

# Treasury Management Update Report Q2 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 (CPIH) fell to 1.7% year/year in August 2019 from 2.0% in July, weaker than the consensus forecast of 1.9% and below the Bank of England's target. The most recent labour market data for the three months to July 2019 showed the unemployment rate edged back down to 3.8% while the employment rate remained at 76.1%, the joint highest since records began in 1971. Nominal annual wage growth measured by the 3-month average excluding bonuses was 3.8% and 4.0% including bonuses. Adjusting for inflation, real wages were up 1.9% excluding bonuses and 2.1% including.

The Quarterly National Accounts for Q2 GDP confirmed the UK economy contracted by 0.2% following the 0.5% gain in Q1 which was distorted by stockpiling ahead of Brexit. Only the services sector registered an increase in growth, a very modest 0.1%, with both production and construction falling and the former registering its largest drop since Q4 2012. Business investment fell by 0.4% (revised from -0.5% in the first estimate) as Brexit uncertainties impacted on business planning and decision-making.

Politics, both home and abroad, continued to be a big driver of financial markets over the last quarter. Boris Johnson won the Conservative Party leadership contest and committed to leaving the EU on 31<sup>st</sup> October regardless of whether a deal was reached with the EU. Mr Johnson prorogued Parliament which led some MPs to put forward a bill requiring him to seek a Brexit extension if no deal is in place by 19th October. The move was successful and, having been approved by the House of Lords, was passed into law. The Supreme Court subsequently ruled Mr Johnson's suspension of Parliament unlawful.

Tensions continued between the US and China with no trade agreement in sight and both countries imposing further tariffs on each other's goods. The US Federal Reserve cut its target Federal Funds rates by 0.25% in September to a range of 1.75% - 2%, a pre-emptive move to maintain economic growth amid escalating concerns over the trade war and a weaker economic environment leading to more pronounced global slowdown. The euro area Purchasing Manager Indices (PMIs) pointed to a deepening slowdown in the Eurozone. These elevated concerns have caused key government yield curves to invert, something seen by many commentators as a predictor of a global recession.

Market expectations are for further interest rate cuts from the Fed and in September the European Central Bank reduced its deposit rate to -0.5% and announced the recommencement of quantitative easing from 1<sup>st</sup> November.

The Bank of England maintained Bank Rate at 0.75% and in its August Inflation Report noted the deterioration in global activity and sentiment and confirmed that monetary policy decisions related to Brexit could be in either direction depending on whether or not a deal is ultimately reached by 31<sup>st</sup> October.

**Financial markets:** After rallying early in 2019, financial markets have been adopting a more risk-off approach in the following period as equities saw greater volatility and bonds rallied (prices up, yields down) in a flight to quality and anticipation of more monetary stimulus from central banks. The Dow Jones, FTSE 100 and FTSE 250 are broadly back at the same levels seen in March/April.

Gilt yields remained volatile over the period on the back of ongoing economic and political uncertainty. From a yield of 0.63% at the end of June, the 5-year benchmark gilt yield fell to 0.32% by the end of September. There were falls in the 10-year and 20-year gilts over the same period, with the former dropping from 0.83% to 0.55% and the latter falling from 1.35% to 0.88%. 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.65%, 0.75% and 1.00% respectively over the period.

Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth remains a global risk. The US yield curve remains inverted with 10-year Treasury yields lower than US 3-month bills. History has shown that a recession hasn't been far behind a yield curve inversion. Following the sale of 10-year Bunds at -0.24% in June, yields on German government securities continue to remain negative in the secondary market with 2 and 5-year securities currently both trading around -0.77%.

**Credit background:** Credit Default Swap (CDS) spreads rose and then fell again during the quarter, continuing to remain low in historical terms. After rising to almost 120bps in May, the spread on non-ringfenced bank NatWest Markets plc fell back to around 80bps by the end of September, while for the ringfenced entity, National Westminster Bank plc, the spread remained around 40bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 34 and 76bps at the end of the period.

There were minimal credit rating changes during the period. Moody's upgraded The Co-operative Bank's long-term rating to B3 and Fitch upgraded Clydesdale Bank and Virgin Money to A-.

### **Local Context**

On 31<sup>st</sup> 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

|                                      | <b>31.3.19<br/>Actual<br/>£m</b> |
|--------------------------------------|----------------------------------|
| General Fund CFR                     | 383.9                            |
| HRA CFR                              | 249.8                            |
| <b>Total CFR</b>                     | <b>633.7</b>                     |
| Less: *Other debt liabilities        | -31.8                            |
| <b>Borrowing CFR - comprised of:</b> | <b>601.9</b>                     |
| - External borrowing                 | 388.8                            |
| - Internal borrowing                 | 213.1                            |

\* 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 30<sup>th</sup> September 2019 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

|                           | <b>31.03.19<br/>Balance<br/>£m</b> | <b>Movement<br/>£m</b> | <b>30.09.19<br/>Balance<br/>£m</b> | <b>30.09.19<br/>Rate<br/>%</b> |
|---------------------------|------------------------------------|------------------------|------------------------------------|--------------------------------|
| Long-term borrowing       | 365.8                              | 50.0                   | 415.8                              | 3.88                           |
| Short-term borrowing      | 23.0                               | -23.0                  | 0.0                                | 0.00                           |
| <b>Total borrowing</b>    | <b>388.8</b>                       | <b>27.0</b>            | <b>415.8</b>                       | <b>3.88</b>                    |
| 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                               | 43.4                   | 59.0                               | 0.64                           |
| <b>Total investments</b>  | <b>30.6</b>                        | <b>38.4</b>            | <b>69.0</b>                        | <b>0.70</b>                    |
| <b>Net borrowing</b>      | <b>358.1</b>                       |                        | <b>346.7</b>                       |                                |

### Borrowing Strategy during the period

At 30<sup>th</sup> September 2019 the Authority held £415.8m of loans, an increase of £27.0m from 31<sup>st</sup> March 2019, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30<sup>th</sup> September are summarised in Table 3 below.

Table 3: Borrowing Position

|                                | 31.03.19     | Net Movement | 30.09.19     | 30.09.19         | 30.09.19         |
|--------------------------------|--------------|--------------|--------------|------------------|------------------|
|                                | Balance      | £m           | Balance      | Weighted Average | Weighted Average |
|                                | £m           |              | £m           | Rate             | Maturity         |
|                                |              |              |              | %                | (years)          |
| Public Works Loan Board        | 240.8        | 50.0         | 290.8        | 3.52             | 28.16            |
| 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                |
| <b>Total borrowing</b>         | <b>388.8</b> | <b>27.0</b>  | <b>415.8</b> | <b>3.88</b>      | <b>32.08</b>     |

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 £50m of long term fixed rate loans from the PWLB in the first two quarters of 2019/20, at an average rate of 1.94% 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. The Authority's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short- and long-term borrowing is maintained.

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 £82.3 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         | 30.09.19    | 30.09.19       | 30.09.19                  |
|--|-------------|-------------|-------------|----------------|---------------------------|
|  | 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         | 11.8        | 11.8        | 0.69           | 1.0                       |
| UK Government:                         |             |             |             |                |                           |
| - Local Authorities                    | 15.0        | -5.0        | 10.0        | 1.07           | 329.0                     |
| - Debt Management Office               | 15.6        | 31.6        | 47.2        | 0.63           | 7.0                       |
| <b>Total investments</b>               | <b>30.6</b> | <b>38.4</b> | <b>69.0</b> | <b>0.70</b>    | <b>52.6</b>               |

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             |
| 30.09.2019  | 3.36         | AA            | 17%              | 26                               | 0.70             |
| Similar LAs | 4.46         | AA-           | 72%              | 92                               | 1.14             |
| All LAs     | 4.28         | AA-           | 62%              | 28                               | 1.22             |

Readiness for Brexit: The scheduled leave date for the UK has been delayed from 31<sup>st</sup> October 2019 and there remains little political clarity as to when this will now occur with the upcoming general election. When a 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 0.73% in the first two quarters of the year. The Council's treasury investment income for the year is forecast at was £338k against a budget of £136.5k.

Borrowing costs for 2019/20 are forecast in line with budget at Q2, 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<br>Maximum | 30.9.19<br>Actual | 2019/20<br>Operational<br>Boundary | 2019/20<br>Authorised<br>Limit | Complied?<br>Yes/No |
|------------------------|---------------|-------------------|------------------------------------|--------------------------------|---------------------|
| Borrowing              | 415.8m        | 415.8m            | 702.4m                             | 752.4m                         | Yes                 |
| PFI and Finance Leases | 31.8          | 31.8m             | 36.3m                              | 39.9m                          | Yes                 |
| <b>Total debt</b>      | <b>447.6m</b> | <b>447.6m</b>     | <b>738.7m</b>                      | <b>792.3m</b>                  | 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.

|                          | 30.9.19<br>Actual | 2019/20<br>Target | Complied? |
|--------------------------|-------------------|-------------------|-----------|
| Portfolio average credit | 3.36 (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.

|                                      | 30.9.19<br>Actual | 2019/20<br>Target | Complied? |
|--------------------------------------|-------------------|-------------------|-----------|
| Total cash available within 3 months | £59.0m            | £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   | 30.9.19<br>Actual | 2019/20<br>Limit | Complied? |
|--|-------------------|------------------|-----------|
| Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates | 0.3m              | £1m              | Yes       |
| Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates | -0.3m             | £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 | 30.9.19 |
|---------------------------------|-------------|-------------|---------|
| under 12 months                 | 0           | 50%         | 14.1%   |
| 12 months & within 2 years      | 0           | 40%         | 7.6%    |
| 2 years & within 5 years        | 0           | 40%         | 19.2%   |
| 5 years & within 10 years       | 0           | 40%         | 0.5%    |
| 10 yrs & within 20 yrs          | 0           | 40%         | 13.7%   |
| 20 yrs & within 30 yrs          | 0           | 40%         | 10.8%   |
| 30 yrs & within 40 yrs          | 0           | 50%         | 17.3%   |
| 40 yrs & within 50 yrs          | 0           | 50%         | 16.8%   |
| 50 yrs & above                  | 0           | 40%         | 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 | 30.09.19 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

The global economy is entering a period of slower growth in response to political issues, primarily the trade policy stance of the US. The UK economy has displayed a marked slowdown in growth due to both Brexit uncertainty and the downturn in global activity. In response, global and UK interest



rate expectations have eased dramatically.

There appears no near-term resolution to the trade dispute between China and the US, a dispute that the US appears comfortable exacerbating further. With the 2020 presidential election a year away, Donald Trump is unlikely to change his stance.

Parliament appears to have frustrated UK Prime Minister Boris Johnson's desire to exit the EU on 31st October. The probability of a no-deal EU exit in the immediate term has decreased, although a no-deal Brexit cannot be entirely ruled out for 2019 and the risk of this event remains for 2020.

Central bank actions and geopolitical risks will continue to produce significant volatility in financial markets, including bond markets.

Our treasury advisor Arlingclose expects Bank Rate to remain at 0.75% for the foreseeable future but there remain substantial risks to this forecast, dependant on Brexit outcomes and the evolution of the global economy. Arlingclose also expects gilt yields to remain at low levels for the foreseeable future.

|                                | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 | Dec-21 | Mar-22 | Jun-22 | Sep-22 | Dec-22 |
|--------------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| <b>Official Bank Rate</b>      |        |        |        |        |        |        |        |        |        |        |        |        |        |
| <b>Upside risk</b>             | 0.00   | 0.00   | 0.25   | 0.25   | 0.25   | 0.25   | 0.25   | 0.25   | 0.25   | 0.25   | 0.25   | 0.25   | 0.25   |
| <b>Arlingclose Central Cas</b> | 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   |
| <b>Downside risk</b>           | 0.50   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   | 0.75   |