Treasury Management Annual Report 2019/20

1. Introduction

1.1 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.

1.2 The Authority's treasury management strategy for 2019/20 was approved at a meeting on 27th February 2019. 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 remains central to the Authority's treasury management strategy.

1.3 Treasury risk management at the Authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the Authority's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

1.4 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 27th February 2019.

2. External Context

2.1 Economic background: The UK's exit from the European Union and future trading arrangements, had remained one of major influences on the UK economy and sentiment during 2019/20. The 29th March 2019 Brexit deadline was extended to 12th April, then to 31st October and finally to 31st January 2020. Politics played a major role in financial markets over the period as the UK's tenuous progress negotiating 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 a lot of the uncertainty and looked set to provide a 'bounce' to confidence and activity.

2.2 The headline rate of UK Consumer Price Inflation UK Consumer Price Inflation fell to 1.7% y/y in February, below the Bank of England's target of 2%. Labour market data remained positive. The ILO 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.

2.3 GDP growth in Q4 2019 was reported as flat by the Office for National Statistics and 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%.

2.4 Then coronavirus swiftly changed everything. COVID-19, which had first appeared in China in December 2019, started spreading across the globe causing plummeting sentiment and falls in financial markets not seen since the Global Financial Crisis as part of a flight to quality into sovereign debt and other perceived 'safe' assets. In response to the spread of the virus and sharp increase in those infected, the government enforced lockdowns, central banks and governments around the world cut interest rates and introduced massive stimulus packages in an attempt to reduce some of the negative economic impact to domestic and global growth.

2.5 The Bank of England, which had held policy rates steady at 0.75% through most of 2019/20, moved in March to cut rates to 0.25% from 0.75% and then swiftly thereafter brought them down further 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 pretty much the entire lockdown of the UK.

2.6 Financial markets: 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 touch 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 but remain extremely volatile. 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 31st March. The 10-year benchmark yield fell from 1% to 0.4%, the 20-year benchmark yield from 1.47% to 0.76% over the same period. 1-month, 3-month and 12-month bid rates averaged 0.61%, 0.72% and 0.88% respectively over the period.

2.7 Credit review: 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 both a common equity Tier 1 (CET1) ratio and a leverage ratio basis. Under the test scenario the banks' aggregate level of CET1 capital would remain twice their level before the 2008 financial crisis.

2.8 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. 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-.

3. <u>Local Context</u>

3.1 On 31st March 2020, the Authority had net investments of £33.265m 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.

3.2 The treasury management position at 31st March 2020 and the change during the year is shown in Table 1 below.

Table 1: Treasury Management Summary

	31.3.19 Balance £m	Movement £m	31.3.20 Balance £m	31.3.20 Rate %
Long-term borrowing	0.000	0.000	0.000	0
Short-term borrowing	3.000	2.000	5.000	0.96
Total borrowing	**3.000**	**2.000**	**5.000**	
Long-term investments	34.250	(2.250)	32.000	3.37
Short-term investments	4.200	2.065	6.265	0.71
Total investments	**38.450**	**(0.185)**	**38.265**	
Net investments	**35.450**	**(2.185)**	**33.265**	

4. Borrowing Update

4.1 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 relatively very expensive. Market alternatives are available and new products will be developed; however, the financial strength of individual authorities will be scrutinised by investors and commercial lenders.

4.2 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, 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.

4.3 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.

4.4 The consultation closes on 31st July 2020 with implementation of the new lending terms expected in the latter part of this calendar year or financial year beginning 2021/22. Officers will be responding to this consultation.

5. Borrowing strategy

5.1 At 31st March 2020 the Authority held £5m of loans, (an increase of £2m from 31st March 2019, as part of its strategy for funding current years' capital programmes and cash flow. Outstanding loans on 31st March are summarised in Table 2 below.

Table 2: Borrowing Position

	31.3.19 Balance £m	Net Movement £m	31.3.20 Balance £m	31.3.20 Weighted Average Rate %	31.3.20 Weighted Average Maturity (years)
Local authorities (short-term)	3.00	2.00	5.00	0.96%	<1
Total borrowing	**3.00**	**2.00**	**5.00**		

5.2 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.

5.3 With short-term interest rates remaining much lower than long-term rates, the Authority considered it more cost effective in the near term to borrow rolling temporary / short-term loans instead.

5.4 As this year has illustrated, PWLB funding margins have lurched quite substantially and there remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields plus 0.80%, i.e. the PWLB HRA borrowing rate. The Authority will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.

6. Treasury Investment Activity

6.1 The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances ranged between £46.005 and £32.540 million due to timing differences between income and expenditure. The investment position is shown in table 3 below.

Table 3: Treasury Investment Position

	31.3.19 Balance £m	Net Movement £m	31.3.20 Balance £m	31.3.20 Income Return %
Banks & building societies (unsecured)	0.000	0.000	0.000	0.00
Covered bonds (secured)	2.250	(2.250)	0.000	0.00
Government (incl. local authorities)	2.000	(2.000)	0.000	0.00
Money Market Funds	2.200	4.065	6.265	0.71
Other Pooled Funds:				
- *Cash plus funds*	3.000	0.000	3.000	1.16
- *Short-dated bond funds*	3.000	0.000	3.000	0.97
- *Strategic bond funds*	5.000	0.000	5.000	2.59
- *Equity income funds*	8.000	0.000	8.000	4.43
- *Property funds*	5.000	0.000	5.000	4.37
- *Multi asset income funds*	8.000	0.000	8.000	3.91
Total investments	**38.450**	**(0.185)**	**38.265**	**3.37**

6.2 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.

6.3 Given the increasing risk and low returns from short-term unsecured bank investments, the Authority has previously diversified into more secure and/or higher yielding asset classes, and this strategy was maintained during the financial year.

6.4 The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 4 below.

Table 4: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Rate of Return %
31.03.2019	3.00	AA	34%	0.92
31.03.2020	4.19	AA-	100%	0.71
Similar LAs	**3.95**	**AA-**	**59%**	**0.68**

*Weighted average maturity

6.5 £32m of the Authority's investments are held in externally managed strategic pooled 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 an average total return -4.99%, comprising a 3.61% income return which is used to support services in year, and -7.60% of unrealised capital loss.

6.6 In a relatively short period since the onset of the COVID-19 pandemic, the global economic fallout was 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, businesses and individuals. Volatility measured by the VIX index was almost as high as during the global financial crisis of 2008/9 and evidenced in plummeting equity prices and the widening of corporate bond spreads, very close to rivalling those twelve years ago. Gilt yields fell but credit spreads widened markedly reflecting the sharp deterioration in economic and credit conditions associated with a sudden stagnation in economies, so corporate bonds yields (comprised of the gilt yield plus the credit spread) rose and prices therefore fell.

6.7 The Authority is invested in bond, equity, multi-asset and property funds. The falls in the capital values of the underlying assets were reflected in the 31st March fund valuations with every fund registering negative capital returns over 12 months to March. Several March-end dividend details are awaited, but early calculations suggest that, despite decent income returns in 2019-20, these funds will post negative total return over the one-year period due to the capital component of total returns.

6.8 The unrealised capital losses (the 'drawdown' referred to by fund managers) in equity income funds were especially large, ranging from -19% to -33% and between -6% to -27% for short- and long-dated bond funds.

6.9 The Authority is using the alternative fair value through profit and loss (FVPL) accounting and must defer the funds' fair value losses to the Pooled Investment Fund Adjustment Account until 2023/24.

6.10 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 is 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. In light of their performance over the medium and long-term and the Authority's latest cash flow forecasts, investment in these funds has been maintained.

<u>Non-Treasury Investments</u>

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

6.12 The Authority also held £3.793m of such investments in

- directly owned property £0.831m

- loans to housing associations £2.962m

A full list of the Authority’s non-treasury investments is below:

Grove Lane Depot, Holt, Norfolk – valued at £0.350m
Fair Meadow House, Itteringham, Norfolk – valued at £0.441m
Loan to Broadland Housing Association – outstanding value £2.962m

6.13 These investments generated £0.150m of investment income for the Authority after taking account of direct costs, representing a rate of return of 3.85%. This rate of return compares favourably to that generated by treasury investments. These investments represent a different risk to the Authority, as property investments do not carry the same interest rate or credit risk, but there is the risk of loss of income through voids and other market factors. They also require more staff time to manage than externalised pooled investments. The Authority does not currently rely on these funds from Non-Treasury investments to balance the budget, but in a climate of reduced Government funding, is likely to do so more in the future. To guard against the risk of reducing levels of income from these investments, they are proactively managed by experienced and qualified individuals within the Authority, with external advice as required.

7. Treasury Performance

7.1 The Authority measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in table 5 below.

Table 5: Performance

	Actual £m	**Budget £m**	**Over/ under**	**Actual %**	**Budget %**	**Over/ under**
Short term borrowing from other Local Authorities	**£0.038m**	**£0.010**	**Over**	**0.76**	**1.13**	**Under**
Total borrowing						
Term deposits (incl MMFs)	0.040	0.015	Over	0.71	1.09	Under
Pooled Funds	1.079	1.214	Under	3.37	3.57	Under
Total treasury investments	**1.120**	**1.228**	**Under**	**2.97**	**3.47**	**Under**

8. Compliance

8.1 The Chief Finance Officer reports that all treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the Authority’s approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 6 below.

Table 6: Debt Limits

	2019/20 Maximum	**31.3.20 Actual**	**2019/20 Operational Boundary**	**2019/20 Authorised Limit**	**Complied?** Yes/No
Borrowing	£7.500m	£5.000m	£15.030m	£23.400m	Yes
PFI and Finance Leases	**£0.000m**	**£0.000m**	**£0.000m**	**£0.000m**	Yes
Total debt	**£7.500m**	**£5.000m**	**£15.030m**	**£23.400m**	Yes

8.2 Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Table 7: Investment Limits

	2019/20 Maximum	**31.3.20 Actual**	**2019/20 Limit**	**Complied?** Yes/No
Any single organisation, except the UK Central and Local Government	Nil	Nil	£6m each	Yes
UK Central and Local Government	£2m	Nil	unlimited	Yes
Any group of organisations under the same ownership	Nil	Nil	£6m per group	Yes
Any group of pooled funds under the same management	£7m	£7m	£15m per manager	Yes
Negotiable instruments held in a broker's nominee account	Nil	Nil	£10m per broker	Yes
Limit per non-UK country	Nil	Nil	£6m per country	Yes
Registered providers and registered social landlords	£3.096m	£2.962m	£10m in total	Yes
Unsecured investments with building societies	Nil	Nil	£5m in total	Yes
Loans to unrated corporates	Nil	Nil	£5m in total	Yes
Money Market Funds	£11.425m	£6.265m	£16m in total	Yes
Real Estate Investment Trusts	Nil	Nil	£10m in total	Yes

9. Treasury Management Indicators

9.1 The Authority measures and manages its exposures to treasury management risks using the following indicators.

Security: The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	31.3.20 Actual	2019/20 Target	Complied?
Portfolio average credit score	4.19	6.0	Yes

Liquidity: The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing.

	31.3.20 Actual	2019/20 Target	Complied?
Total cash available within 3 months	£6.265m	£3m	Yes

Interest Rate Exposures: This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interests was:

Interest rate risk indicator	31.3.20 Actual	2019/20 Limit	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	£34,051	£600,000	Yes
Upper limit on one-year revenue impact of a 1% fall in interest rates	£34,051	£600,000	Yes

The impact of a change in interest rates is calculated on the assumption that maturing loans and investment will be replaced at current rates.

Maturity Structure of Borrowing: This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	31.3.20 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	100%	100%	0%	Yes
12 months and within 24 months	0%	100%	0%	Yes
24 months and within 5 years	0%	100%	0%	Yes
5 years and within 10 years	0%	100%	0%	Yes
10 years and above	0%	100%	0%	Yes

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than a year: The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2019/20	**2020/21**	**2021/22**
Actual principal invested beyond year end	£32m	£32m	£32m
Limit on principal invested beyond year end	£42m	£42m	£42m
Complied?	Yes	Yes	Yes

10. Other

10.1 IFRS 16: CIPFA/LASAAC has proposed delaying the implementation of the new IFRS 16 Leases accounting standard for a further year to 2021/22.