CABINET

THURSDAY 3RD DECEMBER 2020

REPORT OF THE PORTFOLIO HOLDER FOR ASSETS AND FINANCE

TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY MID-YEAR REVIEW REPORT 2020/21

EXEMPT INFORMATION

None

PURPOSE

To present to Members the Mid-year Review of the Treasury Management Strategy Statement and Annual Investment Strategy.

RECOMMENDATIONS

That Council be requested to approve:

1. **the Treasury Management Strategy Statement and Annual Investment Strategy Mid-year Review Report 2020/21;**

2. **that the planned investments in property funds be deferred, with a review during Spring 2021 when the situation should be clearer, to inform future investment plans.**

EXECUTIVE SUMMARY

This mid-year report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management (revised 2017), and covers the following:-

- An economic update for the half of the 2020/21 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's Capital expenditure as set out in the Capital Strategy, and Prudential Indicators;
- A review of the Council's investment portfolio for 2020/21;
- A review of the Council's borrowing strategy for 2020/21;
- A review of any debt rescheduling undertaken during 2020/21;
- A review of compliance with Treasury and Prudential Limits for 2020/21.

The main issues for Members to note are:

1. The Council has complied with the professional codes, statutes and guidance.

2. There are no issues to report regarding non-compliance with the approved prudential indicators.

3. The investment portfolio yield for the first six months of the year is 0.77% (1.02% for the same period in 2019/20) compared to the 3 Month LIBID benchmark rate of 0.11% (0.66% for the same period in 2019/20).

At the meeting on 15th July 2020, Members of the Corporate Scrutiny Committee considered the Capital Outturn report for 2019/20 concluding before any further investments in property funds under existing delegations are made, that a review be carried out.

As the Committee nominated by Council for the scrutiny of Treasury Management functions, it was recommended to and approved by Cabinet on 30th July that the review be scrutinised by the Audit & Governance Committee to inform the Treasury Management Strategy Statement and Annual Investment Strategy Mid-Year Review Report due to be presented to Council in December 2020. This was considered at the Audit & Governance Committee on 29th October 2020 where it was resolved that it be recommended to Cabinet that the planned investments in property funds be deferred, with a review during Spring 2021 when the situation should be clearer, to inform future investment plans.

The aim of this report is to inform Members of the treasury and investment management issues to enable all Members to have ownership and understanding when making decisions on Treasury Management matters. In order to facilitate this, training on Treasury Management issues was most recently delivered for Members in November 2019 and will be provided as and when required.

RESOURCE IMPLICATIONS

All financial resource implications are detailed in the body of this report which links to the Council's Medium Term Financial Strategy.

LEGAL/RISK IMPLICATIONS BACKGROUND

Risk is inherent in Treasury Management and as such a risk based approach has been adopted throughout the report with regard to Treasury Management processes.

SUSTAINABILITY IMPLICATIONS

None

BACKGROUND INFORMATION

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

A report setting out our updated Capital Strategy will be included with the Budget and Medium Term Financial Strategy report presented to Cabinet and Council in February 2021.

The CIPFA Code of Practice on Treasury Management (revised 2017) suggests that Members should be informed of Treasury Management activities at least twice a year, but preferably quarterly. This is the second monitoring report for 2020/21 presented to Members this year and therefore ensures the Council is embracing best practice. Cabinet also receives regular monitoring reports as part of the quarterly healthcheck on Treasury Management activities and risks.

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*."

Introduction

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), which was adopted by this Council on 27th February 2018.

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's Treasury Management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. 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, a **Mid-year Review Report** and an Annual Report (stewardship report) covering activities during the previous year.
4. 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.
5. 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 and Governance Committee.

1. Economic Update and Interest Rates

1.1 As expected, the Bank of England's Monetary Policy Committee kept Bank Rate unchanged on 6th August. It also kept unchanged the level of quantitative easing at £745bn. Its forecasts were optimistic in terms of three areas:

- The fall in **GDP** in the first half of 2020 was revised from 28% to 23% (subsequently revised to -21.8%). This is still one of the largest falls in output of any developed nation. However, it is only to be expected as the UK economy is heavily skewed towards consumer-facing services – an area which was particularly vulnerable to being damaged by lockdown.

- The peak in the **unemployment rate** was revised down from 9% in Q2 to 7½% by Q4 2020.

- It forecast that there would be excess demand in the economy by Q3 2022 causing CPI **inflation** to rise above the 2% target in Q3 2022, (based on market interest rate expectations for a further loosening in policy). Nevertheless, even if the Bank were to leave policy unchanged, inflation was still projected to be above 2% in 2023.

It also squashed any idea of using **negative interest rates**, at least in the next six months or so. It suggested that while negative rates can work in some circumstances, it would be “less effective as a tool to stimulate the economy” at this time when banks are worried about future loan losses. It also has “other instruments available”, including QE and the use of forward guidance.

The MPC expected the £300bn of **quantitative easing** purchases announced between its March and June meetings to continue until the “turn of the year”. This implies that the pace of purchases will slow further to about £4bn a week, down from £14bn a week at the height of the crisis and £7bn more recently.

In conclusion, this would indicate that the Bank could now just sit on its hands as the economy was recovering better than expected. However, the MPC acknowledged that the “medium-term projections were a less informative guide than usual” and the minutes had multiple references to **downside risks,** which were judged to persist both in the short and medium term. One has only to look at the way in which second waves of the virus are now impacting many countries including Britain, to see the dangers. In addition, Brexit uncertainties ahead of the year-end deadline are likely to be a drag on recovery.

Overall, **the pace of recovery** is not expected to be in the form of a rapid V shape, but a more elongated and prolonged one after a sharp recovery in June through to August which left the economy 11.7% smaller than in February. The last three months of 2020 are now likely to show no growth as consumers will probably remain cautious in spending and uncertainty over the outcome of the UK/EU trade negotiations concluding at the end of the year will also be a headwind. If the Bank felt it did need to provide further support to recovery, then it is likely that the tool of choice would be more QE.

There will be some **painful longer term adjustments** as e.g. office space and travel by planes, trains and buses may not recover to their previous level of use for several years, or possibly ever. There is also likely to be a reversal of globalisation as this crisis has shown up how vulnerable long-distance supply chains are. On the other hand, digital services is one area that has already seen huge growth.

One key addition to **the Bank’s forward guidance** was a new phrase in the policy statement, namely that “it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably”. That seems designed to say, in effect, that even if inflation rises to 2% in a couple of years’ time, do not expect any action from the MPC to raise Bank Rate – until they can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate

The **Financial Policy Committee** (FPC) report on 6th August revised down their expected credit losses for the banking sector to “somewhat less than £80bn”. It stated that in its assessment “banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC’s central projection”. The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC’s projection, with unemployment rising to above 15%.

US. The incoming sets of data during the first week of August were almost universally stronger than expected.

However, growth will be dampened by continuing outbreaks of the virus in some states leading to fresh localised restrictions. At its end of August meeting, the Fed tweaked **its inflation target** from 2% to maintaining an average of 2% over an unspecified time period i.e.following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time. This change is aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary "trap" like Japan. It is to be noted that inflation has actually been under-shooting the 2% target significantly for most of the last decade so financial markets took note that higher levels of inflation are likely to be in the pipeline; long term bond yields duly rose after the meeting. The Fed also called on Congress to end its political disagreement over providing more support for the unemployed as there is a limit to what monetary policy can do compared to more directed central government fiscal policy. The FOMC's updated economic and rate projections in mid-September showed that officials expect to leave the fed funds rate at near-zero until at least end-2023 and probably for another year or two beyond that. There is now some expectation that where the Fed has led in changing its inflation target, other major central banks will follow. The increase in tension over the last year between the US and China is likely to lead to a lack of momentum in progressing the initial positive moves to agree a phase one trade deal.

EU. The economy was recovering well towards the end of Q2 after a sharp drop in GDP, (e.g. France 18.9%, Italy 17.6%). However, the second wave of the virus could cause a significant slowdown in the pace of recovery, especially in countries more dependent on tourism. The fiscal support package, eventually agreed by the EU after prolonged disagreement between various countries, is unlikely to provide significant support and quickly enough to make an appreciable difference in weaker countries. The ECB has been struggling to get inflation up to its 2% target and it is therefore expected that it will have to provide more monetary policy support through more quantitative easing purchases of bonds in the absence of sufficient fiscal support.

China. After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and has enabled it to recover all of the contraction in Q1. However, this was achieved by major central government funding of yet more infrastructure spending. After years of growth having been focused on this same area, any further spending in this area is likely to lead to increasingly weaker economic returns. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.

Japan. There are some concerns that a second wave of the virus is gaining momentum and could dampen economic recovery from its contraction of 8.5% in GDP. It has been struggling to get out of a deflation trap for many years and to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. The resignation of Prime Minister Abe is not expected to result in any significant change in economic policy.

World growth. Latin America and India are currently hotspots for virus infections. World growth will be in recession this year. Inflation is unlikely to be a problem for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

1.2 Interest rate forecasts

The Council's treasury advisor, Link Group, provided the following forecasts on 11th August 2020 (PWLB rates are certainty rates, gilt yields plus 180bps):

Link Group Interest Rate View 11.8.20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Bank Rate View	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month average earnings	0.05	0.05	0.05	0.05	0.05	-	-	-	-	-
6 month average earnings	0.10	0.10	0.10	0.10	0.10	-	-	-	-	-
12 month average earnings	0.15	0.15	0.15	0.15	0.15	-	-	-	-	-
5yr PWLB Rate	1.90	2.00	2.00	2.00	2.00	2.00	2.10	2.10	2.10	2.10
10yr PWLB Rate	2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30
25yr PWLB Rate	2.50	2.50	2.50	2.60	2.60	2.60	2.70	2.70	2.70	2.70
50yr PWLB Rate	2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50	2.50	2.50

The coronavirus outbreak has done huge economic damage to the UK and economies around the world. After the Bank of England took emergency action in March to cut Bank Rate to first 0.25%, and then to 0.10%, it left Bank Rate unchanged at its meeting on 6th August (and the subsequent September meeting), although some forecasters had suggested that a cut into negative territory could happen. However, the Governor of the Bank of England has made it clear that he currently thinks that such a move would do more damage than good and that more quantitative easing is the favoured tool if further action becomes necessary. As shown in the forecast table above, no increase in Bank Rate is expected within the forecast horizon ending on 31st March 2023 as economic recovery is expected to be only gradual and, therefore, prolonged.

GILT YIELDS / PWLB RATES. There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was heightened expectations that the US could have been heading for a recession in 2020. In addition, there were growing expectations of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued. Combined, these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers. This means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. The consequence of this has been the gradual lowering of the overall level of interest rates and bond yields in financial markets over the last 30 years. Over the year prior to the coronavirus crisis, this has seen many bond yields up to 10 years turn negative in the Eurozone. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities.
Gilt yields had therefore already been on a generally falling trend up until the coronavirus crisis hit western economies during March. After gilt yields spiked up during the initial phases of the health crisis in March, we have seen these yields fall sharply to

unprecedented lows as major western central banks took rapid action to deal with excessive stress in financial markets, and started massive quantitative easing purchases of government bonds: this also acted to put downward pressure on government bond yields at a time when there has been a huge and quick expansion of government expenditure financed by issuing government bonds. Such unprecedented levels of issuance in “normal” times would have caused bond yields to rise sharply. At the close of the day on 30th September, all gilt yields from 1 to 6 years were in negative territory, while even 25-year yields were at only 0.76% and 50 year at 0.60%.

From the local authority borrowing perspective, HM Treasury imposed **two changes of margins over gilt yields for PWLB rates** in 2019-20 without any prior warning. The first took place on 9th October 2019, adding an additional 1% margin over gilts to all PWLB period rates. That increase was then at least partially reversed for some forms of borrowing on 11th March 2020, but not for mainstream General Fund capital schemes, at the same time as the Government announced in the Budget a programme of increased infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins; this was to end on 4th June, but that date was subsequently put back to 31st July. It is clear HM Treasury will no longer allow local authorities to borrow money from the PWLB to purchase commercial property if the aim is solely to generate an income stream (assets for yield).
Following the changes on 11th March 2020 in margins over gilt yields, the current situation is as follows: -

- **PWLB Standard Rate** is gilt plus 200 basis points (G+200bps)
- **PWLB Certainty Rate** is gilt plus 180 basis points (G+180bps)
- **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
- **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
- **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

It is possible that the non-HRA Certainty Rate will be subject to revision downwards after the conclusion of the PWLB consultation; however, the timing of such a change is currently an unknown, although it would be likely to be within the current financial year.

As the interest forecast table for PWLB certainty rates, (gilts plus 180bps), above shows, there is likely to be little upward movement in PWLB rates over the next two years as it will take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down period. Inflation is also likely to be very low during this period and could even turn negative in some major western economies during 2020/21.

The balance of risks to the UK

The overall balance of risks to economic growth in the UK is probably relatively even, but is subject to major uncertainty due to the virus.

There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, could impact gilt yields, (and so PWLB rates), in the UK.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- **UK -** second nationwide wave of virus infections resulting in further lockdown
- **UK / EU trade negotiations** – if it were to cause significant economic disruption and a fresh major downturn in the rate of growth.
- **UK - Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis.** The ECB has taken monetary policy action to support the bonds of EU states, with the positive impact most likely for "weaker" countries. In addition, the EU recently agreed a €750bn fiscal support package. These actions will help shield weaker economic regions for the next year or so. However, in the case of Italy, the cost of the virus crisis has added to its already huge debt mountain and its slow economic growth will leave it vulnerable to markets returning to taking the view that its level of debt is unsupportable. There remains a sharp divide between northern EU countries favouring low debt to GDP and annual balanced budgets and southern countries who want to see jointly issued Eurobonds to finance economic recovery. This divide could undermine the unity of the EU in time to come.
- Weak capitalisation of some **European banks**, which could be undermined further depending on extent of credit losses resultant of the pandemic.
- **German minority government & general election in 2021.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. The CDU has done badly in subsequent state elections but the SPD has done particularly badly. Angela Merkel has stepped down from being the CDU party leader but she intends to remain as Chancellor until the general election in 2021. This then leaves a major question mark over who will be the major guiding hand and driver of EU unity when she steps down.
- **Other minority EU governments.** Austria, Sweden, Spain, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been a rise in anti-immigration sentiment in Germany and France.
- **Geopolitical risks,** for example in China, Iran or North Korea, but also in Europe and other Middle Eastern countries, which could lead to increasing safe haven flows.
- **US – the Presidential election in 2020:** this could have repercussions for the US

economy and SINO-US trade relations.

Upside risks to current forecasts for UK gilt yields and PWLB rates

- **UK -** stronger than currently expected recovery in UK economy.
- **Post-Brexit** – if an agreement was reached that removed the majority of threats of economic disruption between the EU and the UK.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.

2. Treasury Management Strategy Statement and Annual Investment Strategy Update

The Treasury Management Strategy Statement (TMSS) for 2020/21 was approved by Council on 25th February 2020.

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. The Council's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

3.1 Prudential Indicator for Capital Expenditure

This table below shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

Capital Expenditure	**2020/21 Original Programme**	**Budget B'fwd from 2019/20**	**Virements in Year**	**Total 2020/21 Budget**	**Actual Spend @ Period 6**	**Predicted Outturn**	**2020/21 Revised Estimate***
	£m	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
General Fund	1.579	15.077	0.472	17.127	1.644	3.600	16.844
HRA	10.246	6.004	6.000	22.250	10.455	21.351	21.396
Total	**11.825**	**21.080**	**6.472**	**39.377**	**12.099**	**24.951**	**38.241**

* Includes potential expenditure slippage into 2020/21

3.2 Changes to the Financing of the Capital Programme

The following table draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. Any 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 direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	**2020/21** **Capital Programme** **£m**	**2020/21** **Predicted Outturn** **£m**	**2020/21** **Budget *** **£m**
Unsupported	0.844	4.754	4.985
Supported	10.981	20.197	34.392
Total spend	**11.825**	**24.951**	**39.377**
Financed by:			
Grants - Disabled Facilities	0.400	0.400	0.400
Section 106's	0.090	0.816	0.972
GF Receipts	-	0.080	12.930
GF Reserve	-	0.175	0.298
Sale of Council House Receipts	0.191	0.263	0.392
HRA Receipts	0.741	0.786	0.940
HLF/Donation - Castle Mercian Trail	-	0.226	0.226
Community Infrastructure Levy (CIL)	0.030	-	0.030
Other Grants/Contributions	0.024	0.601	0.609
MRR	2.895	3.528	4.282
HRA 1-4-1 Replacements Receipts	0.600	3.072	3.072
HRA Reserve	5.666	9.061	9.053
HRA Regeneration Fund	0.344	1.066	1.066
HRA Affordable Housing Reserve	-	0.124	0.124
Total Financing	**10.981**	**20.197**	**34.392**
Borrowing need	**0.844**	**4.754**	**4.985**

* includes potential expenditure slippage into 2020/21

3.3 Changes to the Prudential Indicators for the Capital Financing Requirement, External Debt and the Operational Boundary

The following table shows the Capital Financing Requirement (CFR), which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period, which is termed the Operational Boundary.

Prudential Indicator – Capital Financing Requirement

We are on target to achieve the original forecast Capital Financing Requirement.

Prudential Indicator – the Operational Boundary for External Debt

	2019/20 Outturn £m	2020/21 Capital Programme £m	2020/21 Projected Outturn £m	2020/21 Budget £m
CFR – Non Housing	3.523	2.806	4.453	4.627
CFR – Housing	68.532	75.255	72.246	72.246
Total CFR	72.055	78.061	76.698	76.873
Net movement in CFR	**3.188**	**3.010**	**4.643**	**4.818**
Operational Boundary				
Expected Borrowing	63.060	63.060	63.060	63.060
Other long term liabilities	-	-		-
Total Debt 31st March	**63.060**	**63.060**	**63.060**	**63.060**

3.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross 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. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2019/20 Outturn £m	2020/21 Original Estimate £m	2020/21 Projected Outturn £m	2020/21 Budget £m
Gross borrowing	63.060	63.060	63.060	63.060
Less investments	58.981	27.197	43.905	43.673
Net borrowing	4.079	35.863	19.156	19.387
CFR (year end position)	72.055	78.061	76.698	76.873

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

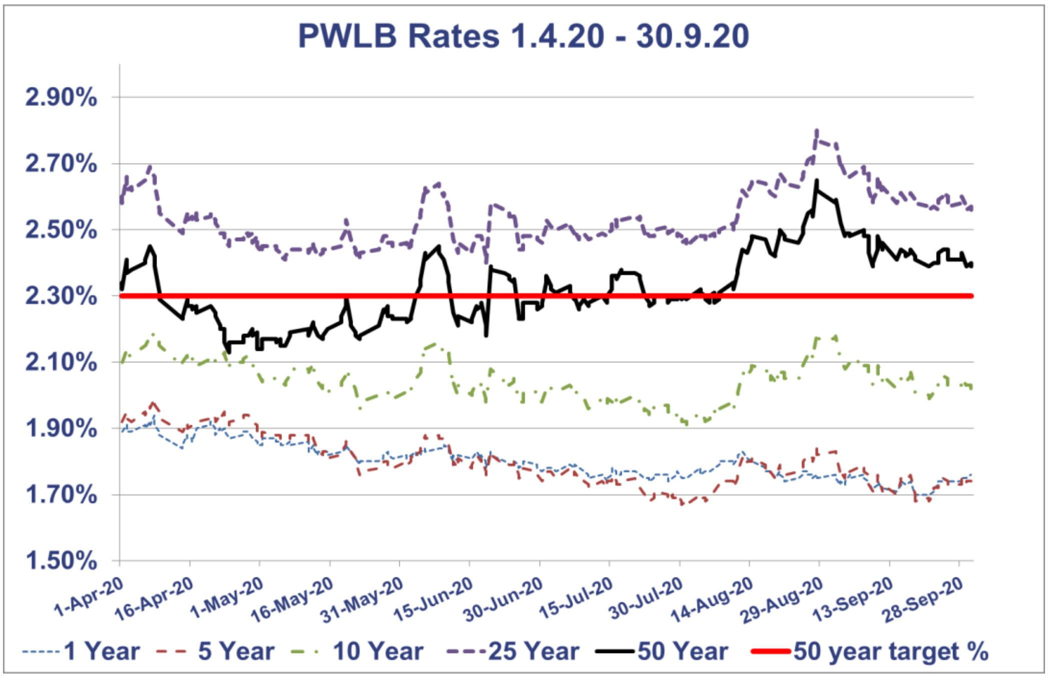
Authorised Limit for External Debt	**2020/21 Original Indicator**	**Current Position**	**2020/21 Revised Indicator**
Borrowing	85.213	85.213	85.213
Total	85.213	85.213	85.213

4. Borrowing

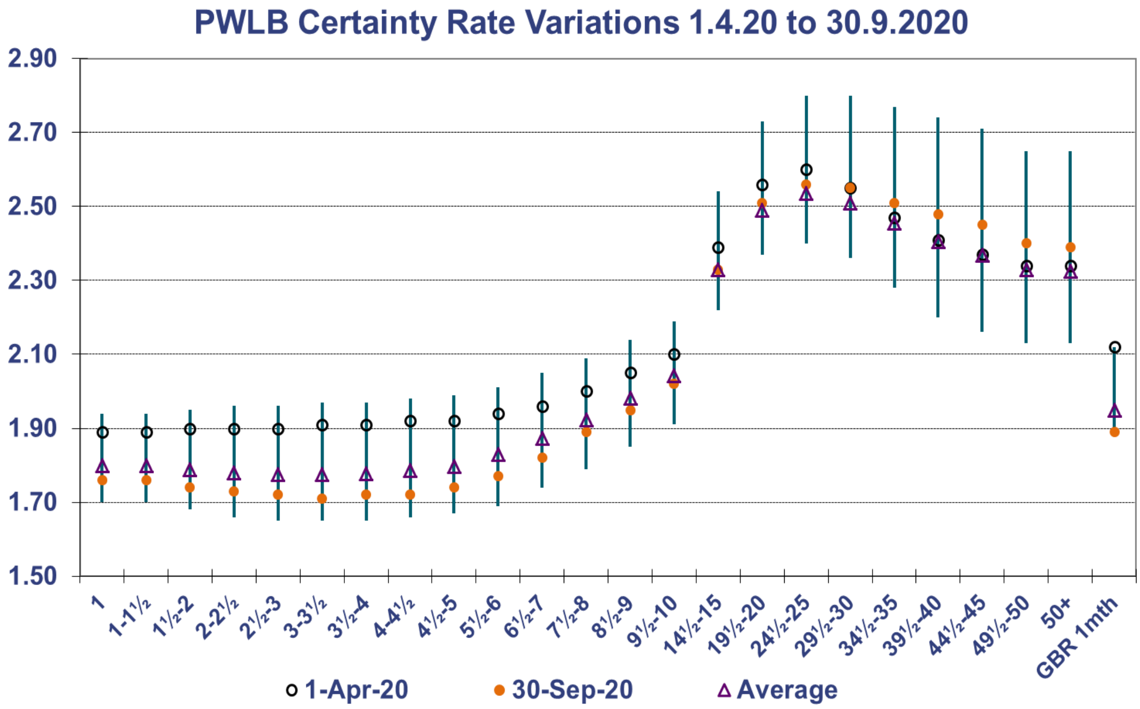
The Council's estimated revised capital financing requirement (CFR) for 2020/21 is £76.698m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Table 3.4 shows the Council has borrowings of £63.060m and plans to utilise £13.638m of cash flow funds in lieu of borrowing. This is 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.

It is not anticipated that any additional borrowing will be undertaken during 2020/21.

PWLB maturity certainty rates (gilts plus 180bps) year to date to 30th September 2020



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.70%	1.67%	1.91%	2.40%	2.13%
Date	18/09/2020	30/07/2020	31/07/2020	18/06/2020	24/04/2020
High	1.94%	1.99%	2.19%	2.80%	2.65%
Date	08/04/2020	08/04/2020	08/04/2020	28/08/2020	28/08/2020
Average	1.80%	1.80%	2.04%	2.54%	2.33%



PWLB rates varied within a relatively narrow range between April and July but the longer end of the curve rose during August. This increase came in two periods; the first in the second week of the month was on the back of hopes for fresh US stimulus. This saw investors switch monies out of government bonds and into equities. The second shift higher at the longer end of the curve came in the latter stages of the month as investors reacted to the announcement of the tweak to the Fed's inflation target. Despite moves further out in the yield curve, the short end remained anchored on the basis of no fundamental change to the interest rate outlook.

The 50-year PWLB target rate for new long-term borrowing was unchanged at 2.30%.

5. Debt Rescheduling

Debt rescheduling opportunities have been very limited in the current economic climate and following the various increases in the margins added to gilt yields which have impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

6. Compliance with Treasury and Prudential Limits

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. During the half year ended 30th September 2020, the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement for 2020. The Executive Director Finance reports that no difficulties are envisaged for the current or future years in complying with these indicators.

All treasury management operations have also been conducted in full compliance with the Council's Treasury Management Practices.

7. Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2020/21, which includes the Annual Investment Strategy, was approved by the Council on 25th February 2020. In accordance with the CIPFA Treasury Management Code of Practice, it sets out the Council's investment priorities as being:

- Security of capital
- Liquidity
- Yield

The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the Council's risk appetite. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with high credit rated financial institutions, using the Link suggested creditworthiness approach, including a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information.

As shown by the interest rate forecasts in section 1.2, it is now impossible to earn the level of interest rates commonly seen in previous decades as all investment rates are barely above zero now that Bank Rate is at 0.10%, while some entities, including more recently the Debt Management Account Deposit Facility (DMADF), are offering negative rates of return in some shorter time periods. Given this risk environment and the fact that increases in Bank Rate are unlikely to occur before the end of the current forecast horizon of 31st March 2023, investment returns are expected to remain low.

Negative investment rates

While the Bank of England has said that it is unlikely to introduce a negative Bank Rate, at least in the next 6 -12 months, some deposit accounts are already offering negative rates for shorter periods. As part of the response to the pandemic and lockdown, the Bank and the Government have provided financial markets and businesses with plentiful access to credit, either directly or through commercial banks. In addition, the Government has provided large sums of grants to local authorities to help deal with the Covid crisis; this has caused some local authorities to have sudden large increases in investment balances searching for an investment home, some of which was only very short term until those sums were able to be passed on.

As for money market funds (MMFs), yields have continued to drift lower. Some managers have suggested that they might resort to trimming fee levels to ensure that net yields for investors remain in positive territory where possible and practical. Investor cash flow uncertainty, and the need to maintain liquidity in these unprecedented times, has meant there is a glut of money swilling around at the very short end of the market. This has seen a number of market operators, now including the DMADF, offer nil or negative rates for very short term maturities. This is not universal, and MMFs are still offering a marginally positive return, as are a number of financial institutions.

Inter-local authority lending and borrowing rates have also declined due to the surge in the levels of cash seeking a short-term home at a time when many local authorities are probably having difficulties over accurately forecasting when disbursements of funds received will occur or when further large receipts will be received from the Government.

Creditworthiness.

Although the credit rating agencies changed their outlook on many UK banks from stable to negative outlook during the quarter ended 30th June 2020 due to upcoming risks to banks' earnings and asset quality during the economic downturn caused by the pandemic, the majority of ratings were affirmed due to the continuing strong credit profiles of UK banks. However, during Q1 and Q2 2020, banks made provisions for *expected* credit losses and the rating changes reflected these provisions. As we move into the next quarters ahead, more information will emerge on *actual* levels of credit losses. (Quarterly performance is normally announced in the second half of the month following the end of the quarter.) This has the potential to cause rating agencies to revisit their initial rating adjustments earlier in the current year. These adjustments could be negative or positive, although it should also be borne in mind that UK banks went into this pandemic with strong balance sheets. Indeed, the Financial Policy Committee (FPC) report on 6th August revised down their expected credit losses for the banking sector to "somewhat less than £80bn". They stated that in their assessment, "banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC's central projection". The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC's projection, with unemployment rising to above 15%.

All three rating agencies have reviewed banks around the world with similar results in many countries of most banks being placed on negative watch, but with a small number of actual downgrades.

Link have conducted some stress testing on the Link credit methodology based list of counterparties supplied to clients, to test for the results of a 1 notch downgrade to all Long Term Ratings from all agencies. Under such a scenario, only Commerzbank, Norddeutsche Landesbank, NatWest Markets Plc (non-ring-fenced entity), Leeds, Skipton and Yorkshire Building Societies moved from Green to No Colour. While there are a further 17 drops in other entities' suggested durations, in these instances, these entities still remain potentially available for use. (Note that this scenario excludes any additional impact from relative movement in CDS pricing.)

Investment Counterparty criteria
The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

CDS prices
Although CDS prices, (these are market indicators of credit risk), for UK banks spiked upwards at the end of March/early April due to the liquidity crisis throughout financial markets, CDS prices have returned to more average levels since then, although they are still elevated compared to end-February. Pricing is likely to remain volatile as uncertainty continues. However, sentiment can easily shift, so it remains important to undertake continual monitoring of all aspects of risk and return in the current circumstances.

Investment balances

The Council held £59.572m of investments as at 30th September 2020, excluding investments in property funds (£55.061m at 31st March 2020) and the investment portfolio yield for the first six months of the year is 0.77% against a benchmark of the 3 months LIBID of 0.11%. A full list of investments held as at 30th September 2020 is detailed in **APPENDIX 1**.

The Executive Director Finance confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2020/21.

The Council's budgeted investment return for 2020/21 is £332k.

Investment Counterparty Criteria

The current investment counterparty criteria selection approved in the TMSS and as approved by Council on 25th February 2020 meets the requirements of the Treasury

Management function.

8.Changes in risk appetite

The 2018 CIPFA Codes and guidance notes have placed enhanced importance on risk management. Where an authority changes its risk appetite e.g. for moving surplus cash into or out of certain types of investment funds or other types of investment instruments, this change in risk appetite and policy should be brought to members' attention in treasury management update reports. There are no such changes to report to Members at this stage.

9. Property Funds

Following a Property Fund Manager selection exercise during 2017/18, supported by Link Asset Services, Council on 27th February 2018 endorsed the approach taken and approved the investment in a short list of Property Funds.

To date, the Council has invested £1.85m with Schroders UK Real Estate Fund and £2m with Threadneedle Property Unit Trust, total investment £3.85m – however, capital values have fallen by £291k since, mainly since 31st March 2020 (£163k).
It should also be noted that investments in property are subject to fluctuations in value over the economic cycle and should also yield capital growth in the longer term as the economy grows.

Table 1: Fund Valuations	Investment	Valuation 31/03/2019	Valuation 31/03/2020	Valuation 30/09/2020
Schroders UK Real Estate Fund	1,848,933	1,897,716	1,884,412	1,796,118
Valuation Increase / (reduction)		48,783	35,479	(52,815)
Threadneedle Property Unit Trust	2,000,249	1,921,884	1,836,032	1,761,749
Valuation Increase / (reduction)		(78,365)	(164,216)	(238,500)
Total	3,849,182	3,819,601	3,720,444	3,557,867
Gain / (loss)		(29,581)	(128,738)	(291,315)

However, this needs to be balanced against the dividends received (which support the revenue budget). The Council received £147k in dividends from its property fund investments in 2019/20 (£108k in 2018/19), £255k in total compared to the valuation reduction of £129k over the same period.

Table 2: Investment Returns	Dividend Returns 31/03/2019	Dividend Returns 31/03/2020	Dividend Returns 30/09/2020	Estimated Return p.a.	
				%	
Schroders UK Real Estate Fund	48,118	56,638	27,300	3.0%	
Gain / (loss)	48,118	104,756	132,056		Half year only to

Threadneedle Property Unit Trust	60,056	90,274	38,684	4.9%	30/9/20 for 2020/21
Gain / (loss)	60,056	150,329	189,014		
Total	108,174	146,911	65,984		
Gain / (loss)	108,174	255,085	321,069		
Annual Revenue % Return	2.8%	3.8%	1.7%	3.9%	
Annual Overall % Return	2.0%	1.2%	(2.5)%		
Cumulative Gain / (loss)	78,593	126,348	29,754		

Internal Treasury Management Return Achieved %	0.9%	1.0%	0.8%	0.7%	

The funds achieved an estimated return of 2.8% in 2018/19 and 3.8% during 2019/20 compared to internal investments with banks and other Councils of less than 1%.

The MTFS includes budgeted income of £300k for 2020/21 (£480k pa from 2021/22) arising from investment of the full £12m budgeted, however, due to uncertainty around arrangements for Brexit and the associated impact on the economy, and then the further uncertainty and questions over the potential outlook for future property fund returns as a result of the coronavirus, any further investment in property funds had been delayed until there is more clarity.

The secondary market investment opportunities available at present (as at 20th November) are set out below – and show that there is a potential discount of up to 5% on purchase costs, which needs to be considered against the risk of capital devaluations in the coming months.

UK Balanced Funds

FUND	BID (BUYERS)	OFFER (SELLERS)	Notes
BlackRock UK Property Fund	-4%	-3%	
CBRE UK Property PAIF	-5%	NAV	
Hermes Property Unit Trust	-3%	-1.5%	
Lothbury Property Trust	-	-3%	
Schroder UK Real Estate Fund	-5%	-3%	Trading NAV -4%
Threadneedle Property Unit Trust	-5%	-3%	

Conclusions

While risk is inherent in investment decisions, property fund investments provide investors with a strong level of return over the medium to longer term investment time horizon – which is why the Council was clear at the outset that the investments would be longer term (at least 10 years) in order to benefit from capital growth and generating significantly improved annual investment returns supporting the revenue budget. The overall return is made up of income, achieved via rental streams and capital via the changing value of underlying properties within a fund. While the second element is the most volatile from a year-to-year perspective, the income produced by the funds is relatively stable.

It is clear that it will be many months before the impact of the pandemic on the wider economy and the associated impact on real estate markets is known, however, we are seeing signs of recovery and resilience in certain parts of the economy, and consequently the Funds real estate portfolio. Most funds are able to report relatively high collection rates (approaching 80%) for both the March and June payment dates which is positive – however, the effects of the furlough scheme measures ending and a second wave over the coming months could seriously impact the wider economy and real estate markets.

It is therefore suggested that planned investments be deferred with a review during Spring 2021, when the situation should be clearer, to inform future investment plans.

REPORT AUTHOR

Please contact Stefan Garner, Executive Director Finance, extension 242, or Jo Goodfellow, Head of Finance, extension 241.

LIST OF BACKGROUND PAPERS

Background Papers -	*Local Government Act 2003*
	CIPFA Code of Practice on Treasury Management in Public Services 2017
	Annual Report on the Treasury Management Service and Actual Prudential Indicators 2019/20 – Council 15th September 2020

	Treasury Management Strategy & Prudential Indicators Report 2020/21 - Council 25th February 2020
	Budget & Medium Term Financial Strategy 2020/21 - Council 25th February 2020
	Review of the Proposed Investment in Property Funds, Audit & Governance Committee – 29th October 2020
	Financial Healthcheck Period 6, September 2020

APPENDIX 1

Investments held as at 30th September 2020:

Borrower	Deposit £	Rate %	From	To	Notice
Lancashire County Council	3,000,000	0.95%	29-Oct-19	28-Oct-20	-
Thurrock Council	3,000,000	0.83%	10-Oct-19	09-Oct-20	-
Lancashire County Council	3,000,000	1.10%	29-Oct-19	27-Oct-20	-
Lloyds Bank	1,000,000	1.10%	29-Nov-19	30-Nov-20	-
Lloyds Bank	1,000,000	1.10%	29-Nov-19	30-Nov-20	-
North Tyneside Council	5,000,000	1.20%	06-Dec-19	07-Jun-21	-
Bank of Scotland	2,000,000	1.10%	03-Jan-20	04-Jan-21	-
Bank of Scotland	2,000,000	1.10%	03-Jan-20	04-Jan-21	-
Coventry City Council	4,000,000	0.90%	29-Apr-20	28-Apr-21	-
Standard Chartered	5,000,000	0.20%	12-Aug-20	12-Feb-21	-
Santander	10,000,000	0.60%	-	-	180 day
MMF – PSDF	9,171,000	0.10%*	-	-	On call
MMF – Federated	6,000,000	0.11%*	-	-	On call
MMF – Federated	4,000,000	0.04%*	-	-	On call
MMF – Aberdeen	1,401,000	0.07%*	-	-	On call
Total	**59.572**	**0.77 (avg)**			

** Interest rate fluctuates daily dependant on the funds investment portfolio, rate quoted is approximate 7 day average.*