North Norfolk District Council Treasury Management Half Yearly Report 2020/21

Introduction

The Authority 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. This quarterly report provides an additional update.

The Authority's treasury management strategy for 2020/21 was approved at a meeting on 26th February 2020. The Authority has 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.

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 26th February 2020.

External Context

Economic background: 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.

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.

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.

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.

The headline rate of UK Consumer Price Inflation (CPI) fell to 0.2% year/year in August, 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% y/y.

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). Despite only a modest rise in unemployment over the period, the rate is expected to pick up sharply in the coming months as the furlough scheme ends in October. On the back of this, the BoE has forecast unemployment could hit a peak of between 8% and 9%.

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.

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

Financial markets: 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.

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.

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.

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.

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.

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

On 31st March 2020, the Authority had net investments of £33.265m arising from its revenue and capital income and expenditure. The treasury management position on 30th September 2020 and the change over the six months is shown in Table 1 below.

Table 1: Treasury Management Summary

	31.3.20 Balance £m	**Movement £m**	**30.9.20 Balance £m**
Long-term borrowing	0.000	0.000	0.000
Short-term borrowing	5.000	(5.000)	0.000
Total borrowing	**5.000**	**(5.000)**	**0.000**
Long-term investments	32.000	0.000	32.000
Short-term investments	6.265	2.805	9.070
Total investments	**38.265**	**2.805**	**41.070**
Net investments	**33.265**	**7.805**	**41.070**

Borrowing Strategy during the period

At 30th September 2020 the Authority held no long-term loans, (same positon as at 31st March 2020), as part of its strategy for funding previous and current years' capital programmes. Some external borrowing is assumed in the current estimates of future year's capital funding, but has not yet been taken out.

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.

With short-term interest rates remaining much lower than long-term rates, the Authority considers it to be more cost effective in the near term to use internal resources or borrowed rolling temporary / short-term loans instead of longer term debt.

Other Debt Activity

Although not classed as borrowing, the Authority can raise capital finance via Private Finance Initiatives and finance leases, etc. The Authority has not done this in the period to 30th September 2020.

Treasury Investment Activity

On 1st April 2020 the Authority received central government funding to support small and medium businesses during the coronavirus pandemic through grant schemes. This was received, temporarily invested in short-dated, liquid instruments such as the DMADF and Money Market Funds. An amount remains to be passed back to Central Government once the reconciliation exercise is complete.

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 £107.155 and £41.070 million due to timing differences between income and expenditure. The investment position is shown in table 2 below.

Table 2: Treasury Investment Position

	31.3.20 Balance £m	**Net Movement £m**	**30.9.20 Balance £m**	**30.9.20 Rate of Return %**
Banks & building societies (unsecured)	0.000	0.000	0.000	N/A
Covered bonds (secured)	0.000	0.000	0.000	N/A
Government (incl. local authorities)	0.000	0.000	0.000	N/A
Money Market Funds	6.265	2.805	9.070	0.16%
Cash plus funds	3.000	0.000	3.000	0.86%
Short-dated bond funds	3.000	0.000	3.000	0.63%
Strategic bond funds	5.000	0.000	5.000	3.01%
Equity income funds	8.000	0.000	8.000	4.14%
Property funds	5.000	0.000	5.000	7.89%
Multi asset income funds	8.000	0.000	8.000	4.21%
Total investments	**38.265**	**2.805**	**41.070**	

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.

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 have temporarily lowered their fees. At this stage 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 cannot be ruled out.

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.

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.

Given the continuing 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 continues to review opportunities to do this further, where cash flow allows. However, in the light of the pandemic crisis and the likelihood of unexpected calls on cash flow, the Authority kept more cash available at very short notice than is normal. Liquid cash was diversified over several Money Market Funds and the DMADF to manage both credit and liquidity risks.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 3 below.

Table 3: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	**Credit Rating**	**Bail-in Exposure**	**Rate of Return %**
31.03.2020 30.09.2020	4.19 4.12	AA- AA-	100% 100%	0.71% 0.05%
Similar LAs **All LAs**	**4.15** **4.16**	**AA-** **AA-**	**65%** **64%**	**0.27%** **0.30%**

Externally Managed Pooled Funds: £32.000m 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 a return of £0.628m which is used to support services in year, and £0.651m 2.03% of unrealised capital loss.

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.

The Authority 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 almost every fund registering negative capital returns over a 12-month period. Since March there here has been improvement in market sentiment which is reflected in an increase in capital values of the short-dated, strategic bond and multi-asset income funds and most of the equity income funds in the Authority's portfolio. The capital value of the property fund is below that at 31st March. Market values at 31st March and 30th September 2020 are as shown in Table 4, above.

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 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.

Because the Authority's externally managed 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.

In 2020/21 the Authority 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.

Non-Treasury Investments

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 the Ministry of Housing, Communities and Local Government (MHCLG) and Welsh Government, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

The Authority also held £3.349m of such investments in

- directly owned property £0.791m
- loans to housing associations £2.558m

These investments generated £0.076m of investment income for the Authority after taking account of direct costs, representing a rate of return of 2.27%. This compares favourably against Treasury investment rates, particularly against shorter term deposits. 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.

Treasury Performance

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 4 below.

Table 4: Performance

	Actual £m	**YTD Budget £m**	**Over/ (under)**	**Actual %**	**Budget %**	**Over/ under**
Term Deposits	0.016	0.023	(0.007)	0.13	0.72	Under
Pooled Funds	0.629	0.586	0.043	3.93	3.67	Over
Total treasury investments	**0.645**	**0.609**	**0.036**	**4.06**	**4.39**	**Under**

Compliance

The Chief Finance Officer reports that all treasury management activities undertaken during the first 5 months of the 2020/21 financial 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 5 below.

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

Table 5: Debt Limits

	Q1 Maximum	**30.9.20 Actual**	**2020/21 Operational Boundary**	**2020/21 Authorised Limit**	**Complied?** Yes/No
Borrowing	£5.000m	£0.000m	£22.680m	£27.400	Yes

Total debt	**£5.000m**	**£0.000m**	**£22.680m**	**£27.400**	Yes

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 6: Investment Limits

	Half-year Maximum	**30.9.20 Actual**	**2020/21 Limit**	**Complied?** Yes/No
Any single organisation, except the UK Central and Local Government	£0.000m	£0.000m	£6m each	Yes
UK Central and Local Government	£60.000m	£0.000m	Unlimited	Yes
Any group of organisations under the same ownership	£0.000m	£0.000m	£6m per group	Yes
Any group of pooled funds under the same management	£7.000m	£7.000m	£15m per manager	Yes
Negotiable instruments held in a broker's nominee account	£0.000m	£0.000m	£10m per broker	Yes
Foreign countries	£0.000m	£0.000m	£6m per country	Yes
Registered providers and registered social landlords	£2.962m	£2.558m	£10m in total	Yes
Unsecured investments with building societies	£0.000m	£0.000m	£5m in total	Yes
Loans to unrated corporates	£0.000m	£0.000m	£5m in total	Yes
Money Market Funds	£16.000m	£9.070m	£16m in total	Yes
Real estate investment trusts	£0.000m	£0.000m	£10m in total	Yes

The balance held with the UK Central and Local Government is a deposit made with the DMADF (Central Government) following the payment of monies to fund the COVID related grants to small businesses announced by the Government in March 2020. This balance has reduced as these grants were paid out, and is nil at the half-year point.

Treasury Management Indicators

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.

	30.9.20 Actual	2020/21 Target	Complied?
Portfolio average credit score	4.12	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

	30.9.20 Actual	2020/21 Target	Complied?
Total sum borrowed in past 3 months without prior notice	£0m	£10m	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	30.9.20 Actual	2020/21 Limit	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	£0m	£0.6m	Yes
Upper limit on one-year revenue impact of a 1% fall in interest rates	£0m	£0.6m	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:

	30.9.20 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	N/A	100%	0%	Yes
12 months and within 24 months	N/A	100%	0%	Yes
24 months and within 5 years	N/A	100%	0%	Yes
5 years and within 10 years	N/A	100%	0%	Yes
10 years and above	N/A	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. The rows marked N/A indicate no borrowing was held at the half year point.

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:

	2020/21	2021/22	2022/23
Actual principal invested beyond year end	£32m	£32m	£32m
Limit on principal invested beyond year end	£50m	£50m	£50m
Complied?	Yes	Yes	Yes

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

	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.15	0.15	0.15	0.15	0.30	0.30	0.30	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	0.10
Downside risk	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50

The medium-term global economic outlook is weak. While the strict initial lockdown restrictions have eased, coronavirus has not been supressed and second waves have prompted more restrictive measures on a regional and national basis. This ebb and flow of restrictions on normal activity will continue for the foreseeable future, at least until an effective vaccine is produced and importantly, distributed.

The global central bank and government responses have been significant and are in many cases on-going, maintaining more stable financial, economic and social conditions than otherwise. This has supported a sizeable economic recovery in Q3.

However, the scale of the economic shock to demand, on-going social distancing measures, regional lock downs and reduced fiscal support will mean that the subsequent pace of recovery is limited. Early signs of this are already evident in UK monthly GDP and PMI data, even before the latest restrictions.

This situation will result in central banks maintaining low interest rates for the medium term. In the UK, Brexit is a further complication. Bank Rate is therefore likely to remain at low levels for a very long time, with a distinct possibility of being cut to zero. Money markets have priced in a chance of negative Bank Rate.

Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid inflation expectations. There is a chance yields may follow a slightly different path in the medium term, depending on investor perceptions of growth and inflation, or if the UK leaves the EU without a deal.

The Authority’s Treasury advisor, Arlingclose, expects Bank Rate to remain at the current 0.10% level and additional monetary loosening in the future most likely through further financial asset purchases (QE). While Arlingclose’s central case for Bank Rate is no change from the current level of 0.1%, further cuts to Bank Rate to zero or even into negative territory cannot be completely ruled out.

Gilt yields are expected to remain very low in the medium term. Shorter-term gilt yields are currently negative and will remain around zero or below until either the Bank of England expressly rules out negative Bank Rate or growth/inflation prospects improve.

Downside risks remain in the near term, as the government dials down its fiscal support measures, reacts to the risk of a further escalation in infection rates and the Brexit transition period comes to an end.