Cabinet

27 January 2021

Title	Treasury Management Half Yearly Report 2020/21
Purpose of the report	To note
Report Author	Anna Russell, Deputy Chief Accountant
Cabinet Member	Councillor Sati Buttar
Confidential	No
Corporate Priority	Financial Sustainability
Recommendations	Cabinet is asked to: 1. Note the treasury position achieved during the first six months of 2020/21 and the financial environment in global markets.
Reason for Recommendation	Not applicable

1. Key issues

1.1 Treasury Management is the management of the Council's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

1.2 The Council 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 Council to report on performance of the treasury management function at least twice yearly (mid-year and at year end).

1.3 The Council's Treasury Management Strategy for 2020/21 was reviewed and approved by Cabinet on 29 January 2020, and approved by Council on 27 February 2020, and has been consistently applied since the beginning of the financial year.

1.4 This report is an interim statement of treasury activities for the first six months of the financial year, to the end of September 2020. The Council 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. This report covers treasury activity and the associated monitoring and control of risks.

1.5 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 Council's Capital Strategy, complying with CIPFA's requirement, was approved by Council on 27 February 2020 and will be refreshed in February 2021 for financial year 2021-22.

External Context - Economic background

1.6 The spread of the coronavirus pandemic dominated during the period as countries around the world tried to manage the delicate balancing act of containing transmission of the virus while easing lockdown measures and getting their populations and economies working again. After a relatively quiet few months of Brexit news it was back in the headlines towards the end of the period as agreement between the UK and EU on a trade deal was looking difficult and the government came under fire, both at home and abroad, as it tried to pass the Internal Market Bill which could override the agreed Brexit deal, potentially breaking international law.

1.7 The Bank of England (BoE) maintained Bank Rate at 0.1% and its Quantitative Easing programme at £745 billion. The potential use of negative interest rates was not ruled in or out by BoE policymakers, but then a comment in the September Monetary Policy Committee meeting minutes that the central bank was having a harder look at its potential impact than was previously suggested took financial markets by surprise.

1.8 Government initiatives continued to support the economy, with the furlough (Coronavirus Job Retention) scheme keeping almost 10 million workers in jobs, grants and loans to businesses and 100 million discounted meals being claimed during the 'Eat Out to Help Out' (EOHO) offer.

1.9 GDP growth contracted by a massive 19.8% (revised from first estimate -20.4%) in Q2 2020 (Apr-Jun) according to the Office for National Statistics, pushing the annual growth rate down to -21.5% (first estimate -21.7%). Construction output fell by 35% over the quarter, services output by almost 20% and production by 16%. Recent monthly estimates of GDP have shown growth recovering, with the latest rise of almost 7% in July, but even with the two previous monthly gains this still only makes up half of the lost output.

1.10 The headline rate of UK Consumer Price Inflation (CPI) fell to 0.2% year on year in August before rising to 0.5% in September, further below the Bank of England's 2% target, with the largest downward contribution coming from restaurants and hotels influenced by the EOHO scheme. The Office for National Statistics' preferred measure of CPIH which includes owner-occupied housing was 0.5% year on year.

1.11 In the three months to July, labour market data showed the unemployment rate increased from 3.9% to 4.1% while wages fell 1% for total pay in nominal terms (0.2% regular pay) and was down 1.8% in real terms (-0.7% regular pay). On the back of this, the BoE has forecast unemployment could hit a peak of between 8% and 9%.

1.12 The US economy contracted at an annualised rate of 31.7% in Q2 2020 (Apr-Jun). The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25% but announced a change to its inflation targeting regime. The move is to a more flexible form of average targeting which will allow the central bank to maintain interest rates at low levels for an extended period to support the economy even when inflation is ‘moderately’ above the 2% average target, particularly given it has been below target for most of the last decade.

1.13 The European Central Bank maintained its base rate at 0% and deposit rate at -0.5%.

External Context – Financial markets

1.14 Equity markets continued their recovery, with the Dow Jones climbing to not far off its pre-crisis peak, albeit that performance being driven by a handful of technology stocks including Apple and Microsoft, with the former up 75% in 2020. The FTSE 100 and 250 have made up around half of their losses at the height of the pandemic in March. Central bank and government stimulus packages continue to support asset prices, but volatility remains.

1.15 Ultra-low interest rates and the flight to quality continued, keeping gilts yields low but volatile over the period with the yield on some short-dated UK government bonds remaining negative. The 5-year UK benchmark gilt yield started and ended the June–September period at -0.06% (with much volatility in between). The 10-year gilt yield also bounced around, starting at 0.21% and ending at 0.23% over the same period, while the 20-year rose from 0.56% to 0.74%. 1-month, 3-month and 12-month bid rates averaged 0.02%, 0.06% and 0.23% respectively over the period.

1.16 At the end of September, the yield on 2-year US treasuries was around 0.13% while that on 10-year treasuries was 0.69%. German bund yields remain negative across most maturities.

External Context – Credit Review

Credit default swap spreads eased over most of the period but then started to tick up again through September. In the UK, the spreads between ringfenced and non-ringfenced entities remains, except for retail bank Santander UK whose CDS spread remained elevated and the highest of those we monitor at 85bps while Standard Chartered was the lowest at 41bps. The ringfenced banks are currently trading between 45 and 50bps.

1.17 After a busy second quarter of the calendar year, the subsequent period has been relatively quiet for credit changes for the names on our counterparty list. Fitch assigned a AA- deposit rating to Netherlands lender Rabobank with a negative outlook and prior to that, while not related to our counterparty list but quite significant, revised the outlook on the US economy to Negative from Stable while also affirming its AAA rating.

1.18 There continues to remain much uncertainty around the extent of the losses banks and building societies will suffer due to the impact from the coronavirus pandemic and for the UK institutions on our list there is the added complication of the end of the Brexit transition period on 31st December and what a trade deal may or may not look like. 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.

Local Context

1.19 With the purchase of properties starting with the BP international campus site in Sunbury during 2016/17, the Council now has significant levels of long-term borrowing, secured to fund historic property acquisitions.

1.20 The Council's current strategy for funding capital developments is to take advantage of the cheap borrowing rates available when needed, while maintaining the investment portfolio that has been built up.

1.21 For the year ended 31st March 2020, the Council had: capital expenditure of £78m, including £14.6m (18.7%) on investment properties; and net borrowing of £1,030m arising from its revenue and capital income and expenditure. 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 are summarised at Tables 1 and 2 below**.**

Table 1: CFR Summary as at 31st March 2020

	2019/20 £'000
Opening Capital Financing Requirement	**1,051,120**
Capital investment	
Property, Plant and Equipment	62,507
Investment Properties	14,640
Intangible Assets	19
Revenue Spend Funded from Capital under Statute	964
Total Capital Investment	**78,130**
Sources of Finance	
Capital Receipts	(565)
Government Grants and Contributions	(784)
Revenue contributions	(750)
Repayment of debt	(11,052)
Total Sources of Finance	(13,151)
Closing Capital Financing Requirement	**1,116,100**

1.22 As this shows, the CFR represents the cost of capital expenditure that remains to be financed, after applying sources of finance. This therefore is the underlying need to borrowing. The opening CFR (1 April 2019) of £1.05m was increased by £78.13m capital expenditure during 2020/21 and decreased by £13.15m of funds applied, leaving a closing CFR of £1,12m.

1.23 Lower official interest rates have decreased the cost of short-term, temporary loans and investment returns from cash assets that can be used instead of borrowing. The Council pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk.

1.24 The treasury management position on 30th September 2020 and the change over the six months is shown in Table 2 next.

Table 2: Treasury Management Summary

	31/03/2020 Balance £m	Movement £m	30/09/2020 Balance £m
Long-term borrowing	(1,068)	8	(1,060)
Short-term borrowing	(45)	(48)	(93)
Total borrowing	**(1,113)**	**(40)**	**(1,153)**
Long-term investments	31	6	37
Short-term investments	35	45	80
Cash and cash equivalents	17	(12)	5
Total investments	**83**	**39**	**122**
Net borrowing	**(1,030)**	**(1)**	**(1,031)**

1.25 Short-term investments total £80m, and cash balances £5m, reflecting the increases in income generation. These cash funds are being kept liquid to ensure that funding is readily available for development project costs expected over the coming months.

2. Borrowing Update

2.1 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. Additional £1.15bn "infrastructure rate" funding at gilt yields plus 0.60% has been made available to support specific local authority infrastructure projects for England, Scotland and Wales, for which there is a bidding process.

2.2 In November, HM Treasury published the consultation results, and announced changes to PWLB lending terms: reduction by 1% on certainty rate loans (which had been increased by 1% in October 2019) that councils can access; but access only if an authority has no intention over three years to buy investment assets primarily for yield.

2.3 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.

2.4 If the Council considers 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.

3. Borrowing Strategy during the period

3.1 On 30th September 2020, the Council held £1,153m of loans, an increase of £40m from 31st March 2020, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30th September are summarised in Table 3 next.

Table 3: Borrowing Position

	31/03/2020 Balance £m	Movement £m	30/09/2020 Balance £m
Public Works Loan Board	1,057	(5)	1,052
Local authorities - long-term	11	(3)	8
Local authorities - short-term	45	48	93
Total Borrowing	**1,113**	**40**	**1,153**

3.2 On 30th September 2020, the Council also had short-term borrowing totalling £93m. This reflected the cash-flow impact of some of the costs associated with development capital projects. These funds were borrowed from other local authorities because of the affordable rates on offer.

3.3 The Council will also consider borrowing additional funds on both a long- and short-term basis for future development projects. Work is ongoing with Arlingclose and the portfolio holder to ensure that the cheapest and most appropriate duration and source are secured

3.4 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, with flexibility to renegotiate loans should the Council's long-term funding and asset management plans change.

Treasury Investment Activity

3.5 Both the CIPFA Code and Government guidance require the Council to invest 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 Council'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.

3.6 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 temporarily lowered their fees. 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 of net negative returns cannot be ruled out.

3.7 On 25th September the overnight, 1- and 2-week deposit rates on Debt Management Account Deposit Facility (DMADF) deposits dropped below zero percent to -0.03%, the rate was 0% for 3-week deposits and 0.01% for longer maturities.

3.8 The return on Money Market Funds net of fees also fell over the six months and for many funds net returns range between 0% and 0.1%. In many instances, the fund management companies have temporarily lowered or waived fees to maintain a positive net return.

3.9 In the light of the pandemic crisis and the likelihood of unexpected calls on cash flow, the Council has kept more cash available at very short notice than is normal. Liquid cash was diversified over several counterparties and Money Market Funds to manage both credit and liquidity risks.

3.10 As at 30th September 2020, the Council's investment portfolio totalled £123.5m, with £46.0m of this being short-term and cash funds. A breakdown of investments is given in **Appendix A**.

Externally Managed Strategic Funds

3.11 Funds totalling £32.5m of the Council's investments are held in externally managed strategic (bond, equity, multi-asset and 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 a return of £0.39m to end September 2020 (October £0.56m, annualised 3.61%). A full list of these and their current performance is detailed in **Appendix B**.

3.12 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, reflecting lockdown-induced paralysis and the uncharted challenges for governments, businesses and individuals.

3.13 The Council is invested in bond, equity, multi-asset and property funds. The falls in the capital values of the underlying assets, in particular bonds and equities, were reflected in the 31st March 2020 fund valuations, with most funds registering negative capital returns over a 12-month period. Since March, there has been improvement in market sentiment which is reflected in partial recovery in capital values of funds in the Council's portfolio.

3.14 Similar to many other property funds, dealing (i.e. buying or selling units) in the CCLA Local Authorities Property Fund and the Columbia Threadneedle Property Fund was suspended by the funds 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 dealing suspension was lifted in September 2020. There has also been a change to redemption terms for the CCLA Local Authorities Property Fund; from September 2020 investors are required to give at least 90 calendar days' notice for redemptions.

3.15 The Council's investment in externally managed funds has been maintained on the basis that such funds are expected to yield returns over the long-term. Such funds have no defined maturity date but are available for withdrawal after a notice period. Consequently, fund performance and continued suitability in meeting the Council's investment objectives are regularly reviewed. Strategic fund investments are made in the knowledge that capital values will fluctuate, up and down, over months, quarters and even years; but with confidence that, over a three- to five-year period, total returns will exceed cash interest rates.

3.16 In 2020/21, the Council expects to receive significantly 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. The budget for income from investments, has been decreased from £1.34m (2020/21) to £1.25m (2021/22).

Non-Treasury Investments

3.17 The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in the Investment Guidance issued by the Ministry of Housing, Communities and Local Government (MHCLG), in which the definition of investments is further broadened to also include all such assets held partially for financial return.

3.18 The Council held such investments in directly owned property valued at £985m at the end of March 2020, as well as shareholding in Knowle Green Estates Limited, with investment property of £4.7m. A new company delivering commercial waste services, Spelthorne Direct Services Limited, was set up during 2020/21.

3.19 These investments are expected to generate £50m of investment income for the Council, representing a rate of return of 4.8%.

Investment Performance Monitoring

3.20 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 2020/21.

3.21 The Council seeks professional advice from Arlingclose and closely adheres to the advice set out in the Ministry of 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 quarterly review meetings are held with Arlingclose, the Council's treasury advisor.

Estimates for income 2020/21

3.22 The corporate world is still adjusting to the economic shock, with probably more to come, and it is still too early to tell which companies will withstand the economic damage in the short- to medium-term or which will choose to conserve cash in very difficult economic conditions simply to survive.

3.23 Investment income in 2020/21 was set against a very different economic backdrop. Bank Rate, which was 0.75% in February 2020, now stands at 0.1%. Interest earned from short-dated money market investments will be significantly lower. In relation to income from the Council's externally managed strategic funds, dividends and income distributions 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.

Compliance

3.24 The Chief Finance Officer reports that treasury management activities undertaken during the first half year complied with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy, although noting that limits on the bank account were exceeded on three occasions.

3.25 On one occasion, the current bank balance exceeded limits by end of day; on two occasions the bank account was overdrawn over the facility limit. The underlying reason for these instances was limited staff availability in the context of increasing treasury management activities, with the COVID-19 crisis resulting in a sudden and unexpected increase in the volume of work and frequency of Government returns that the Finance Team had to deal with. In response to these breaches, the Treasury Management team has tightened up on processes with particular regard to in-day progress checks.

3.26 The CS Lucas TM system has been implemented, and the team will continue to integrate that system into the Treasury Management function and reporting during 2020/21. This system includes reporting on upcoming loans and borrowing, which has helped strengthen related processes.

4. Other

4.1 **IFRS 16:** The implementation of the new IFRS 16 Leases accounting standard has been delayed until 2021/22.

5. Financial implications

5.1 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. Therefore, it is our aim to continue to maintain flexibility commensurate with the high level of security and liquidity and minimal risk when making investment decisions.

6. Other considerations

6.1 The Council fully complies with best practice as set out in CIPFA's 2019 Treasury Management and Prudential Codes and in MHCLG's Guidance on Investments effective from April 2018. As issues arise, as when limits were breached noted at section 3, measures are taken to address the underlying reasons.

6.2 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.

7. Sustainability/Climate Change Implications

7.1 None.

8. Timetable for implementation

8.1 Not applicable.

Background papers: None.

Appendices: TMHY20-21 Appendix A - Details of Investments
TMHY20-21 Appendix B - Strategic Funds