longer term funding options are appraised.
- 3.8 Delays in capital projects due to COVID-19 constraints and the availability of low cost borrowing mean that related funding needs are not as pressing as expected. However, this is offset by emergency spending pressures and reduced income, also due to COVID-19, which has been impacting on cash reserves following year end.
- 3.9 During 2019-20, the cash balance on the current bank account exceeded the internal limits. In September, £3m funds were not received as notified resulting in an overdraft. In response, the team does not rely on those notifications, and the funds are dealt with only once received. In January and in March, balances were £3m credit and £5m overdrawn respectively. Both occasions were on period start/ end days, and were the result of team members not being able to give due attention to treasury tasks because of other work commitments, the latter being during the COVID-19 period. This has been and is being addressed through procedural changes and through system improvements.

Borrowing Activity

- 3.10 At 31 March 2020, the Council held £1,110m of loans, an increase of £60m from 31 March 2019, including £1,057m long-term Public Works Loan Board (PWLB) borrowing as part of the strategy for funding major acquisitions and developments. The 31 March 2020 borrowing position is show in Table 3 below.

Table 3: Borrowing Position

	Balance 31/03/2019 £m	Movement £m	Balance 31/03/2020 £m	Rate 31/03/2020 %	Maturity (wtd av) years
PWLB	1,027	30	1,057	2.27%	49
Local authorities					
- Long-term	17	(17)	0	0.00%	2
- Short-term	6	47	53	0.97%	<1
Total Borrowing	1,050	60	1,110		

- 3.11 Borrowing increased during 2019-20 by £60m net, with £35m raised for PWLB (£30m net of repayments), and £45m from local authorities (£30m net of repayments). This borrowing, taking advantage of low PWLB and inter-authority rates, supported capital programme spend, which in 2019-20 included affordable housing developments and a local retail acquisition. It should be noted that there is no requirement to link such borrowing to specific spend. Also, all borrowing through PWLB and local authorities is at fixed rates of interest over fixed terms.

- 3.12 The Council will need to borrow additional funds on both long- and short-term bases to fund the housing and regeneration programme in the future. Work is ongoing with Arlingclose and the portfolio holder to ensure that the cheapest and most appropriate duration and source are secured.
- 3.13 The Council'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. Flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.
- 3.14 Affordability and the "cost of carrying" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing.

Investment Activity to 31 March 2020

- 3.15 The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield consistent with these principles. The ability to maximise interest returns within these guidelines is paramount to generating sufficient funds to support the Council's revenue budget.
- 3.16 As at 31 March 2020, the Council's investment portfolio was a total of £88.2m (2.07 % average return), with £28.2m of this in pooled funds (3.97% average return) and £43.4m in short-term and cash-flow funds (0.71% to 1.25% return). A breakdown of the investments is given in **Appendix A**.
- 3.17 Given the increasing risk and continued low returns from short-term unsecured bank investments, it is the Council's aim to further diversify into more secure or higher yielding asset classes. The availability of funds for investment is dependent upon the timing of precept payments, receipt of grants and progress on the capital programme. The Council has no funds placed with the 'challenger' bank, Metro Bank.
- 3.18 The pooled fund investments form a key part of the portfolio and a full list of these and their current performance is detailed in **Appendix B**.
- 3.19 An update from Arlingclose on the impact of COVID-19 is included at **Appendix C**.
- 3.20 At Spelthorne, the COVID-19 crisis has impacted cash-flow and availability of funds through: increased demands such as emergency costs following the economic and social lockdown; reductions in various funding, grant and income streams.
- 3.21 The COVID-19 lockdown occurred towards the end of March when the majority of dividends had been distributed. As a result, the impact on 2019-20 dividend income has been relatively low, with pooled funds delivering a yield of 3.97% return compared to an expected 5%.
- 3.22 In contrast, COVID-19 has severely affected pooled fund capital values, which have decreased by £4.3m, with increases in only four of the funds held (one bond, one equity, two in the CCLA property fund).

- 3.23 The unrealised capital losses (that is, decrease in capital value) will not impact on the General Fund as the Council has elected to present changes in the funds' fair values in other comprehensive income (FVOCI).
- 3.24 The next section includes consideration of the impact of COVID-19 on 2020/21 budgets.

Investment Performance Monitoring

- 3.25 Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2019-20.
- 3.26 Table 4 shows the performance of the Council's investments compared to budget.

Table 4: Performance of investments

Investment Income 2019/20	Budget	Actual	Variance from budget
	£'000	£'000	£'000
Pooled Fund - Dividends	(715)	(1,290)	(575)
Fixed Term Deposits - Interest	(375)	(375)	0
Money Market Funds - Dividends	(200)	(236)	(36)
Total Investment Income	(1,290)	(1,901)	(611)

- 3.27 The Council seeks professional advice from Arlingclose and closely adheres to the advice set out in the Ministry for Housing, Communities and Local Government (MHCLG) guidance. Given Spelthorne's dependency on investment returns to balance the budget, the Council's investment strategy is also kept under constant review and regular quarterly review meetings are held with Arlingclose, the Council's treasury advisors. All investment and borrowing decisions are made in consultation with our advisors.
- 3.28 Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating for institutions defined as having "high credit quality" is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.
- 3.29 Based on Arlingclose's advice on how income might be impacted by COVID-19, income from pooled funds is estimated to be reduced by £0.6m (39%). However, fixed term deposits will continue to meet expectations. Budgeting for such funds is relatively conservative/ prudent, as indicated by the (£0.6m) actual income above budget in 2019/20, which means that the forecast income on pooled funds and fixed term deposits can be managed without use of reserves. This is without including income from money market funds.

Non-Treasury Investments

- 3.30 The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of an authority as well as other non-financial assets that an authority holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.
- 3.31 The Authority also held £1bn of such investments in directly owned property. These investments generated £52m of investment income for the Council after taking account of direct costs, representing a rate of return of 5.2%. Note that the council-owned subsidiary is not categorised as investment property, as the assets are held mainly, not for rental return, but for operational purposes, such as meeting housing needs in the borough and supporting regeneration.

4. Financial implications

- 4.1 The financial implications are as set out in this report. The ability to maximise interest returns is paramount to generate sufficient funds to support the General Fund and even a small decline in interest rates can mean a significant reduction in cash returns. Our aim is to continue to maintain flexibility commensurate with the high level of security and liquidity and minimal risk when making investment decisions.

5. Other considerations

- 5.1 The Council fully complies with best practice as set out in the Chartered Institute of Public Finance and Accountancy (CIPFA) Prudential Code for Capital Finance in Local Authorities, the Department for Communities and Local Government (DCLG, now MHCLG) Guidance on Investments issued in March 2004 and the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management in the Public Sector 2009 and Cross Sectional Guidance Notes.
- 5.2 Nothing in the Council's current strategy is intended to preclude or inhibit capital investment in local projects deemed beneficial to the local community and which have been approved by the Council.

6. Timetable for implementation

- 6.1 Treasury management is an ongoing activity and normally there is no specific timetable for implementation.

Background papers: There are none

Appendices: Appendices A – C are attached