Appendix 1 – Treasury Management Outturn Report H1 2020/21

1. Introduction

1.1. 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.

1.2. The Authority's treasury management strategy for 2020/21 was approved at a meeting of full Council 24 February 2020. 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.

1.3. 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 24 February 2020.

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

2.1. **Economic background:** The spread of the coronavirus pandemic dominated during the period as countries around the world tried to manage the delicate balancing act of containing transmission of the virus while easing lockdown measures and getting their populations and economies working again. After a relatively quiet few months of Brexit news it was back in the headlines towards the end of the period as agreement between the UK and EU on a trade deal was looking difficult and the government came under fire, both at home and abroad, as it tried to pass the Internal Market Bill which could override the agreed Brexit deal, potentially breaking international law.

2.2. The Bank of England (BoE) maintained Bank Rate at 0.1% and its Quantitative Easing programme at £745 billion. The potential use of negative interest rates was not ruled in or out by BoE policymakers, but then a comment in the September Monetary Policy Committee meeting minutes that the central bank was having a harder look at its potential impact than was previously suggested took financial markets by surprise.

2.3. Government initiatives continued to support the economy, with the furlough (Coronavirus Job Retention) scheme keeping almost 10 million workers in jobs, grants and loans to businesses and 100 million discounted meals being claimed during the 'Eat Out to Help Out' (EOHO) offer.

2.4. GDP growth contracted by a massive 19.8% (revised from first estimate -20.4%) in Q2 2020 (Apr-Jun) according to the Office for National Statistics, pushing the annual growth rate down to -21.5% (first estimate -21.7%). Construction output fell by 35% over the quarter, services output by almost 20% and production by 16%. Recent monthly estimates of GDP have shown growth recovering, with the latest rise of almost 7% in July, but even with the two previous monthly gains this still only makes up half of the lost output.

2.5. The headline rate of UK Consumer Price Inflation (CPI) fell to 0.2% year/year in August, further below the Bank of England's 2% target, with the largest downward contribution coming from restaurants and hotels influenced by the EOHO scheme. The Office for National Statistics' preferred measure of CPIH which includes owner-occupied housing was 0.5% y/y.

2.6. In the three months to July, labour market data showed the unemployment rate increased from 3.9% to 4.1% while wages fell 1% for total pay in nominal terms (0.2% regular pay) and was down 1.8% in real terms (-0.7% regular pay). Despite only a modest rise in unemployment over the period, the rate is expected to pick up sharply in the coming months as the furlough scheme ends in October. On the back of this, the BoE has forecast unemployment could hit a peak of between 8% and 9%.

2.7. The US economy contracted at an annualised rate of 31.7% in Q2 2020 (Apr-Jun). The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25% but announced a change to its inflation targeting regime. The move is to a more flexible form of average targeting which will allow the central bank to maintain interest rates at low levels for an extended period to support the economy even when inflation is 'moderately' above the 2% average target, particularly given it has been below target for most of the last decade.

2.8. The European Central Bank maintained its base rate at 0% and deposit rate at -0.5%.

2.9. **Financial markets:** Equity markets continued their recovery, with the Dow Jones climbing to not far off its pre-crisis peak, albeit that performance being driven by a handful of technology stocks including Apple and Microsoft, with the former up 75% in 2020. The FTSE 100 and 250 have made up around half of their losses at the height of the pandemic in March. Central bank and government stimulus packages continue to support asset prices, but volatility remains.

2.10. Ultra-low interest rates and the flight to quality continued, keeping gilts yields low but volatile over the period with the yield on some short-dated UK government bonds remaining negative. The 5-year UK benchmark gilt yield started and ended the June–September period at -0.06% (with much volatility in between). The 10-year gilt yield also bounced around, starting at 0.21% and ending at 0.23% over the same period, while the 20-year rose from 0.56% to 0.74%. 1-month, 3-month and 12-month bid rates averaged 0.02%, 0.06% and 0.23% respectively over the period.

2.11. At the end of September, the yield on 2-year US treasuries was around 0.13% while that on 10-year treasuries was 0.69%. German bund yields remain negative across most maturities.

2.12. **Credit review:** Credit default swap spreads eased over most of the period but then started to tick up again through September. In the UK, the spreads between ringfenced and non-ringfenced entities remains, except for retail bank Santander UK whose CDS spread remained elevated and the highest of those we monitor at 85bps while Standard Chartered was the lowest at 41bps. The ringfenced banks are currently trading between 45 and 50bps.

2.13. After a busy second quarter of the calendar year, the subsequent period has been relatively quiet for credit changes for the names on our counterparty list. Fitch assigned a AA- deposit rating to Netherlands lender Rabobank with a negative outlook and prior to that, while not related to our counterparty list but quite significant, revised the outlook on the US economy to Negative from Stable while also affirming its AAA rating.

2.14. There continues to remain much uncertainty around the extent of the losses banks and building societies will suffer due to the impact from the coronavirus pandemic and for the UK institutions on our list there is the added complication of the end of the Brexit transition period on 31st December and what a trade deal may or may not look like. The institutions on Arlingclose's counterparty list and recommended duration remain under constant review, but at the end of the period no changes had been made to the names on the list or the recommended maximum duration of 35 days.

3. Local Context

3.1. On 30 September 2020, the Authority had borrowing of £514.4m 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

Type of Liability	**30.09.20 Actual £m**
General Fund CFR	449.2
HRA CFR	274.3
Total CFR **	**723.5**
Less: *Other debt liabilities	-28.2
Borrowing CFR – comprised of:	**695.3**
- External borrowing	514.4
- Internal borrowing	180.9

* finance leases, PFI liabilities and transferred debt that form part of the Authority's total debt
** CFR figures are as at 31.03.20 these are calculated annually in the annual Statement of Accounts

3.2. Lower official interest rates have lowered the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The Authority pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk.

3.3. The treasury management position on 30th September 2020 and the change over the six months is shown in Table 2 below.

Table 2: Treasury Management Summary

Type of Borrowing / Investment	**31.03.20 Balance (£m)**	**Movement (£m)**	**30.09.20 Balance (£m)**	**30.09.20 Rate (%)**
Long-term borrowing	506.7	(2.2)	504.4	3.34
Short-term borrowing	25.0	(15.0)	10.0	0.98
Total borrowing	**531.7**	**(17.2)**	**514.4**	**3.25**
Long-term investments	0.0	0.0	0.0	0.00
Short-term investments	15.0	15.0	30.0	1.00
Cash and cash equivalents	77.3	(36.8)	40.5	0.01
Total investments	**92.3**	**(21.8)**	**70.5**	**0.42**
Net borrowing	**439.4**		**444.0**	

Borrowing Update

3.4. On 9th October 2019 the PWLB raised the cost of certainty rate borrowing to 1.8% above UK gilt yields making it relatively expensive.

3.5. The Chancellor's March 2020 Budget statement included significant changes to Public Works Loan Board (PWLB) policy and launched a wide-ranging consultation on the PWLB's future direction. Announcements included a reduction in the margin on new Housing Revenue Account (HRA) loans to 0.80% above equivalent gilt yields: the value of this discount is 1% below the rate at which the authority usually borrows from the PWLB.

3.6. The consultation titled "Future Lending Terms" allows stakeholders to contribute to developing a system whereby PWLB loans can be made available at improved margins to support qualifying projects. It contains proposals to allow authorities that are not involved in "debt for yield" activity to borrow at lower rates as well as stopping local authorities using PWLB loans to buy commercial assets primarily for yield. The consultation also broaches the possibility of slowing, or stopping, individual authorities from borrowing large sums in specific circumstances.

3.7. The consultation closed on 31st July 2020 with the announcement and implementation of the revised lending terms expected in the latter part of this calendar year or early next year.

3.8. Municipal Bonds Agency (MBA): The MBA revised its standard loan terms and framework agreement. Guarantees for the debt of other borrowers are now proportional and limited and a requirement to make contribution loans in the event of a default by a borrower has been introduced. The agency has issued 5-year floating rate and 40-year fixed rate bonds in 2020, in both instances Lancashire County Council is the sole borrower and guarantor.

3.9. If the Authority were to consider future borrowing through the MBA, it would first ensure that it had thoroughly scrutinised the legal terms and conditions of the arrangement and taken proper advice on these.

Borrowing Strategy during the period

3.10. At 30th September 2020 the Authority held £514.4m of loans, a decrease of £17.2m compared to 31st March 2020), as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30th September are summarised in Table 3 below.

3.11. Table 3: Borrowing Position

Type of Borrowing	31.03.20 Balance (£m)	Net Movement (£m)	30.09.20 Balance (£m) (£m)	30.09.20 Weighted Average Rate (%)	30.09.20 Weighted Average Maturity (Years)
Public Works Loan Board	381.7	(2.2)	379.4	2.90	25.15
Banks (LOBO)	125.0	0.0	125.0	4.72	39.69
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	(15.0)	10.0	0.98	0.45
Total borrowing	**531.7**	**(17.2)**	**514.4**	**3.31**	**28.20**

3.12. 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.

3.13. With short-term interest rates remaining much lower than long-term rates and temporary investments earning Bank Rate or lower, the Authority considered it to be more cost effective in the near term to use internal resources or short-term loans instead. The net movement in temporary / short-term loans is shown in table 3 above.

3.14. 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.

3.15. 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 quarter.

Treasury Investment Activity

3.16. The Authority received central government funding to support small and medium businesses during the coronavirus pandemic through grant schemes. Funds were received, temporarily invested in short-dated, liquid instruments such as call accounts and Money Market Funds and disbursed by the end of September.

3.17. 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 £56.7 and £166.6 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

Investments	31.03.20 Balance £m	Net Movement £m	30.09.20 Balance £m	30.09.20 Rate of Return %	30.09.20 Weighted Average Maturity Days
Banks & building societies (unsecured)	0.0	0.0	0.0	0.00	0.0
Money Market Funds	0.0	25.0	25.0	0.01	1.0
UK Government:					
- Local Authorities	15.0	15.0	30.0	1.00	145.6
- Debt Management Office	77.3	-61.8	15.5	-0.03	1.0
Total investments	**92.3**	**-21.8**	**70.5**	**0.42**	**62.6**

3.18. 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.

3.19. Continued downward pressure on short-dated cash rate brought net returns on money market funds (MMFs) close to zero even after some managers had temporarily lowered their fees. At this stage, although close to nil, negative returns are not the central case of most MMF managers over the short-term, and fee waivers should maintain slight positive net yields, but the possibility of negative rates cannot be ruled out.

3.20. On 25th September 2020the overnight, 1- and 2-week deposit rates on Debt Management Office (DMO) deposits dropped below zero percent to -0.03%, the rate was 0% for 3-week deposits and 0.01% for longer maturities.

3.21. The return on Money Market Funds net of fees also fell over the six months and for many funds net returns range between 0% and 0.1%. In many instances, the fund management companies have temporarily lowered or waived fees to maintain a positive net return.

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

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

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (Days)	Rate of Return
31.03.2020	3.70	AA	24%	74	0.42%
30.09.2020	3.68	AA-	35%	63	0.42%
Similar Local Authorities	4.33	AA-	70%	71	0.00%
All Local Authorities	4.16	AA-	64%	18	-0.46%

Scoring:
AAA = highest credit quality = 1
D = lowest credit quality = 26
Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

Non-Treasury Investments

3.23. 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 the Investment Guidance issued by the Ministry of Housing, Communities and Local Government (MHCLG) and Welsh Government, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

Treasury Performance

3.24. 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 in line with budget of £136.5k.

3.25. Borrowing costs for 2020/21 are forecast in line with budget at Q2, at £20.4m (£16.4m HRA, £4.0m 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.

Estimates for income 2020/21

3.26. The corporate world is still adjusting to the economic shock, with probably more to come, and it is still too early to tell which companies will withstand the economic damage in the short- to medium-term or which will choose to conserve cash in very difficult economic conditions simply to survive.

3.27. Investment income in the Authority's 2020/21 was set against a very different economic backdrop. Bank Rate, which was 0.75% in until February 2020, now stands at 0.1%. In light of these changes, interest earned from short-dated money market investments will be significantly lower.

Compliance

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

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

Table 6: Debt Limits

	Q1 Maximum	**30.9.20 Actual**	**2020/21 Operational Boundary**	**2020/21 Authorised Limit**	**Complied?** Yes/No
Borrowing	531.7	514.4	929.6	979.6	Yes
PFI and Finance Leases	28.1	28.1	28.1	30.9	Yes
Total debt	**559.8**	**542.5**	**957.7**	**1,010.5**	**Yes**

3.30. 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 first half of the year.

Treasury Management Indicators

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

3.32. **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.

	30.9.20 Actual	2020/21 Target	Complied?
Portfolio average credit score	3.68 (AA-)	7.0 (A-)	Yes

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

	30.9.20 Actual	2020/21 Target	Complied?
Total cash available within 3 months	56.7	10.1	Yes

3.34. **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	30.09.20 Actual	2020/21 Limit	Complied?
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	0.3	£1m	Yes
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	-0.3	£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.

3.35. **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:

	30.9.20 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	0%	50%	13.9%	Yes
12 months and within 24 months	0%	40%	7.7%	Yes
24 months and within 5 years	0%	40%	16.6%	Yes
5 years and within 10 years	0%	40%	4.4%	Yes
10 years and within 20 years	0%	40%	16.4%	Yes
20 years and within 30 years	0%	40%	7.8%	Yes

30 years and with 40 years	0%	50%	17.8%	Yes
40 years and within 50 years	0%	50%	15.8%	Yes
50 years and above	0%	40%	0%	Yes

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.

3.36. **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:

	2020/21	2021/22	2022/23
Actual principal invested beyond year end	Nil	Nil	Nil
Limit on principal invested beyond year end	£10m	£10m	£10m
Complied?	Yes	Yes	Yes

4. <u>Outlook for the remainder of 2020/21</u>

4.1. The medium-term global economic outlook is weak. While the strict initial lockdown restrictions have eased, coronavirus has not been supressed and second waves have prompted more restrictive measures on a regional and national basis. This ebb and flow of restrictions on normal activity will continue for the foreseeable future, at least until an effective vaccine is produced and importantly, distributed.

4.2. The global central bank and government responses have been significant and are in many cases on-5going, maintaining more stable financial, economic and social conditions than otherwise. This has supported a sizeable economic recovery in Q3.

4.3. However, the scale of the economic shock to demand, on-going social distancing measures, regional lock downs and reduced fiscal support will mean that the subsequent pace of recovery is limited. Early signs of this are already evident in UK monthly GDP and PMI data, even before the latest restrictions.

4.4. This situation will result in central banks maintaining low interest rates for the medium term. In the UK, Brexit is a further complication. Bank Rate is therefore likely to remain at low levels for a very long time, with a distinct possibility of being cut to zero. Money markets have priced in a chance of negative Bank Rate.

4.5. Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid inflation expectations. There is a chance yields may follow a slightly different path in the medium term, depending on investor perceptions of growth and inflation, or if the UK leaves the EU without a deal.

4.6. Arlingclose expects Bank Rate to remain at the current 0.10% level and additional monetary loosening in the future most likely through further financial asset purchases (QE). While Arlingclose's central case for Bank Rate is no change from the current level of 0.1%, further cuts to Bank Rate to zero or even into negative territory cannot be completely ruled out.

4.7. Gilt yields are expected to remain very low in the medium term. Shorter-term gilt yields are currently negative and will remain around zero or below until either the Bank of England expressly rules out negative Bank Rate or growth/inflation prospects improve.

4.8. Downside risks remain in the near term, as the government dials down its fiscal support measures, reacts to the risk of a further escalation in infection rates and the Brexit transition period comes to an end. The below tables sets out Arlingclose's forecast of official Bank of England Rates in the medium term.

	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.15	0.15	0.15	0.15	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Downside risk	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50