Report to Audit Committee
16 December 2020
By the Director of Corporate Resources
INFORMATION REPORT

Not exempt

Treasury Management and Prudential Indicators mid-year report 2020/21

Executive Summary

This report covers treasury activity and prudential indicators for the first half of 2020/21. During the period the Council complied with its legislative and regulatory requirements and the statutory borrowing limit, the Authorised Limit, was not breached.

At 30 September 2020, the Council had no external debt and its investments totalled £53.6m (£42.9m at 30 September 2019).

During the first half of 2020/21, the Council's cash balances were invested in accordance with the Council's treasury management strategy apart from one breach of the limit for a single local authority. Interest of £0.43m was earned on investments at an average return of 1.7% (2.3% full year 2019/20).

Treasury investment income for the full year is likely to be significantly below the budget as the pandemic keeps interest rates and dividend yields low. Commercial property income is also likely to underperform as some tenants suffer from the fallout from the pandemic.

Recommendations

The Committee is recommended to:

i) Note the treasury management stewardship report at the mid-year 2020/21
ii) Note the mid-year prudential indicators for 2020/21

Reasons for Recommendations

i) This mid-year report is a requirement of the Council's reporting procedures
ii) This report meets the requirements of the relevant CIPFA Codes of Practice for Treasury Management and Prudential Indicators in Capital Finance.

Background Papers
"Capital Strategy 2020/21 incorporating Investment and Treasury Management Strategy" – Audit Committee 18 December 2019
"Budget 2020/21 and Medium Term Financial Strategy to 2023/24" – Cabinet 23 January 2020

Consultation: Arlingclose Limited. Council's Treasury management advisors
Wards affected: All
Contact: Julian Olszowka, Group Accountant, Technical 01403 215310

Background Information

1 Introduction

The purpose of this report

1.1 This report covers treasury management activity and prudential indicators for the first half of 2020/21. It meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003. The Code recommends that Members are informed of Treasury Management activities at least twice a year.

Background

1.2 In line with the CIPFA Prudential Code for Capital Finance in Local Authorities the Council adopts prudential indicators for each financial year and reports on performance relative to those indicators. This requirement is designed to show that capital spending is prudent, affordable and sustainable and that treasury practices adequately manage risk. The original indicators for 2020/21 together with Capital Strategy were approved by Council on 14 October 2020. The Capital Strategy including the Treasury Management Strategy 2020/21 had been recommended for approval by this Committee on 18 December 2019. The late approval of the strategy was an unfortunate procedural error.

1.3 The economic background to treasury management remains challenging with the pandemic adding to existing concerns over Brexit, indebtedness, productivity and growth weighing on the economy and financial system which has still not fully recovered from the 2008 financial crisis. Arlingclose Limited, the Council’s treasury management advisors, have provided a commentary on the half-year so far in Appendix A.

Local Context

1.4 At the end of 2019/20 the Council’s underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £33.9m, while usable reserves and working capital which are the underlying resources available for investment were £73m. The Council had no borrowing and £39m of investments reflecting its use of internal resources rather than borrowing in order to reduce risk and keep interest costs low.

1.5 On 30 September 2020, the Council had no borrowing and investments of £53.6m. Investment totals had fluctuated much more than usual as Covid-19 related grants flowed in and out of the Council. Short term rates collapsed to near zero in the period. With the large amounts of cash being held at times, the Council had to use the Government to invest its cash more than it would usually plan to. In a few instances the rate became negative although only by some hundredths of 1%.

1.6 Rates on offer for short term cash look like remaining effectively at zero for an extended period challenging any hope of significant short-term investment returns. A £2m investment in a multi-asset fund was undertaken in September 2020. The first dividend received was an income return of just under 3%.

2 Treasury management

Borrowing Activity

2.1 There was no borrowing in the period. No borrowing is envisaged in the second half of the year although the Council's balances will fall towards the end of the year as tax receipts are significantly front loaded.

Investment Activity

2.2 The treasury management position at 30 September 2020 is shown below. This is the month end position but the daily position can vary as a large portion of income comes in at the beginning of month to be distributed to precepting authorities a few days later.

	31.3.20 Balance £m	Movement £m	30.9.20 Balance £m	30.9.20 Rate %
Call accounts	0.5	3.5	4.0	0.1
Money Market Funds – call	5.5	9.0	14.5	0.2
Money Market Funds – cash plus or short bonds	9.3	0.1	9.4	0.9
Short-term deposits	4.0	-1.0	3.0	1.1
Pooled Funds - Property	4.8	-0.2	4.6	4.2
Pooled Funds – Multi-Asset	4.5	2.2	6.7	4.6
Pooled Funds – Equity	2.9	0.6	3.5	3.3
Pooled Funds – Bonds	5.5	0.4	5.9	2.6
REIT	2.0	0.0	2.0	1.3
Total Investments	39.0	14.6	53.6	1.7

2.3 Both the CIPFA Code and government guidance require the Council 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 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.

2.4 Investment income on an accrued basis in the period was £0.43m which just below the budget of £0.44m. The average return was 1.7% below the budgeted figure of 2.1%. Average cash balances were more than those in the budget but the excess cash doesn't increase returns with rates effectively at zero. Although the Council's revenue income was depressed by pandemic effects the receipt of Covid-19 grant monies and a slowdown in capital spend more than compensated.

2.5 The returns in the second half of the year are expected to be severely reduced by cash rates close to zero and dividends squeezed by the pandemic's effect on the economy. The outturn position on income is expected to be £150,000 below budget. That said the recent news on vaccines may bring a favourable movement in dividend income as companies become less defensive but it is still too early to rely on that happening.

2.6 Given the risk and low returns from short-term unsecured bank investments, the Council has reduced its exposure to them except through well diversified money market funds or call accounts. Otherwise the Council has used local authorities and central government alongside strategic pooled funds. These strategic pooled funds, comprising equity, bonds and property, are a key part of the strategy. As can be seen from the table above they are a significant contributor to overall income.

2.7 Pooled funds asset values though can be volatile in the short term. The market crash in March 2020 caused by the Covid-19 pandemic left values down £1.9m at the end of 2019/20 relative to the purchase price. At the end of the first half of the year the value of these investments was recovering but was still £0.7m below the initial investment. The positive news about vaccines has buoyed up asset prices and the capital value loss is now below £0.2m. However, it should be remembered that these investments are longer term so any snapshot of capital gain or loss should not be overemphasised.

Compliance

2.8 The Director of Corporate Resources reports that all treasury management activities undertaken during the first half of 2020/21 complied with the CIPFA Code of Practice and the Treasury Management Strategy recommended by this Committee with the exception of one breach of the local authority limit.

2.9 As mentioned in the 2019/20 end of year treasury management report to this committee on 15 July 2020, there was a breach on the first day of 2020/21 when an investment of £5m was made with a local authority while the relevant limit was £4m. It was due to a misreading of limits during the early days of remote working when the Council was having to deal with abnormal amounts of cash being routed through the Council for emergency grants. The investment was returned without any issue in May 2020.

2.10 The background to the investment was that the Council was receiving a payment of £29m on 1 April 2020 on top of its normal Council Tax and NNDR inflows. This meant investing just under £40m on the day. With many of the traditional counterparties seen as too risky, the use of local authorities became more prominent. The Council had invested in local authorities before but in £1m to £2m amounts. With the amount of money having to be invested, larger deals were necessary. In the pressured situation of finding counterparties, a deal was done at £5m when the limit was £4m due to a mix up as to which limits referred to which type of investment, not helped by the fact that staff had just started working from home using conferencing software for the first time.

2.11 The investment was repaid on 5 May 2020. Although in breach of the limit, the risk of the default of the counterparty was judged to be minimal. Local authorities are seen as very secure investments with extremely small risk attached. Added to that, the timescale of the investment was one where central government was providing a large cash injection to the sector and the failure of any council at that time would have been unthinkable from the perspective of central government.

2.12 Security of capital has remained the Council's main investment objective. Key to this is the counterparty policy as set out in its treasury management strategy. Counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

Treasury Management Indicators

2.13 The Council measures and manages its exposures to treasury management risks using the following indicators.

2.14 **Security benchmark** – The Council set a security benchmark rating of A, which is the average credit rating for the investment portfolio. The average rating was at above the benchmark at either A+ or AA- during the first half of the year.

2.15 **Liquidity benchmark** – The Council sets a benchmark to maintain a minimum of liquidity. The benchmark set was that £3m is available within a rolling three-month period without additional borrowing. The Director of Corporate Resources can report that liquidity arrangements were well within benchmark during the year to date with overnight cash alone not falling below £9m.

Compliance with Prudential Indicators

2.16 The Council can confirm compliance with its Prudential Indicators for 2020/21, which were set out in the Council's Treasury Management Strategy.

Treasury Management Indicators

2.17 **Interest rate exposures** - This indicator is set to control the Council's exposure to interest rate risk. The exposures to variable rate interest rates is quantified by the one-year revenue impact of a 1% rise or fall in interest rates. The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates. This indicator is close to its limits as cash balances in money markets funds are much larger than normally planned as a result of the cash held significantly exceeding the projected cash balances and opportunities to invest for a meaningful return being very limited. It is worth noting that the possibility of a 1% change in interest rates in the short term is very low.

Interest rate risk indicator - Upper limit	Limit	Actual	Complied
One-year revenue impact of a 1% rise	£0.2m	£0.19m	✓
One-year revenue impact of a 1% fall	£0.2m	£0.19m	✓

2.18 **Principal sums invested for periods longer than 364 days** – The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its long-term investments. There was no investments for more than 364 days so the Council was well within the indicator set:

	Original Indicator	Maximum Position
Maximum principal sums invested > 364 days	£12m	£0m

3 Prudential Indicators 2020/21

3.1 The Local Government Act 2003 requires the Council to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much it can afford to borrow. The objectives of the Prudential Code are to ensure that capital investment plans are affordable, prudent and sustainable. To demonstrate that the Council meets these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

3.2 **The Council's Capital Expenditure and Financing 2020/21 -** This is one of the required prudential indicators and shows total capital expenditure for the year and how this is financed. The estimated indicator is shown below.

2020/21	Original estimate £m	Current projection £m
Total capital expenditure	18.4	6.5
Resourced by:		
External Resources	5.5	2.5
Internal Resources	7.7	2.2
Debt	5.2	1.8
Total financing	18.4	6.5

3.3 The estimated capital spend in 2020/21 is well under the original budget with financing similarly lower than expected. The original indicator had £3.5m included for leases under accounting rule changes that were postponed. The capital programme was then pared down by £7.2m in a report to cabinet on 23 July 2020 dealing with the pandemic's effect.

3.4 **The Council's overall borrowing need -** The Council's underlying need to borrow is termed the Capital Financing Requirement (CFR). It represents the accumulated net capital expenditure which has not been financed by revenue or other resources. Part of the Council's treasury activities is to address this borrowing need, either through borrowing from external bodies, or utilising temporary cash resources within the Council.

3.5 The Council is required to make an annual revenue charge, the Minimum Revenue Provision (MRP), to reduce the CFR – effectively a repayment of the borrowing need. The Council's 2020/21 MRP Policy was approved on 12 February 2020 within the 2020/21 Budget report.

3.6 The Council's CFR for the year is shown below, and represents a key prudential indicator. The current projection is much less than the original estimate because the projected unfinanced capital spend is much lower than the original. No increase in long-term borrowing is projected in this financial year.

Capital Financing Requirement and External Debt Year end 2020/21	Original estimate £m	Current projection £m
CFR	39.5	34.8
External debt	0	0

3.7 External borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2020/21 and next two financial years. No difficulties are envisaged for the current or future years in complying with this Prudential Indicator as no long-term borrowing is currently planned.

3.8 **Borrowing limits -** The Council approved these Prudential Indicators as part of the 2020/21 Budget report.

3.9 **Operational boundary for external debt:** The operational boundary is the Council's estimate of most likely, but not worst case scenario for external debt.

3.10 **Authorised limit for external debt:** The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

	Limit	Actual	Met?
Operational boundary – borrowing	£0m	£0m	✓
Operational boundary – other long-term liability	£4m	£0m	✓
Operational boundary – **TOTAL**	**£4m**	**£0m**	✓
Authorised limit – borrowing	£15m	£0m	✓
Authorised limit – other long-term liability	£6m	£0m	✓
Authorised limit – **TOTAL**	**£21m**	**£0m**	✓

3.11 **The ratio of financing costs to net revenue stream -** This indicator identifies the trend in the cost of capital (financing costs net of interest and investment income) against the net revenue stream. The indicator for the year was 2%. Based on current estimates the ratio is expected to be 1% for the year.

4 Non-Treasury Investments

4.1 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 MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

4.2 The Council has a significant directly owned property portfolio valued at £55m at the end of 2019/20. The original investment strategy set £3.8m as the income net of direct costs figure from the property portfolio and the present forecast is £3.6m. The final income figure is uncertain because of the effects of the pandemic. The Head of Property and Facilities is engaging with tenants who may be affected and the final income figure will depend on the outcome of discussions.

4.3 There are a number of other indicators that were set for the year that cannot be definitively calculated until the end of the year when the accounts are closed and all relevant income and expenditure is accrued and central expenses are apportioned across all the Council's services. Some indicators can estimated as a snap shot from property records and the table below shows the original estimated indicators and the latest projections.

Indicator	Estimate	Latest
Average Vacancy levels	1%	3%
Tenant over 5%	5	5
Weighted Average Unexpired Lease Term	9yr	9yr
Bad debts written off	£10,000	£200,000

4.4 A number of indicators for the investment properties require the end of year value of properties. A valuation of all properties is carried out at year end as a part of the final accounts. Valuations have been affected by the uncertainty caused by the pandemic and this may still affect the values at 31 March 2021 which is the year end date.

4.5 The Council has one small loan (£0.3m) to a community run leisure centre. The centre has been given a year's payment holiday in its repayments as it has been heavily affected by the pandemic. It is expected to recommence payment in 2021/22 and no increase in the expectation of any credit loss is envisaged. The interest income of £7,000 will not be paid this year but the unpaid interest will be wrapped up into future interest payments.

4.6 No other loan has been made against the overall limit of £1.5m. It was expected there would be loans to the Council's housing company this year. None were made in the first half of the year and none is expected to be made in the rest of the year. The initial planning and preparation of sites have taken longer than expected. This is a new venture for the Council and the pandemic has also slowed progress.

4.7 The Council has a limit on share investment of £0.5m. Equity investment of £60,000 has been made in the half year and the forecast is for £60,000 more equity investment to be made before the end of the financial year.

5 Staffing consequences

5.1 There are no direct staff resourcing consequences. However, the risks in the investment environment highlights the continuing need for staff training and staff will take advantage of courses run by its advisors Arlingclose Limited.

6 Financial consequences

6.1 Interest earned in 2020/21 is projected to be £0.78m, which is £0.15m under budget of £0.93m. MRP is projected at £0.88m which is £0.05m under budget of £0.93m.

7 Other considerations

7.1 There are no consequences of any action proposed in respect of Risk; Crime & Disorder; Human Rights; Equality & Diversity and Sustainability.

Appendix A

Economic background to the midpoint of 2020/21

Economic background: The spread of the coronavirus pandemic dominated the period as countries around the world tried to balance containing the virus 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 recovered from March lows. 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.

Credit background: 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 ring-fenced and non-ring-fenced 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 ring-fenced 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.