Treasury Management Update Report Q3 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: The headline rate of UK Consumer Price Inflation remained unchanged in November 2019 at 1.5% year-on-year, the same as October 2019, as accommodation services and transport continued to pull the level of inflation below the Bank of England target of 2%. Labour market data remained positive. The ILO unemployment rate continued to hold at historic lows at 3.8%, its lowest level since 1975. The 3-month average annual growth rate for pay excluding bonuses rose to 3.5% in November 2019 providing some evidence that a shortage of labour is supporting wages. However, adjusting for inflation this means real wages were only up by 0.9%.

The Quarterly National Accounts for Q3 GDP showed the UK economy expanded by 0.4% following the 0.2% contraction in Q1. Construction rebounded by 1.2%, reversing the fall of the same magnitude in the previous quarter, while growth in the services sector was up 0.5%, beating the 0.1% gain in Q2. Production increased by a more modest 0.1% and agriculture fell 0.1%. On an annual basis, GDP growth continued to fall further below its trend rate, slipping to 1.1% from 1.2%.

Politics continued to play a major role in financial markets over the period as the UK's progress negotiating its exit from the European Union together with its future trading arrangements has driven volatility, particularly in foreign exchange markets. Following the General Election in December, the new government progressed with achieving Brexit on 31st January 2020, but the subsequent limited Brexit transitionary period, which the government is seeking to enforce, will result in continuing economic uncertainty.

The Bank of England maintained Bank Rate to 0.75% in December following a 7-2 vote by the Monetary Policy Committee. Despite keeping rates on hold, MPC members did confirm that if Brexit uncertainty drags on or global growth fails to recover, they are prepared to cut interest rates as required. Moreover, the downward revisions to some of the growth projections in the Monetary Policy Report (formerly the Quarterly Inflation Report) suggest the Committee may now be less convinced of the need to increase rates even if there is a Brexit deal.

The fallout from the US-China trade war continued and is likely to drag on global growth in 2020, however it has been reported that Phase I of the deal would be signed at the White House on 15th January. The US economy continued to perform relatively well compared to other developed nations; however, the Federal Reserve started to unwind its monetary tightening through 2019. The Fed cut rates three times to 1.5% - 1.75%, to stimulate growth as GDP continued to slow.

Slow economic growth in Europe continued and Christine Lagarde took control as the head of the European Central Bank. In her first announcement as ECB chief, Ms Lagarde confirmed that the bank would continue to provide the monetary support needed to bring euro area inflation back towards target.

Financial markets: Financial markets adopted a more risk-on approach over the quarter as equities rallied in expectation of ongoing monetary stimulus from central banks. The Dow Jones ended the 2019 calendar year up 22%, while the FTSE 100 and FTSE 250 jumped on the UK general election result with the former gaining 12% during 2019 and the latter around 25%.

Gilt yields remained volatile over the period. From 0.28% at the end of September, the 5-year benchmark gilt rose to 0.60% by the end of December. There were rises in the 10-year and 20-year gilts over the same period, with the former climbing from 0.48% to 0.82% and the latter from 0.88% to 1.24%. 1-month, 3-month and 12-month SONIA (Sterling Overnight Index Average) bid rates averaged 0.63%, 0.76% and 0.93% respectively over the period.

The US yield curve returned to 'normal' over the period with 2-year ending 2019 at 1.56% and the 10-year at 1.91%. German bunds continued to remain firmly negative with the 10-year ending 2019 at -0.19% with 2 and 5-year securities ending at -0.61% and -0.46% respectively.

Credit background: Credit Default Swap (CDS) spreads fell over the quarter. Non-ringfenced bank NatWest Markets plc CDS fell to 50 basis points at the end of December from over 80bp in September, while for the ringfenced entity, National Westminster Bank plc, the spread fell to around 30bp. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 29 and 50bp at the end of the quarter.

Fitch affirmed the UK's AA sovereign rating, removed it from Rating Watch Negative (RWN) and assigned a negative outlook. Fitch then affirmed UK banks' long-term ratings, removed the RWN and assigned a stable outlook. Standard & Poor's also affirmed the UK sovereign AA rating and revised the outlook to stable from negative.

Moody's revised HSBC Bank's outlook to negative from stable as it expects restructuring costs to negatively impact net income over the next year or two.

The Bank of England announced its latest stress tests results for the main seven UK banking groups. All seven passed on both a common equity Tier 1 (CET1) ratio and a leverage ratio basis. Under the test scenario the banks' aggregate level of CET1 capital would remain twice their level before the 2008 financial crisis.

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	383.9
HRA CFR	249.8
Total CFR	**633.7**
Less: *Other debt liabilities	-31.8
Borrowing CFR - comprised of:	**601.9**
- 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 31st December 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	31.12.19 Balance £m	31.12.19 Rate %
Long-term borrowing	365.8	41.7	407.4	3.76
Short-term borrowing	23.0	-23.0	0.0	0.00
Total borrowing	**388.8**	**18.7**	**407.4**	**3.76**
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	8.2	23.8	0.67
Total investments	**30.6**	**3.2**	**33.8**	**0.79**
Net borrowing	**358.1**		**373.6**	

Borrowing Strategy during the period

At 31st December 2019 the Authority held £408.2m of loans, an increase of £19.4m from 31st March 2019, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 31st December are summarised in Table 3 below.

Table 3: Borrowing Position

	31.03.19 Balance £m	Net Movement £m	31.12.19 Balance £m	31.12.19 Weighted Average Rate %	31.12.19 Weighted Average Maturity (years)
Public Works Loan Board	240.8	41.7	282.4	3.34	28.20
Banks (LOBO)	125.0	0.0	125.0	4.72	40.44
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**	**18.7**	**407.4**	**3.76**	**31.95**

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, it raised £50m of long term fixed rate loans from the PWLB in the first three 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.

Following the decision of the PWLB to increase the rates paid by Local Authorities by 1.0% in October 2019, long-term borrowing will now be considered from a variety of sources besides the PWLB such as banks, pensions and local authorities, and will investigate the possibility of issuing bonds and similar instruments, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA Code. The Authority's immediate cashflow requirements can be fulfilled by short term borrowing from other Local Authorities.

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 £24.3 and £83.2 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 Balance £m	Net Movement £m	31.12.19 Balance £m	31.12.19 Rate of Return %	31.12.19 Weighted Average Maturity days
Banks & building societies (unsecured)	0.0	0.0	0.0	0.00	0.0
Money Market Funds	0.0	23.8	23.8	0.67	1.0
UK Government:					
- Local Authorities	15.0	-5.0	10.0	1.07	329.0
- Debt Management Office	15.6	-15.6	0.0	0.00	0.0
Total investments	**30.6**	**3.2**	**33.8**	**0.79**	**98.0**

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
31.12.2019	4.30	AA-	70%	46	0.78
Similar LAs	**4.23**	**AA-**	**67%**	**182**	**0.92**
All LAs	**4.11**	**AA-**	**60%**	**59**	**0.81**

Readiness for Brexit: Following the vote in parliament in favour of Prime Minister Boris Johnson's Brexit Withdrawal Agreement Bill, the UK left the EU on the scheduled date of 31st January 2020 and entered into a post-Brexit transition period. The bill bans an extension to this transition period which means if a trade deal cannot be reached by 31st December 2020 the UK would then be forced to trade with the EU under a no-deal scenario. As this new leave date approaches, the Authority will ensure there are enough accounts open with UK-domiciled banks and Money Market Funds to hold sufficient liquidity and that its Debt Management Account Deposit Facility (DMADF) remains available for use in an emergency.

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 0.72% in the first three quarters of the year. The Council's treasury investment income for the year is forecast at was £354k against a budget of £136.5k.

Borrowing costs for 2019/20 are forecast in line with budget at Q3, 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

	Q3 Maximum	**31.12.19 Actual**	**2019/20 Operational Boundary**	**2019/20 Authorised Limit**	**Complied?** Yes/No
Borrowing	415.3m	407.4m	702.4m	752.4m	Yes
PFI and Finance Leases	31.8	31.8m	36.3m	39.9m	Yes
Total debt	**447.6m**	**439.2m**	**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.

	31.12.19 Actual	**2019/20 Target**	**Complied?**
Portfolio average credit	4.30 (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.

	31.12.19 Actual	**2019/20 Target**	**Complied?**
Total cash available within 3 months	£33.8m	£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	**31.12.19 Actual**	**2019/20 Limit**	**Complied?**
Upper limit on one-year revenue impact of a 1% rise in interest rates	0.2m	£1m	Yes
Upper limit on one-year revenue impact of a 1% fall in interest rates	-0.2m	£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	31.12.19
under 12 months	0	50%	14.3%
12 months & within 2 years	0	40%	8.8%
2 years & within 5 years	0	40%	17.8%
5 years & within 10 years	0	40%	1.8%
10 yrs & within 20 yrs	0	40%	11.5%
20 yrs & within 30 yrs	0	40%	11.0%
30 yrs & within 40 yrs	0	50%	20.1%
40 yrs & within 50 yrs	0	50%	14.6%
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**	**31.12.19 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 continues to slow on the back of ongoing geopolitical issues, primarily the trade policy stance of the US and its spat with China. However, a Phase I of a trade deal between the two countries was signed on 15th January 2020.

The UK economy continues to slow due to both post-Brexit uncertainty and the downturn in global activity. In response, global and UK interest rate expectations have eased. Central bank actions and geopolitical risks will continue to produce significant volatility in financial markets over the period, including bond markets.

Parliament passed Prime Minister Boris Johnson's Withdrawal Agreement Bill and the UK exited the EU on 31st January 2020. The bill ruled out an extension to the transition period for agreeing a trade deal which meant a no-deal Brexit cannot be entirely ruled out for 2020.

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/trade deal outcomes as well as the evolution of the global economy. Arlingclose also expects gilt yields to remain at low levels for the foreseeable future and judges the risks to be weighted to the downside.

	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
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	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75