AUDIT COMMITTEE – 31 JANUARY 2020

Title of paper:	Treasury Management 2019/20 Half Yearly Update	
Director(s)/ Corporate Director(s):	Laura Pattman, Strategic Director of Finance	**Wards affected:** All
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Other colleagues who have provided input:	Members of Treasury Management Panel: Laura Pattman, Strategic Director of Finance Theresa Channell, Head of Corporate Finance Susan Risdall, Technical Team Leader Jo Worster, Strategic Finance Team Leader	
Recommendation(s):		
1	To note the treasury management actions taken the first half year of 2019/20.	

1 REASONS FOR RECOMMENDATIONS

1.1 To ensure that Councillors are kept informed of the actions taken by the Chief Finance Officer (CFO) under delegated authority. The currently adopted Treasury Management Code of Practice requires the CFO to submit at least three reports on treasury management each year; a policy and strategy statement for the ensuing financial year, a 6-monthly progress report and an outturn report after the end of the financial year.

1.2 The CIPFA Prudential Code requires local authorities to nominate a body within the organisation to be responsible for scrutiny of treasury management activity. It is considered that the City Council's Audit Committee is the most appropriate body for this function. In undertaking this function, the Audit Committee holds the responsibility to provide effective scrutiny of treasury management policies and practices.

2 BACKGROUND

2.1 **Capital Strategy**

In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued revised Prudential and Treasury Management Codes. As from 2019/20, all local authorities have been required to prepare a Capital Strategy which is to provide the following: -

- a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services;
- an overview of how the associated risk is managed;
- the implications for future financial sustainability.

2.2 **Treasury Management**

The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of

the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

Accordingly, treasury management is defined as:
"The management of the local authority's borrowing, investments and 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."

2.3 This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).

The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the Full Council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead. Receipt by Executive Board of a Mid-year Review Report and an Annual Report, covering activities during the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Audit Committee.

2.4 This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of the 2019/20 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure, and prudential indicators;
- A review of the Council's investment portfolio for 2019/20;
- A review of the Council's borrowing strategy for 2019/20;
- A review of any debt rescheduling undertaken during 2019/20;
- A review of compliance with Treasury and Prudential Limits for 2019/20.

3 TREASURY MANAGEMENT ACTIVITY TO 30 SEPTEMBER 2019

3.1 Summary. This report sets out the 2019/20 performance in the 6 months to 30 September 2019 in respect of the management of the Council's external debt and investments. The key points are:

3.1.1 £40m of new long-term borrowing has been undertaken in the period to 30 September 2019 (see section 3.4.5);

3.1.2 the balance of external debt increased by £24.3m and the average rate of interest payable on the debt portfolio decreased from 3.359% at 31 March 2019 to 3.316% at 30 September 2019 (see section 3.4.2);

3.1.3 the average rate of interest earned on short-term investments was 0.93%. This is benchmarked against the 7 day London Inter-bank (LIBID) rate provided by the Bank of England, which averaged 0.58% for the same period (see section 3.9.3);

3.1.3 the 2019/20 budget for General Fund Treasury Management was £54.6m (see section 3.12);

3.1.4 there were no breaches of the Prudential Indicators set for 2019/20 (see section 3.10);

3.1.5 the PWLB standard interest rate on new loans has been increased by 1% from 9 October 2019 (section 4.10).

3.2 <u>The Economy and Interest rates during 2019/20</u>

3.2.1 Growth and Inflation:
The first half of 2019/20 has seen UK economic growth fall as Brexit uncertainty took a toll. In its Inflation Report of 1 August, the Bank of England was notably downbeat about the outlook for both the UK and major world economies. The Monetary Policy Committee meeting of 19 September reemphasised their concern about the downturn in world growth and also expressed concern that the prolonged Brexit uncertainty would contribute to a build-up of spare capacity in the UK economy, especially in the context of a downturn in world growth.

The Monetary Policy Committee (MPC) left Bank Rate unchanged at 0.75% throughout 2019, so far, and is expected to hold off on changes until there is some clarity on what is going to happen over Brexit. However, it is also worth noting that the new Prime Minister is making some significant promises on various spending commitments and a relaxation in the austerity programme. This will provide some support to the economy and, conversely, take some pressure off the MPC to cut Bank Rate to support growth.

The Consumer Price Index inflation % (CPI) has been hovering around the Bank of England's target of 2% during 2019, but fell to 1.7% in August. It is likely to remain close to 2% over the next two years and so it does not pose any immediate concern to the MPC at the current time. However, if there was a no deal Brexit, inflation could rise towards 4%, primarily as a result of imported inflation on the back of a weakening pound.

3.2.2 Forecast Interest rates
The Council's treasury advisor, Link Asset Services, has provided the following forecast. This forecast includes the increase in margin over gilt yields of 100bps introduced on 9.10.19 (see section 3.11.1 for further detail).

Link Asset Services Interest Rate View	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.25
3 Month LIBID	0.70	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.10	1.20
6 Month LIBID	0.80	0.80	0.80	0.90	1.00	1.10	1.10	1.20	1.30	1.40
12 Month LIBID	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60
5yr PWLB Rate	2.30	2.50	2.60	2.70	2.70	2.80	2.90	3.00	3.00	3.10
10yr PWLB Rate	2.60	2.80	2.90	3.00	3.00	3.10	3.20	3.30	3.30	3.40
25yr PWLB Rate	3.30	3.40	3.50	3.60	3.70	3.70	3.80	3.90	4.00	4.00
50yr PWLB Rate	3.20	3.30	3.40	3.50	3.60	3.60	3.70	3.80	3.90	3.90

The above forecasts have been based on an assumption that there is some sort of muddle through to an agreed deal on Brexit at some point in time. Given the current level of uncertainties, this is a huge assumption and so forecasts may need to be materially reassessed in the light of events over the next few weeks or months.

3.2.3 Appendix B shows the money market interest rates, the PWLB borrowing rates for the half-year to 30 September 2019 and a forward view for PWLB loan rates.

3.3 Local Context

3.3.1 The Treasury Management Strategy Statement, (TMSS), for 2019/20 was approved by Full Council on 4 March 2019.

There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

3.3.2 The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources based on robust financial modelling, the capital expenditure will give rise to a borrowing need

3.3.3 At 31/03/2019 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £1,383.2m.

The CFR is forecast to increase by £91.4m to £1,474.6m by 31/03/2020 which is broadly in line with the original estimate.

Table 1 below shows the original and expected financing arrangements of the capital programme. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This borrowing need may also be supplemented for maturing debt and other treasury requirements.

TABLE 1: CAPITAL EXPENDITURE	2019/20 Original Estimate £m	2019/20 Revised Estimate £m
Total capital expenditure	221.556	277.707
Financed by:		
Capital receipts	21.47	21.974
Capital grants & Contributions	68.057	85.014
Internal Funds / Revenue (inc. Major Repairs Reserve)	38.019	39.497
Total financing	127.546	146.485
Borrowing requirement	94.010	131.222

Note to table: Original estimate was Q3 2018/19 used for the Treasury Management Strategy Report.

3.3.4 The increase in estimated capital expenditure is largely due to slippage on capital projects that had expenditure forecast to be incurred in 2018/19. The associated financing of these schemes has also moved from 2018/19 to the 2019/20 revised forecasts shown above.

3.3.5 The council is evaluating further 'proposed capital schemes' that would increase the council's borrowing requirement, but as the financial implications of these schemes are yet to be fully quantified they have not been included in the above estimates.

3.4 Borrowing

3.4.1 To finance the CFR the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions.

3.4.2 At 30/9/2019 the Council has increased the balance of external loans by £24.3m on the 31/3/2019 balance, as part of its strategy for funding previous years' capital programmes. The Council expects to increase borrowing by up to a further £77m in 2019/20 based on the revised capital program and forecast cash flow requirements.

3.4.3 **Table 2** summarises the Council's outstanding external debt at 30 September 2019 showing the value of debt and the average interest rate payable on the debt:

TABLE 2: DEBT PORTFOLIO				
	01-Apr-19		30-Sep-19	
DEBT	**£m**	**Average Interest %**	**£m**	**Average Interest %**
PWLB borrowing	882.0	3.368	913.3	3.346
Market loans inc LOBO	49.0	4.348	49.0	4.348
Temporary borrowing	22.2	0.843	15.2	0.603
TOTAL LOANS DEBT	**953.2**	**3.359**	**977.5**	**3.316**
Other inc PFI	201.0		196.2	
TOTAL DEBT	**1154.2**		**1173.7**	

At 30/09/2019, the Council had £1,173.7m of external borrowing including £196.2m of Private Finance Initiative (PFI) and lease liabilities. The Council has continued to maintain borrowing and investments below their underlying levels, referred to as internal borrowing, subject to holding a minimum investment balance of around £30m.

As at 31 March 2019 the Council had c.£228m of internal borrowing, a reduction of c.£68m against the previous year reducing the exposure to an increase in interest rates. The council expects to maintain this position as a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

3.4.4 The chief objective when borrowing continues to be striking 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 long-term plans change being a secondary objective.

Affordability and the "cost of carry" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest lower than the cost of borrowing. To date short-term interest rates have remained, and are likely to remain for a significant period, lower than long-term rates. The Council determined it to be more cost effective in the short-term to maintain the use internal resources and borrow short-term loans for some of its borrowing requirement.

This strategy has been effective in managing the council's cost of financing despite the increasing borrowing levels.

3.4.5 In 2019/20 the Council has borrowed a further £40m from the Public Works Loans Board (PWLB) £20m at a fixed rate of 1.91%, on a 31 year maturity loan basis and £20m at a fixed rate of 1.62%, on a 38 year maturity loan basis to fund capital expenditure and maturing loans. The PWLB was the Authority's preferred source of long term borrowing given the transparency and control that its facilities provide.

Temporary and short-dated loans borrowed from the markets, predominantly from other local authorities, has also remained affordable and attractive. In the 6 months to 30 September a total of £134m of such loans were borrowed at an average rate of 0.671% and an average life of 38 days which includes the replacement of maturing loans.

3.5 <u>Debt rescheduling</u>

Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

3.6 <u>PWLB Certainty Rate Update</u>

The Council qualifies for borrowing at the 'Certainty Rate' (0.20% below the PWLB standard rate) for a 12 month period from 01/11/2019. The Council submitted its application to the MHCLG to access this reduced rate for a further 12 month period from 01/11/2019.

The PWLB standard rate has been increased by 1% with effect from 9th October 2019.

3.7 <u>Lender's Option Borrower's Options (LOBO) Loans</u>

The Council holds £34.000m of LOBO loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has

the option to either accept the new rate or to repay the loan at no additional cost. £19.000m of these LOBO loans have options during the year, none have been exercised by the lender. The Council acknowledges there is an element of refinancing risk even though in the current interest rate environment lenders are unlikely to exercise their options.

3.8 Housing Revenue Account (HRA) Treasury Management Strategy

From 1 April 2002, the Council's HRA was allocated a separate debt portfolio based on the appropriate proportion of the Councils existing debt at that time. As a result of existing debt maturing, and not being replaced, the HRA accumulates an internal borrowing position. The interest payable in 2019/20 is expected to be £12.985m at an average rate of 4.44%. This includes £37.161m of fixed rate internal borrowing maturing 01 October 2044.

3.9 Investments

3.9.1 In accordance with the Code, 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 for 2019/20.

3.9.2 As shown by forecasts in section 3.2.2, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.75% Bank Rate which is not expected to increase in 2019/20.

The council has borrowed to reduce its internal borrowing levels over the last 12 months and so 'cash backed' some of the reserves and increases balances on investments. The council has continued to limit its exposure to bank credit risk by using short term bank notice accounts and utilising highly diverse and liquid money market funds with the longer term deposits placed with other local authorities as shown in table 3 below.

3.9.3 The Council held £80.0m of investments as at 30 September 2019 (£90.0m at 31 March 2019) and the investment portfolio yield for the first 6 months of the year is 0.93% against a benchmark (Average 7-day LIBID) of 0.58%.

3.9.4 **Appendix A** provides details of the Council's external investments at 30 September 2019, analysed between investment type and individual counterparties showing the current Fitch long-term credit rating.

Table 3 below summarises investment activity in 2019/20.

TABLE 3 - Investment Activity in 2019/20	Balance on 01/04/2019 £m	Balance on 30/09/2019 £m	Avg Rate/Yield (%) Avg days to maturity
Short term Investments (call accounts, deposits)			
- Banks and Building Societies with ratings of A- or higher	0	40.0	1.00% / 80
- Local Authorities	57.5	10.0	0.86% / 264
Long term Investments			
- Local Authorities	0.0	10.0	0.90% / 573
Money Market Funds	33.1	20.0	0.73% / 1
TOTAL INVESTMENTS	**90.6**	**80.0**	**0.90% / 145**
- Increase/ (Decrease) in Investments £m		(10.6)	

3.9.5 The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy have not been breached during the first 6 months of 2019/20.

3.9.6 Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

3.10 Compliance with Prudential Indicators

3.10.1 The Council confirms compliance with its Prudential Indicators for 2019/20 set on 4 March 2019 as part of the Council's Treasury Management Strategy Statement.

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

3.10.3 **Interest Rate Exposures**: This indicator is set to control the Council's exposure to interest rate risk. The limits on variable rate interest rate exposures are:

	2019/20 £m	2020/21 £m	2021/22 £m
Upper limit on variable interest rate exposure	300	300	300
Actual	87		

3.10.4 **Maturity Structure of Borrowing**: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	Lower	Upper	Actual
Under 12 months	0%	25%	6%
12 months and within 24 months	0%	25%	3%
24 months and within 5 years	0%	25%	7%
5 years and within 10 years	0%	25%	13%
10 years and within 25 years	0%	50%	13%
25 years and within 40 years	0%	50%	21%
40 years and above	0%	50%	36%

3.10.5 **Principal Sums Invested for Periods Longer than 365 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 investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

	2019/20 £m	2020/21 £m	2021/22 £m
Limit on principal invested beyond year end	100	50	20
Actual	10		

3.10.6 **Operational Boundary and Authorised Limit for External Debt**: The operational boundary is based on the Council's estimate of most likely, i.e. prudent, but not worst

case scenario 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.

The table below shows the expected debt position during 2019/20.

	2019/20 Original Estimate £m	**Current Position £m**	**2019/20 Revised Estimate £m**
Borrowing	992.7	977.5	1,054.3
Other long term liabilities*	191.4	196.2	191.4
Total debt (year end position)	**1,184.1**	**1,173.7**	**1,245.7**
Operational Boundary for external debt	**1,421.0**	**1,421.0**	**1,421.0**
Authorised limit for external debt	**1,471.0**	**1,471.0**	**1,471.0**

** On balance sheet PFI schemes and finance leases etc.*

3.11 Other

3.11.1 **Increase in the cost of borrowing from the PWLB**

On 9 October 2019 the Treasury and PWLB announced an increase in the margin over gilt yields of 100bps on top of the current margin of 80 bps which this authority has paid prior to this date for new borrowing from the PWLB. There was no prior warning that this would happen and it now means that every local authority has to fundamentally reassess how to finance their external borrowing needs and the financial viability of capital projects in their capital programme due to this unexpected increase in the cost of borrowing. Representations are going to be made to HM Treasury to suggest that areas of capital expenditure that the Government are keen to see move forward e.g. housing, should not be subject to such a large increase in borrowing.

Whereas this authority has previously relied on the PWLB as its main source of funding, it now has to fundamentally reconsider alternative cheaper sources of borrowing. At the current time, this is a developmental area as this event has also taken the financial services industry by surprise. We are expecting that various financial institutions will enter the market or make products available to local authorities. Councilors will be updated as this area evolves.

It is possible that the Municipal Bond Agency will be offering loans to local authorities in the future. This Authority may make use of this new source of borrowing as and when appropriate.

3.12 General Fund Revenue Implications

Treasury management payments comprise interest charges and receipts and provision for repayment of debt. A proportion of the City Council's debt relates to capital expenditure on council housing and this is charged to the HRA. The remaining costs are included within the treasury management section of the General Fund budget. The General Fund Treasury Management budget is £54.6m for 2019/20.

An estimated outturn for 2019/20 is included in the quarter 2 revenue monitoring report on the 17 December 2019 Executive Board agenda. The budget for 2020/21 will be submitted with the 2020/21 treasury management strategy, in February 2020.

3.13 Risk Management

Risk management plays a fundamental role in treasury activities, due to the value and nature of transactions involved. The management of specific treasury management risks is set out in the Manual of Treasury Management Practices and Procedures and a risk register is maintained for the treasury function.

The treasury management risk register's overall risk rating at 30 September 2019 was Likelihood = unlikely, Impact = moderate which represents the same risk assessment as at 31 March 2019. The register includes for example how the council mitigates against having an inappropriate strategy for borrowing or investments, and the risk of not capturing and including the revenue implications of planned capital expenditure in the councils financial planning.

The Treasury Management working group continue to manage this risk register and take appropriate actions as required.

4 BACKGROUND PAPERS OTHER THAN PUBLISHED WORKS OR THOSE DISCLOSING EXEMPT OR CONFIDENTIAL INFORMATION

4.1 None.

5 PUBLISHED DOCUMENTS REFERRED TO IN COMPILING THIS REPORT

5.1 Money Market and PWLB loan rates
5.2 Treasury Management in the Public Services Code of Practice 2017–CIPFA
5.3 Prudential Code 2017-CIPFA
5.4 Treasury Management in the Public Services Guidance Notes 2018 - CIPFA
5.5 Statutory guidance on local government investments 3rd Edition 2018
5.6 Statutory guidance on Minimum Revenue Provision (MRP) 2018