REPORT NO.1

HARBOROUGH DISTRICT COUNCIL

REPORT TO THE CABINET MEETING OF 02 NOVEMBER 2020

PUBLIC REPORT: Yes

EXEMPT REPORT: No

Report Title	Annual Treasury Management Report 2019-20 and Prudential Indicators
Report Author	Clive Mason, Chief Officer: Finance and Assets
Purpose of Report	Treasury Management is an integral part of the Council's finances relating to cash flow management and financing of capital schemes and therefore underpins all of the Council's aims. The annual treasury report is a requirement of the Council's reporting procedures and covers the treasury management activity for 2019/20. The report also covers the actual Prudential Indicators for 2019/20 in accordance with the requirements of the Prudential Code.
Reason for Decision	This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2019/20. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management, (the Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities, (the Prudential Code). During 2019/20 the minimum reporting requirements were that the full Council should receive the following reports: • an annual treasury strategy in advance of the year • a mid-year treasury update report • an annual review following the end of the year describing the activity compared to the strategy (this report) The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is, therefore, important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.
Portfolio (holder)	Councillor James Hallam, Finance

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Corporate Priorities	YOUR COUNCIL: innovative, proactive and efficient CO 10 — Deliver Financial Sustainability for the future
Financial Implications	• These are covered in detail in this report.
Risk Management Implications	• Management of the Council's financial resources is key to achieving targets set out in the budget. Security of the Council's money in the current banking market is paramount.
Environmental Implications	• None
Legal Implications	• This report covers the requirement for capital financing and treasury management as set out in the Local Government Act 2003 and subsequent Regulations.
Equality Implications	• None
Data Protection Implications	• None
Consultation	• The Prudential Indicators contained within this report have been compiled to take account of the borrowing requirements and available resources determined as part of the Council's capital programme and overall budget setting process. Members and officers have been involved in the budget process from the outset.
Options	• None
Background Papers	• Treasury Management, Prudential Code, and Budget working papers held in Finance.
Appendices	• None
Recommendation	• **To note the Annual Treasury Management Report for 2019/20** • **To note the Prudential Indicators for 2019/20**

Key Facts

1. The Council's Capital Expenditure and Financing

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

	2018/19 Actual £000	2019/20 Budget £000	2019/20 Actual £000
Capital expenditure	7,152	17,620	9,023
Financed in year	4,225	14,689	6,081
Unfinanced capital expenditure	2,927	2,931	2,942

2. <u>The Council's Overall Borrowing Need</u>

The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR).

Gross borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2019/20) plus the estimates of any additional capital financing requirement for the current (2020/21) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allowed the Council some flexibility to borrow in advance of its immediate capital needs in 2019/20. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2019 Actual £000	31 March 2020 Budget £000	31 March 2020 Actual £000
Capital Financing Requirement	8,262	13,989	10,480
Gross borrowing position	1,501	11,252	1,490
Under /(over) funding of CFR	6,761	2,737	8,990

The authorised limit - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2019/20 the Council has maintained gross borrowing within its authorised limit.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary are acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital, (borrowing and other long term obligation costs net of investment income), against the net revenue stream.

	2019/20 £000
Authorised limit	26,000
Maximum gross borrowing position during the year	1,501
Operational boundary	15,500
Average gross borrowing position	1,495
Financing costs as a proportion of net revenue stream	6.54%

3. Treasury Position as at 31 March 2020

At the beginning and the end of 2019/20 the Council's treasury position was as follows:

DEBT PORTFOLIO	31 March 2019 Principal £000	Average Rate/ Return	Average Life	31 March 2020 Principal £000	Average Rate/ Return	Average Life
Fixed rate funding:						
-PWLB	1,490	5.01%	32.6 years	1,490	5.01%	31.6 years
Total debt	1,490			1,490		
CFR	8,262			10,480		
(Over)/under borrowing	6,772			8,990		
Total investments	22,995	0.76%	100 days	22,480	0.57%	102 days
Net debt	21,505			20,990		

The maturity structure of the debt portfolio was as follows:

	31 March 2019 actual £000	2019/20 original limits %	31 March 2020 actual £000
Under 12 months	0	10%	0
12 months to 2 years	0	10%	0
2 years and within 5 years	22	20%	22
5 years and within 10 years	0	30%	0
10 years and within 20 years	0	100%	0
20 years and within 30 years	0	100%	0
30 years and within 40 years	1,468	100%	1,468
40 years and within 50 years	0	100%	0

INVESTMENT PORTFOLIO	Actual 31.3.19 £000	Actual 31.3.19 %	Actual 31.3.20 £000	Actual 31.3.20 %
Treasury investments				
Banks	8,495	37%	8,980	40%
Building Societies - rated	7,000	30%	10,000	44%
Building Societies – unrated	6,000	26%	2,000	9%
Total managed in house	21,495	93%	20,980	93%
Property funds	1,500	7%	1,500	7%
Total managed externally	1,500	7%	1,500	7%
TOTAL TREASURY INVESTMENTS	22,995	100%	22,480	100%

Non Treasury investments				
Third party loans	1,832	46%	1,832	46%
Subsidiaries	2,150	54%	2,150	54%
TOTAL NON TREASURY INVESTMENTS	3,982	100%	3,982	100%

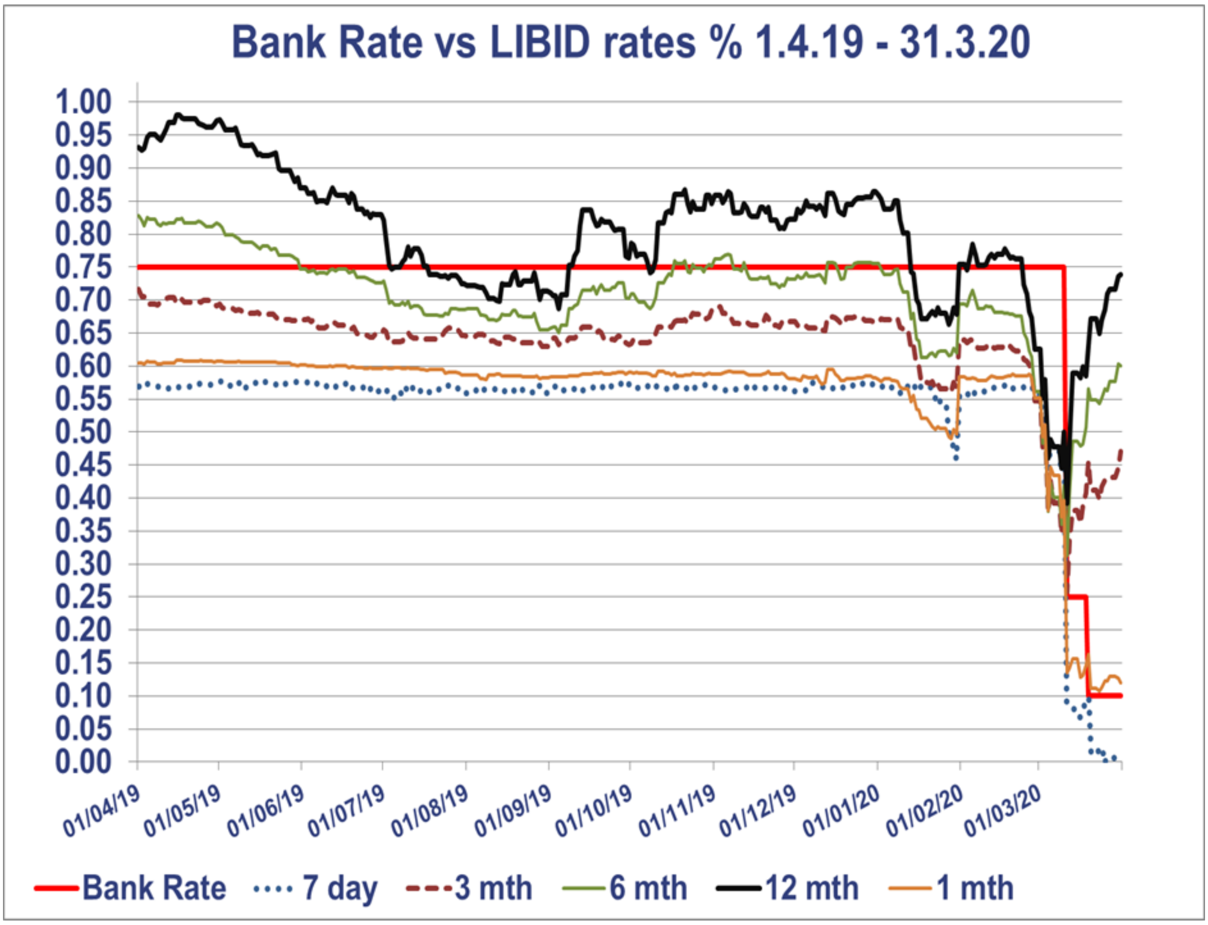
Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the year.

The maturity structure of the investment portfolio was as follows:

	2018/19 Actual £000	31 March 2020 Actual £000
Investments		
Longer than 1 year	1,500	1,500
Up to 1 year	21,495	20,980
Total	22,995	22,480

4. <u>The strategy for 2019/20</u>

4.1 Investment strategy and control of interest rate risk



Investment returns remained low during 2019/20. The expectation for interest rates within the treasury management strategy for 2019/20 was that Bank Rate would stay at 0.75% during 2019/20 as it was not expected that the MPC would be able to deliver on an increase in Bank Rate until the Brexit issue was finally settled. However, there was an expectation that Bank Rate would rise after that issue was settled but would only rise to 1.0% during 2020.

Rising concerns over the possibility that the UK could leave the EU at the end of October 2019 caused longer term investment rates to be on a falling trend for most of April to September. They then rose after the end of October deadline was rejected by the Commons but fell back again in January before recovering again after the 31 January departure of the UK from the EU. When the coronavirus outbreak hit the UK in February/March, rates initially plunged but then rose sharply back up again due to a shortage of liquidity in financial markets.

While the Council has taken a cautious approach to investing, it is also fully appreciative of changes to regulatory requirements for financial institutions in terms of additional capital and liquidity that came about in the aftermath of the financial crisis. These requirements have provided a far stronger basis for financial institutions, with annual stress tests by regulators evidencing how institutions are now far more able to cope with extreme stressed market and economic conditions.

Investment balances have been kept to a minimum through the agreed strategy of using reserves and balances to support internal borrowing, rather than borrowing externally from the financial markets. External borrowing would have incurred an additional cost, due to the differential between borrowing and investment rates as illustrated in the charts shown above and below. Such an approach has also provided benefits in terms of reducing the counterparty risk exposure, by having fewer investments placed in the financial markets.

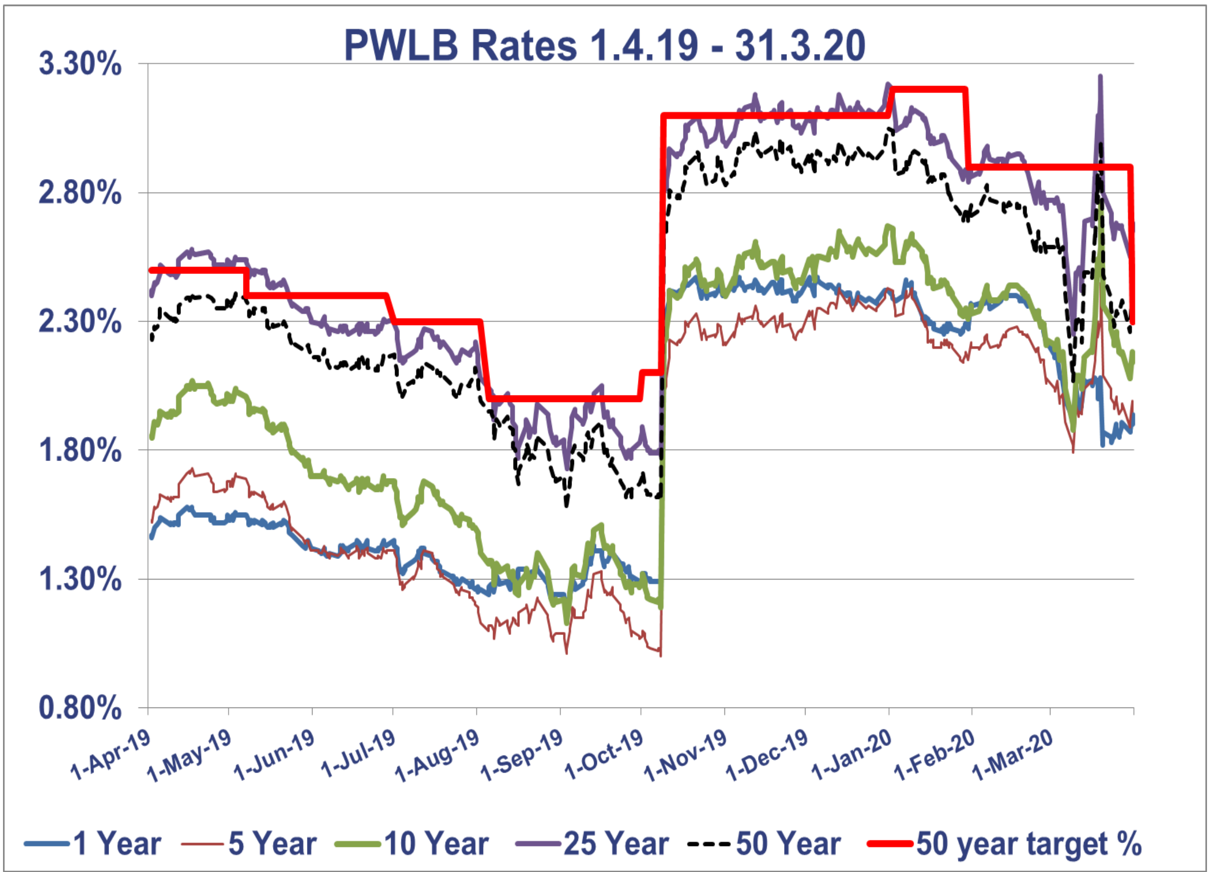
4.2 Borrowing strategy and control of interest rate risk

During 2019-20, the Council maintained an under-borrowed position. This meant that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as investment returns were low and minimising counterparty risk on placing investments also needed to be considered.

The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this was kept under review to avoid incurring higher borrowing costs in the future when this authority may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.

Interest rate forecasts expected only gradual rises in medium and longer term fixed borrowing rates during 2019/20 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period.

Link Asset Services Interest Rate View	31.3.20						
	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 Month LIBID	0.45	0.40	0.35	0.30	0.30	0.30	0.30	0.30
6 Month LIBID	0.60	0.55	0.50	0.45	0.40	0.40	0.40	0.40
12 Month LIBID	0.75	0.70	0.65	0.60	0.55	0.55	0.55	0.55
5yr PWLB Rate	1.90	1.90	1.90	2.00	2.00	2.00	2.10	2.10
10yr PWLB Rate	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30
25yr PWLB Rate	2.50	2.50	2.50	2.60	2.60	2.60	2.70	2.70
50yr PWLB Rate	2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50



PWLB rates are based on, and are determined by, gilt (UK Government bonds) yields through H.M.Treasury determining a specified margin to add to gilt yields. There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was heightened expectations that the US could have been heading for a recession in 2020, and a general background of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued; these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers: this means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. This has pulled down the overall level of interest rates and bond yields in financial markets over the last 30 years. We have therefore seen, over the last year, many bond yields up to 10 years in the Eurozone turn negative. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities.

Gilt yields were on a generally falling trend during the last year up until the coronavirus crisis hit western economies. Since then, gilt yields have fallen sharply to unprecedented lows as investors have panicked in selling shares in anticipation of impending recessions in western economies, and moved cash into safe haven assets i.e. government bonds. However, major western central banks also started quantitative easing purchases of government bonds which will act to maintain downward pressure on government bond yields at a time when there is going to be a huge and quick expansion of government expenditure financed by issuing government bonds; (this would normally cause bond yields to rise). At the close of the day on 31 March, all gilt yields from 1 to 5 years were between 0.12 – 0.20% while even 25-year yields were at only 0.83%.

However, HM Treasury has imposed **two changes in the margins over gilt yields for PWLB rates** in 2019-20 without any prior warning; the first on 9 October 2019, added an additional 1% margin over gilts to all PWLB rates. That increase was then partially reversed for some forms of borrowing on 11 March 2020, at the same time as the Government announced in the Budget a programme of increased spending on infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins. It is clear that the Treasury intends to put a stop to local authorities borrowing money from the PWLB to purchase commercial property if the aim is solely to generate an income stream.

There is likely to be little upward movement in PWLB rates over the next two years as it will take national economies a prolonged period to recover all the momentum they will lose in the sharp recession that has been caused during the coronavirus shut down period. Inflation is also likely to be very low during this period and could even turn negative in some major western economies during 2020-21.

5. <u>Borrowing Outturn</u>

Due to low investment returns, no borrowing was undertaken during the year.

Borrowing in advance of need
The Council has not borrowed more than, or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed.

Rescheduling
No rescheduling was done during the year.

6. Investment Outturn

Investment Policy – the Council's investment policy is governed by MHCLG investment guidance, which has been implemented in the annual investment strategy approved by the Council on 25 February 2019. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data, (such as rating outlooks, credit default swaps, bank share prices etc.).

The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

Resources – the Council's cash balances comprise revenue and capital resources and cash flow monies. The Council's core cash resources comprised as follows:

Balance Sheet Resources	31 March 2019 £000	31 March 2020 £000
Balances	6,723	9,238
Earmarked reserves	6,804	4,014
Usable capital receipts	4,758	5,140
Total	**18,285**	**18,392**

Investments held by the Council

- The Council maintained an average balance of £28m of internally managed funds.
- The internally managed funds earned an average rate of return of 0.78%.
- The comparable performance indicator is the average 7-day LIBID rate, which was 0.56% at 29 February 2020 (the 31 March 2020 rate of 0.18% is not a useful comparator).
- Total investment income was £223k compared to a budget of £116k.

7. Other Issues

1. IFRS 9 fair value of investments

Following the consultation undertaken by the Ministry of Housing, Communities and Local Government, [MHCLG], on IFRS 9 the Government has introduced a mandatory statutory override for local authorities to reverse out all unrealised fair value movements resulting from pooled investment funds. This was effective from 1 April 2018 for 2018/19. The statutory override applies for five years from this date. Local authorities are required to disclose the net impact of the unrealised fair value movements in a separate unusable reserve throughout the duration of the override in order for the Government to keep the override under review and to maintain a form of transparency. Risk management will need to take account of the 2018/19 Accounting Code of Practice proposals for the valuation of investments.

2. Changes in risk appetite

The 2018 CIPFA Codes and guidance notes have placed enhanced importance on risk management. Where an authority changes its risk appetite e.g. for moving surplus cash into or out of certain types of investment funds or other types of investment instruments, this change in risk appetite and policy should be brought to members' attention in treasury management update reports.