

Treasury Management Update Report Q1 2019/20

Introduction

The Authority has adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports. This quarterly report provides an additional update.

The Authority's treasury management strategy for 2019/20 was approved at a meeting of full Council on 25 February 2019. The Authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk remains central to the Authority's treasury management strategy.

The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 25 February 2019.

External Context (provided by the Council's treasury management advisor, Arlingclose)

Economic background: UK Consumer Price Inflation (CPI) for June 2019 was 2.0% year/year, coming in at consensus and meeting the Bank of England's inflation target. The most recent labour market data for the three months to May 2019 showed the unemployment rate remain at a low of 3.8% while the employment rate of 76.0% dipped by 0.1%, the first quarterly decrease since June to August 2018. The 3-month average annual growth rate for pay excluding bonuses was 3.6% as wages continue to rise steadily and provide some upward pressure on general inflation. Once adjusted for inflation, real wages were up 1.7%.

There was a rise in quarterly GDP growth in the first calendar quarter for 2019 to 0.5%, from 0.2% in Q4 2018 with stockpiling ahead of the (now delayed) 29th March Brexit distorting data. Production and construction registered positive output and growth, however at the end of June 2019, seasonally adjusted Markit UK Construction PMI (Purchasing Manager's Index) logged a record-low figure of 43.1, suggesting that construction has suffered a largest contraction in output since April 2009. GDP growth was 1.8% year/year, however with the service sector slowing and a weaker global backdrop the outlook was for subdued growth.

Politics has been a big driver over the last quarter. The 29th March Brexit deadline was extended to 12th April and then to 31st October 2019: there is still no clear consensus as to the terms on which the UK will leave the EU. Theresa May announced her resignation as Prime Minister and leader of the Conservative Party in May and the leadership contest for her successor is ongoing with Boris Johnson the current favourite.

The struggling British high street has continued to dominate headlines with the Arcadia group being saved from collapse in June following an agreement for rent reductions from landlords. The car industry has also struggled in the UK and beyond with announcements of cuts to 12,000 jobs across Europe by Ford.

With the deterioration in the wider economic environment, compounded by Brexit-related uncertainty and the risk of a no-deal Brexit still alive, the speech by Bank of England Governor Mark Carney in early July signalled a major shift to the Bank's rhetoric and increased the possibility of interest rate cuts, rather the Bank's erstwhile 'gradual and limited' rate hike guidance.

Globally, tensions between the US and China became progressively more fraught with US President Donald Trump threatening to more than double tariffs on some Chinese goods. There were also moves in both the US and UK to block or restrict access to markets by Chinese telecoms giant Huawei. Amid low inflation and a weak economy in the Eurozone Mario Draghi signalled in late June that another round of stimulus (QE) may be likely. The US and EU have also carved the path for interest rates to be cut in the future.

Financial markets: 2018 was a year to forget in terms of performance of riskier asset classes, most notably equities. However, since the beginning of 2019 markets have rallied, and the FTSE 100 is up over 10% in pure price terms for the first 6 months of the calendar year. Nearly all of these gains were realised in the last quarter of FY 2018/19, as Q1 2019/20 has only seen a modest increase of around 2%.

Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. Gilt yields fell - the 5-year benchmark gilt yield falling to 0.63% at the end of June from 0.75% at the start of April. There were falls in the 10-year and 20-year gilts over the same period dropping from 1.00% to 0.83% and from 1.47% to 1.35% respectively. Money markets rates stabilised with 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.60%, 0.68% and 0.92% respectively over the period.

Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth is not just a UK phenomenon but a global risk. The US yield curve inverted (10-year Treasury yields were lower than US 3-month money market rates) in March 2019 and this relationship remained and broadened throughout the period. History has shown that a recession hasn't been far behind a yield curve inversion. Germany sold 10-year Bunds at -0.24% in June, the lowest yield on record. Bund yields had been trading at record lows in the secondary market for some time, however the negative yield in the primary market suggests that if investors were to hold until maturity, they are guaranteed to sustain a loss - highlighting the uncertain outlook for Europe's economy.

Credit background: Credit Default Swap (CDS) spreads fell slightly across the board during the quarter, continuing to remain low in historical terms. After hitting around 97bps at the start of the period, the spread on non-ringfenced bank NatWest Markets plc fell back to around 82bps at the end of June, while for the ringfenced entity, National Westminster Bank plc, the spread fell from 67bps to 58bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 28 and 59bps at the end of the period.

S&P upgraded RBS Group and its subsidiaries, including National Westminster Bank PLC, Natwest Markets PLC, The Royal Bank of Scotland and Ulster Bank Ltd. S&P raised the long-term issuer ratings by one notch due to RBS Group's strengthened credit fundamentals following a long period of restructuring. S&P believes the group and its subsidiaries have enhanced their capacity to manage the current UK political and economic uncertainties.

There were minimal other credit rating changes during the period. Moody's revised the outlook on Barclays Bank PLC to positive from stable to reflect the bank's progress in its restructuring plans, including de-risking the balance sheet, improving its risk profile and profitability and resolving litigation issues in the US. Moody's also revised the outlook to stable from negative for Goldman Sachs International Bank, reflecting a slowdown in loan growth as well as a stronger revenue growth for sales and trading.

Local Context

On 31st March 2019, the Authority had borrowing of £388.8m, and investments of £30.6m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31.3.19 Actual £m
General Fund CFR	385.0
HRA CFR	249.8
Total CFR	634.8
Less: *Other debt liabilities	-34.7
Borrowing CFR - comprised of:	600.1
- External borrowing	388.8
- Internal borrowing	211.3

* finance leases, PFI liabilities and transferred debt that form part of the Authority's total debt

The Authority pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

The treasury management position at 30th June 2019 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.03.19 Balance £m	Movement £m	30.06.19 Balance £m	30.06.19 Rate %
Long-term borrowing	365.8	40.0	405.8	4.14
Short-term borrowing	23.0	-23.0	0.0	0.00
Total borrowing	388.8	17.0	405.8	3.94
Long-term investments	0.0	0.0	0.0	0.00
Short-term investments	15.0	-5.0	10.0	1.07
Cash and cash equivalents	15.6	25.7	41.3	0.66
Total investments	30.6	20.7	51.3	0.74
Net borrowing	358.1		354.5	

Borrowing Strategy during the period

At 30th June 2019 the Authority held £405.8m of loans, an increase of £17.0m from 31st March 2019, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30th June are summarised in Table 3 below.

Table 3: Borrowing Position

	31.03.19	Net Movement	30.06.19	30.06.19	30.06.19
	Balance	£m	Balance	Weighted Average	Weighted Average
	£m		£m	Rate	Maturity
				%	(years)
Public Works Loan Board	240.8	40.0	280.8	3.60	28.43
Banks (LOBO)	125.0	0.0	125.0	4.72	41.19
Banks (fixed-term)	0.0	0.0	0.0	0.00	0
Local authorities (long-term)	0.0	0.0	0.0	0.00	0
Local authorities (short-term)	23.0	-23.0	0.0	0.00	0
Total borrowing	388.8	17.0	405.8	3.94	32.36

The Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective.

As the Authority has an increasing CFR due to the capital programme and an estimated borrowing requirement, the raised £40m of long term fixed rate loans from the PWLB in the first quarter of 2019/20, at an average rate of 2.12% which will provide longer-term certainty and stability to the debt portfolio. This borrowing was taken to fund the Council's growing underlying need to borrow from the capital programme, in conjunction with considerations around interest rates.

Going forwards into future years, the Council has a significant capital programme, and a large proportion of this will be financed by borrowing, which the Council will have to undertake in coming years. The Council's treasury advisor, Arlingclose undertakes weekly 'cost of carry' analysis to inform the Council about whether it is financially beneficial to undertake borrowing now or to delay this for set time periods: given PWLB interest rate forecasts. Any borrowing which is taken to prior to capital expenditure taking place, and reducing the extent of the Council's internal borrowing, would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing, creating an immediate cost for revenue budgets.

LOBO loans: The Authority continues to hold £125m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the period.

Treasury Investment Activity

The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances ranged between £24.9 and £59.8 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.03.19	Net	30.06.19	30.06.19	30.06.19
	Balance	Movement	Balance	Rate of Return	Weighted Average Maturity
	£m	£m	£m	%	days
Banks & building societies (unsecured)	0.0	0.0	0.0	0.00	0.0
Money Market Funds	0.0	11.3	11.3	0.73	1.0
UK Government:					
- Local Authorities	15.0	-5.0	10.0	1.07	329.0
- Debt Management Office	15.6	14.4	30.0	0.63	8.0
Total investments	30.6	20.7	51.3	0.74	69.1

Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

The table below shows counterparty credit quality as measured by credit ratings on the final day of each quarter during the year. The table also shows the percentage of the in-house investment portfolio exposed to bail-in risk. Bail-in is the response to the government bail-outs in the global financial crisis, when a number of banks failed and received government bail-outs in 2008. Under bail-in, unsecured deposits made with certain financial institutions would be at risk, should the institution fail, and investors would lose a portion of their invested funds. The below table shows a snapshot at a point in time, and movements in the figures do not reflect changes in policy or strategy, but are indicative of the Council's cashflows on that particular date.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking - Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2019	3.37	AA	0%	122	0.77
30.06.2019	3.59	AA-	22%	51	0.74
Similar LAs	4.52	A+	45%	115	1.23
All LAs	4.31	AA-	44%	28	1.37

Readiness for Brexit: The scheduled leave date for the UK to leave the EU is now 31st October 2019 and there remains little political clarity as to whether a deal will be agreed by this date, the potential of a no-deal Brexit has not been ruled out. Particularly as this new leave date approaches the Authority will ensure that sufficient funds are invested with the Debt Management Account Deposit Facility (DMADF) in order to have liquid investments to be able to access cash on a daily basis.

Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return. Further details of the Authority's non-treasury investments are given in the Council's Statement of Accounts and Treasury Management Strategy Statement.

Treasury Performance

Treasury Investments generated an average rate of return of 0.74% in the first three quarters of the year. The Council's treasury investment income for the year is forecast at was £216k against a budget of £136.5k.

Borrowing costs for 2019/20 are forecast in line with budget at Q1, at £15.3m (£10.6m HRA, £4.7m General Fund). In prior years these budgets have underspent due to a number of factors, including: the current lower interest rate environment reducing interest costs for the Council, and delays in the capital programme's delivery. Should slippage in the Council's capital programme occur, it will reduce the borrowing requirement, and reduce this forecast.

Compliance

The Director of Finance reports that all treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy.

The council's total borrowing limits are set out in the table below. The Authorised Limit sets the maximum level of external borrowing on a gross basis (i.e. not net of investments) and is the statutory limit determined under Section 3(1) of the Local Government Act 2003 (referred to in the legislation as the Affordable Limit). The Indicator separately identifies borrowing from other long term liabilities such as finance leases. The Authorised Limit has been set on the estimate of the most likely, prudent but not worst case scenario with sufficient headroom over and above this to allow for unusual cash movements.

The Operational Boundary links directly to the Council's estimates of the CFR and estimates of other cashflow requirements. This indicator is based on the same estimates as the Authorised Limit reflecting the most likely, prudent but not worst case scenario but without the additional headroom included within the Authorised Limit. The Operational Boundary and Authorised Limit apply at the total level.

The authorised limit and operational boundary do not therefore, set out absolute limits of what the Council expects to borrow in the year.

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

Table 6: Debt Limits

	Q1 Maximum	30.6.19 Actual	2019/20 Operational Boundary	2019/20 Authorised Limit	Complied? Yes/No
Borrowing	405.8m	405.8m	702.4m	752.4m	Yes
PFI and Finance Leases	34.7m	34.7m	36.3m	39.9m	Yes
Total debt	440.5m	440.5m	738.7m	792.3m	Yes

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure, however, Haringey’s debt remained well below this limit at all points in the quarter.

Treasury Management Indicators

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

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

	30.6.19 Actual	2019/20 Target	Complied?
Portfolio average credit	3.59 (AA-)	7.00 (A-)	Yes

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

	30.6.19 Actual	2019/20 Target	Complied?
Total cash available within 3 months	£41.3m	£10.0m	Yes

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

Interest rate risk indicator	30.6.19 Actual	2019/20 Limit	Complied?
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	0.5m	£1m	Yes
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	-0.5m	£1m	Yes

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

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

Maturity structure of borrowing	Lower Limit	Upper Limit	30.6.19
under 12 months	0	50%	20.6%
12 months & within 2 years	0	40%	1.7%
2 years & within 5 years	0	40%	19.6%
5 years & within 10 years	0	40%	0.5%
10 yrs & within 20 yrs	0	40%	11.6%
20 yrs & within 30 yrs	0	40%	11.1%
30 yrs & within 40 yrs	0	50%	17.7%
40 yrs & within 50 yrs	0	50%	17.2%
50 yrs & above	0	40%	0.0%

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

Total short term borrowing: the Council has used short term borrowing (under 1 year in duration) from other local authorities extensively in recent years, as an alternative to longer term borrowing from PWLB, due to the lower interest rates, and corresponding revenue savings. Short term borrowing exposes the Council to refinancing risk: the risk that interest rates rise quickly over a short period of time, and are at significantly higher rates when loans mature and new borrowing has to be raised. With this in mind, the Authority has set a limit on the total amount of short term local authority borrowing, as a proportion of all borrowing.

Short term borrowing	Limit	30.06.19 Actual	Complied?
Upper limit on short term borrowing from other local authorities as a percentage of total borrowing	30%	0%	Yes

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

	2019/20	2020/21	2021/22
Actual principal invested beyond year end	0.0m	0.0m	0.0m
Limit on principal invested beyond year end	£10.0m	£10.0m	£10.0m
Complied?	Yes	Yes	Yes

Outlook for the remainder of 2019/20

Having increased interest rates by 0.25% in November 2018 to 0.75%, the Bank of England's Monetary Policy Committee (MPC) is now expected to maintain Bank Rate at this level for the foreseeable future. There are, however, upside and downside risks to this forecast, dependant on Brexit outcomes and the evolution of the global economy.

The resignation of Theresa May added further to the political uncertainty. Boris Johnson replaced her as Prime Minister and appears to favour exiting the EU on 31st October. It is unlikely the UK will be able to negotiate a different withdrawal deal before the deadline.

With the downside risks to the UK economy growing and little likelihood of current global trade tensions being resolved imminently and global growth recovering soon thereafter, our treasury advisor Arlingclose's central forecast is for that the Bank of England's MPC will maintain Bank Rate at 0.75% but will stand ready to cut rates should the Brexit process engender more uncertainty for business and consumer confidence and for economic activity.

	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50
Arlingclose Central Case	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Downside risk	0.00	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50

Gilt yields have fallen to recent lows. Resolution of global political uncertainty would see yields rise but volatility arising from both economic and political events continue to offer longer-term borrowing opportunities for those clients looking to lock in some interest rate certainty.