Report for: Corporate Committee 30 July 2020

Title: Treasury Management Strategy Review

Report authorised by: Jon Warlow, Director of Finance (S151 Officer)

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Ward(s) affected: N/A

Report for Key/ Non Key Decision: Non Key decision

1. Describe the issue under consideration

1.1. The Corporate Committee recommended the draft treasury management strategy to Full Council in the meeting on 3 February 2020. The Council's Treasury Management Strategy for 2020/21 was approved as part of the Council's annual budget papers by Full Council on 24 February 2020.

1.2. Since March 2020 the economy has been heavily impacted by the Coronavirus pandemic, and thus the backdrop in which the Council's treasury strategy and activity takes place has changed. The Chair of the Corporate Committee has therefore requested that a review of the treasury management strategy be conducted, which is the topic of this report.

2. Cabinet Member Introduction

2.1. Not applicable.

3. Recommendations

3.1. That members note the contents of this report.

4. Reason for Decision

4.1. None.

5. Other options considered

5.1. None.

6. Background information

6.1. <u>Economic background:</u> (provided by the Council's treasury management Advisor, Arlingclose Ltd).

6.1.1. The UK's exit from the European Union took a back seat during the first quarter of 2020/21 as the global economic impact from coronavirus took centre stage. Part of the measures taken to stop the spread of the pandemic included the government implementing a nationwide lockdown in late March which effectively shut down almost the entire UK economy. These measures continued throughout most of the quarter with only some easing of restrictions at the end of May and into June.

6.1.2. Bank Rate was maintained at 0.1% despite some speculation that the Bank of England's Monetary Policy Committee (MPC) might cut further and some MPC members also suggesting that negative rates are part of the Bank's policy tools. In June the Bank increased the asset purchase scheme by £100 billion, taking the recent round of QE (quantitative easing) to £300bn and total QE to £745 billion.

6.1.3. At the same time, the government also implemented a range of fiscal stimulus measures totalling over £300 billion which had been announced in March and designed to dampen the effect of the pandemic on the labour market.

6.1.4. GDP growth contracted by 2.2% in Q1 (Jan-Mar) 2020 pushing the annual growth rate down to -1.6%. The lockdown only came into force on 23rd March, and the markets are braced for a dire set of growth data for Q2. In April UK GDP fell 20.4% month-on-month. On the back of the 5.8% month-on-month fall in March, this means economic output fell by 25% compared to its pre-coronavirus peak in February 2020.

6.1.5. The headline rate of UK Consumer Price Inflation UK Consumer Price Inflation fell to 1.2% year on year in May, further below the Bank of England's 2% target.

6.1.6. In the three months to June, labour market data remained largely unchanged on the previous quarter. This is likely due to the government's furlough scheme as more than a quarter of the UK workforce was estimated to be supported by it. The ILO (International Labour Organisation) unemployment rate remained unchanged at 3.9% while the employment rate fell to 76.4%. However, employers will have to contribute towards furlough payments from August and the scheme is due to stop at the end of October; unemployment is expected to rise as a result.

6.1.7. The US economy contracted at an annualised rate of 5.0% in Q1 2020. The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25% while the US government announced a $2 trillion fiscal stimulus package. Relations between the US and China, which had briefly improved when Phase 1 of the trade agreement was signed in January, deteriorated over the quarter.

6.1.8. With little room to move on interest rates, the European Central Bank maintained interest rates at 0% and the rate on the deposit facility (which banks may use to make overnight deposits with the Eurosystem) at -0.5% and announced a further huge, open-ended commitment to buy €600bn of bonds under its Pandemic Emergency Purchase Programme (PEPP) which can be reinvested out to 2022. This lifted the ECB's total bond buying support package to €1.35trillion.

6.1.9. Financial markets: After selling off sharply in March, equity markets started recovering in April and while still down on their pre-crisis levels, the Dow Jones and FTSE 100 and 250 have made up around half of the losses. Measures implemented by central banks and governments continue to maintain some degree of general investor confidence, however volatility remains.

6.1.10. Ultra-low interest rates and the flight to quality continued to keep gilts yields low over the period with the yield on some short-dated government bonds turning negative. The 5-year UK benchmark gilt yield dropped from 0.18% at the beginning of April 2020 to -0.06% on 30th June. The 10-year benchmark gilt yield fell from 0.31% to 0.14% over the same period, and the 20-year from 0.69% to 0.52%. 1-month, 3-month and 12-month bid rates averaged 0.04%, 0.28% and 0.44% respectively over the quarter.

6.1.11. Over the quarter (April–June), the yield on 2-year US treasuries fell from 0.24% to 0.20% while that on yield on 10-year treasuries fell from 0.63% to 0.61%. German bund yields remain negative.

6.1.12. Credit review: After rising sharply in late March, credit default swap spreads slowly eased over the quarter but remained above their pre-crisis levels.

6.1.13. Fitch downgraded the UK sovereign rating to AA- in March which was followed by a number of actions on UK and also non-UK banks from early April onwards. This included revising the outlook on all banks on the counterparty list to negative, with the exception of

Barclays Bank, Rabobank, Handelsbanken and Nordea Bank which were placed on Rating Watch Negative, as well as downgrading Close Brothers' long-term rating to A-. Network Rail Infrastructure and LCR Finance's long-term ratings were downgraded from AA to AA-. HSBC Bank and HSBC UK Bank were the exceptions however, with Fitch upgrading their long-term ratings to AA-.

6.1.14. Fitch affirmed the ratings of Canadian banks but revised their outlook to negative. The agency also downgraded the long- and short-term ratings of Australia's four largest banking groups. It upgraded the long-term deposit rating of both Bayerische Landesbank and Landesbank Baden-Wuerttemberg (LBBW) but downgraded the viability ratings, and revised outlooks to negative. Fitch later placed three Singapore banks on Rating Watch Negative.

6.1.15. S&P (Standard and Poor) also took action on a range of UK and European banks, affirming their ratings but revising their outlook downwards due to the economic consequences of COVID-19. Moody's downgraded the long-term rating of Nationwide BS from Aa3 to A1 and S&P downgraded the long- and short-term ratings of HSBC Bank PLC and HSBC UK Bank PLC to A+ and A-1 respectively

6.1.16. In May, Fitch and S&P downgraded TfL's long-term rating to A+ from AA- after the 95% reduction in tube and train fares which make up 47% of TfL's revenue. However, the UK government agreed to a £1.6 billion support package which will help ease some of the stress TfL faces.

6.1.17. As the extent of the losses that banks and building societies will suffer due to the impact from the coronavirus epidemic remains uncertain but is expected to be substantial, in early June following Arlingclose's stress testing of the institutions on the counterparty list using bail-in analysis, a number of UK banks and building societies were suspended from the counterparty list for unsecured deposits. Although much better capitalised than before the 2007-09 financial crisis, under the current economic circumstances these entities were suspended for reasons of prudence. For those remaining on the list, the duration advice remains up to 35 days.

6.2. <u>Review of Borrowing strategy:</u>

6.3. The table below summarises the Council's borrowing position over the quarter of April-June 2020:

	31.03.20 Balance £m	Net Movement £m	30.06.20 Balance £m	30.06.20 Weighted Average Rate %	30.06.20 Weighted Average Maturity (years)
Public Works Loan Board	381.7	-0.3	381.4	2.89	25.37
Banks (LOBO)	125.0	0.0	125.0	4.72	39.94
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)	25.0	-5.0	20.0	0.95	0.50
Total borrowing	**531.7**	**-5.3**	**526.4**	**3.25**	**27.89**

6.4. The Council's borrowing portfolio has remained at a similar level throughout the period, with no new loans raised during the period.

6.5. The Council's treasury management strategy states that: *'The Authority's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. Given the significant cuts to public expenditure and in particular to local government funding, the Authority's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead. However, given the size of the Council's capital programme, and the need to diversify the Council's debt portfolio, long term borrowing will also be required during 2020/21, so the strategy will be to fulfil the Council's borrowing requirement with a mixture of long and short term borrowing.'*

6.6. In recent years the Council has therefore addressed its borrowing requirement from two sources:

- the Public Works Loan Board (PWLB), for long term loans of up to 50 years in duration
- other local authorities for short term loans of up to 1 year in duration (which is generally more cost effective)

6.7. The treasury strategy places a limit on short term borrowing as a proportion of overall borrowing, of 30%. This is done to mitigate 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. As at 30/06/20 the Council's short term borrowing was around 4% of the total borrowing portfolio, so significantly within this limit.

6.8. Throughout the pandemic, the intra-local authority market has functioned as usual, with authorities continuing to borrow and lend from one another. Interest rates have reduced over recent months, however at the time of writing, the differential between borrowing from the PWLB and other local authorities remains significant, and there is therefore still a compelling rationale for inclusion of this in the Council's borrowing strategy.

6.9. The treasury strategy contains a number of paragraphs relating to the Council's Lender's Option Borrowers Option (LOBO) loans, and the situations where the Council will repay these early. In the current reduced interest rate environment, it is not currently anticipated that a scenario will occur where it is in the Council's financial interests to repay these early.

Review of Investment strategy

6.10. The below table summarises the Council's investment position over the quarter of April-June 2020:

	31.03.20 Balance £m	Net Movement £m	30.06.20 Balance £m	30.06.20 Rate of Return %	30.06.20 Weighted Average Maturity days
Banks & building societies (unsecured)	0.0	0.0	0.0	0.00	0.0
Money Market Funds	0.0	23.9	23.9	0.14	1.0
UK Government:					
- Local Authorities	15.0	25.0	40.0	0.95	182.6
- Debt Management Office	77.3	-41.1	36.2	0.01	1.0
Total investments	**92.3**	**7.8**	**100.1**	**0.42**	**73.6**

6.11. The Council's cash balances have been higher since the start of the pandemic than would usually be the case. The Council understands via benchmarking completed by Arlingclose, the Council's treasury advisor, that this is a position mirrored throughout the local government sector. A number of measures have been introduced since March 2020 which have ultimately increased the cash balances of authorities:

- Authorities have received various streams of government funding, which in general have been paid in advance of expenditure, and in advance of the usual date on which they would be paid to the Council.
- Authorities have been responsible for passporting significant amounts of government assistance to local businesses, increasing cash balances temporarily until all funds are administered.
- The government has also deferred some payments that authorities would usually make early in the financial year to a later point.

6.12. Throughout the period since March 2020 the Council has been monitoring cash levels carefully, and maintaining higher than usual levels of cash invested so that they are accessible each business day to meet the Council's payment needs, (these cash balances are represented by the Debt Management Office and Money Market Fund balances in the table above). The Council's cashflow forecast is for cash levels will return to 'usual' levels (sub £50m) by the end of 2020.

6.13. Interest rates have fallen sharply since March 2020 when the Bank Rate was cut from 0.75% to 0.10%, as can be seen by the interest rates in the table above. An overnight investment with the Debt Management Office, for example has fallen from 0.63% to 0.01%. The Council prioritises security of funds invested, and liquidity considerations over the yield on an investment.

6.14. The forecast of the Council's treasury advisor, Arlingclose, does not currently anticipate that a negative interest rate scenario will materialise, however it cannot be ruled out completely as a future potential. The Council's treasury strategy has considered the impact of negative interest rates, and includes the below statement:
'Negative interest rates: If the UK enters into a recession in 2020/21, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.'

6.15. The treasury management strategy imposes a maximum £5m limit on any one investment Counterparty, with the exception of the Debt Management Office (part of HM treasury). This is on the basis that the Council maintains a treasury management reserve of the same amount. The treasury reserve remains at this level post the closure of the 2019/20 financial year.

6.16. The treasury management strategy included the below statement (par 5.4):
'The Authority will consider diversifying into more secure and/or higher yielding asset classes during 2020/21, in particular for the estimated £10m that is available for longer-term investment due to being required for the MiFID professional client status. Any such diversification would represent a change in strategy over the coming year, and would be the subject of further reports.'
As the pandemic impacted from March 2020, no work has taken place to progress this further, and it is not proposed that work should begin on this in the near future given the current volatility of market conditions. As noted in the strategy, no such diversification will take place without future decision making by the corporate committee to endorse this.

7. Contribution to Strategic Outcomes

7.1. None.

8. Statutory Officers comments (Chief Finance Officer (including procurement), Assistant Director of Corporate Governance, Equalities)

Finance and Procurement

8.1. Finance Comments are included throughout this report.

Legal

8.2. The Assistant Director for Corporate Governance has been consulted on the content of this report. The report raises no legal issues and is consistent with the legislations governing the financial affairs of the Council.

8.3. In considering the report Members must take into account the expert financial advice available to it and any further oral advice given at the meeting of the Committee.

Equalities

8.3. There are no equalities issues arising from this report.

9. Use of Appendices

9.1. Not applicable

10. Local Government (Access to Information) Act 1985

10.1. Not applicable.