TEES VALLEY COMBINED AUTHORITY | TEES VALLEY MAYOR

AGENDA ITEM 9

REPORT TO THE TEES VALLEY AUDIT AND GOVERNANCE COMMITTEE

27th NOVEMBER 2020

REPORT OF GROUP DIRECTOR OF FINANCE AND RESOURCES

TREASURY MANAGEMENT OUTTURN REPORT 2019/20

SUMMARY

This report informs Members of the 2019/20 performance against the treasury management and prudential indicators set in the Treasury Management Strategy approved by the Authority in March 2019.

RECOMMENDATIONS

It is recommended that Cabinet note the contents of the report.

INTRODUCTION

1. The Authority 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.

2. The Authority's treasury management strategy for 2019/20 was approved at Cabinet meeting on 15th March 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 is therefore central to the Authority's treasury management strategy.

3. The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by Cabinet covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, was also approved by full Cabinet at the 15th March 2019 meeting.

DETAIL

External Context

4. The UK's exit from the European Union and future trading arrangements, had remained one of major influences on the UK economy and sentiment during 2019/20. The 29th March 2019 Brexit deadline was extended to 12th April, then to 31st October and finally to 31st January 2020. Politics played a major role in financial markets over the period as the UK's tenuous progress negotiating its exit from the European Union together with its future trading arrangements drove volatility, particularly in foreign exchange markets. The outcome of December's General Election removed a lot of the uncertainty and looked set to provide a 'bounce' to confidence and activity.

5. The headline rate of UK Consumer Price Inflation fell to 1.7% y/y in February, below the Bank of England's target of 2%. Labour market data remained positive. The International Labour Office (ILO) unemployment rate was 3.9% in the three months to January 2020 while the employment rate hit a record high of 76.5%. The average annual growth rate for pay excluding bonuses was 3.1% in January 2020 and the same when bonuses were included, providing some evidence that a shortage of labour had been supporting wages.

6. GDP growth in Q4 2019 was reported as flat by the Office for National Statistics and service sector growth slowed and production and construction activity contracted on the back of what at the time were concerns over the impact of global trade tensions on economic activity. The annual rate of GDP growth remained below-trend at 1.1%. Then coronavirus swiftly changed everything. COVID-19, which had first appeared in China in December 2019, started spreading across the globe causing plummeting sentiment and falls in financial markets not seen since the Global Financial Crisis as part of a flight to quality into sovereign debt and other perceived 'safe' assets.

7. In response to the spread of the virus and sharp increase in those infected, the government enforced lockdowns, central banks and governments around the world cut interest rates and introduced massive stimulus packages in an attempt to reduce some of the negative economic impact to domestic and global growth.

8. The Bank of England, which had held policy rates steady at 0.75% through most of 2019/20, moved in March to cut rates to 0.25% from 0.75% and then swiftly thereafter brought them down further to the record low of 0.1%. In conjunction with these cuts, the UK government introduced a number of measures to help businesses and households impacted by a series of ever-tightening social restrictions, culminating in pretty much the entire lockdown of the UK.

9. The US economy grew at an annualised rate of 2.1% in Q4 2019. After escalating trade wars and a protracted standoff, the signing of Phase 1 of the trade agreement between the US and China in January was initially positive for both economies, but COVID-19 severely impacted sentiment and production in both countries. Against a slowing economic outlook, the US Federal Reserve began cutting rates in August. Following a series of five cuts, the largest of which were in March 2020, the Fed Funds rate fell from of 2.5% to range of 0% - 0.25%. The US government also unleashed a raft of COVID-19 related measures and support for its economy including a $2 trillion fiscal stimulus package. With interest rates already on (or

below) the floor, the European Central Bank held its base rate at 0% and deposit rate at -0.5%.

10. Financial markets sold off sharply as the impact from the coronavirus worsened. After starting positively in 2020, the FTSE 100 fell over 30% at its worst point with stock markets in other countries seeing similar huge falls. In March sterling touched its lowest level against the dollar since 1985. The measures implemented by central banks and governments helped restore some confidence and financial markets have rebounded in recent weeks but remain extremely volatile. The flight to quality caused gilts yields to fall substantially. The 5-year benchmark falling from 0.75% in April 2019 to 0.26% on 31st March. The 10-year benchmark yield fell from 1% to 0.4%, the 20-year benchmark yield from 1.47% to 0.76% over the same period. 1-month, 3-month and 12-month bid rates averaged 0.61%, 0.72% and 0.88% respectively over the period.

11. In Q4 2019 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. 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.

12. After remaining flat in January and February and between a range of 30-55bps, Credit Default Swap spreads rose sharply in March as the potential impact of the coronavirus on bank balance sheets gave cause for concern. Spreads declined in late March and through to mid-April but remain above their initial 2020 levels. NatWest Markets Plc (non-ringfenced) remains the highest at 128bps and National Westminster Bank Plc (ringfenced) still the lowest at 56bps. The other main UK banks are between 65bps and 123bps, with the latter being the thinly traded and volatile Santander UK CDS.

13. While the UK and Non-UK banks on the Arlingclose counterparty list remain in a strong and well-capitalised position, the duration advice on all these banks was cut to 35 days in mid-March.

14. Fitch downgraded the UK sovereign rating to AA- in March which was followed by a number of actions on UK and Non-UK banks. 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 cutting Close Brothers long-term rating to A-. Having revised their outlooks to negative, Fitch upgraded the long-term ratings on Canadian and German banks but downgraded the long-term ratings for Australian banks. HSBC Bank and HSBC UK Bank, however, had their long-term ratings increased by Fitch to AA-.

Local Context

15. The treasury management position on 31st March 2020 and the change during the year is shown in Table 1 below.

Table 1: Treasury Management Summary

	31.3.19 Balance £m	Movement £m	30.3.20 Balance £m
Long-term borrowing	0.00	30.00	30.00
Short-term borrowing	0.00	0.00	0.00
Total Borrowing	**0.00**	**30.00**	**30.00**
Long-term investments	0.00	0.00	0.00
Short-term investments	27.50	27.50	0.00
Cash and cash equivalents	1.66	60.99	62.65
Total Investments	**29.16**	**33.49**	**62.65**
Net Investments	**29.16**	**3.49**	**32.65**

16. During the year the Authority took out its first borrowing to support the 10-year investment plan programme, at the end of March this remained unspent accounting for the increase in funds invested.

17. On the advice of Arlingclose all investments were called back to be placed in accounts where the maturity was less than 35 days duration. This accounts for the movement between short term investments and cash and cash equivalents in the year.

Borrowing Update

18. On 9th October 2019 the PWLB raised the cost of certainty rate borrowing by 1% to 1.8% above UK gilt yields as HM Treasury was concerned about the overall level of local authority debt. PWLB borrowing remains available but the margin of 180bp above gilt yields appears relatively very expensive. Market alternatives are available and new products will be developed; however, the financial strength of individual authorities will be scrutinised by investors and commercial lenders.

19. 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.

20. The consultation titled “Future Lending Terms” represents a frank, open and inclusive invitation, allowing key stakeholders to contribute to developing a system whereby PWLB loans can be made available at improved margins to support qualifying projects. It contains proposals on allowing 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 without impeding their ability to pursue their core policy objectives of service delivery and regeneration.

21. The consultation closed on 31st July 2020 with implementation of the new lending terms expected in the latter part of this calendar year or financial year beginning 2021/22

Borrowing Strategy

22. At 31st March 2020 the Authority held £30m of loans as part of its strategy for funding the capital programmes within the Investment Plan, this was the first borrowing taken out by the Authority. Outstanding loans on 31st March 2020 are summarised in Table 2 below.

Table 2: Borrowing Position

	31.3.19 Balance £m	**Net Movement £m**	**31.3.20 Balance £m**	**31.3.20 Weighted Average Rate %**	**31.3.20 Weighted Average Maturity (years)**
Public Works Loans Board	0	30.00	30.00	2.67	24.83
Total borrowing	**0**	**30.00**	**30.00**	**2.67**	**24.83**

23. 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.

24. The Authority has an increasing capital financing requirement due to the capital programme within the investment plan and an estimated borrowing requirement as

determined by the Liability Benchmark which also takes into account usable reserves and working capital.

Treasury Investment Activity

25. The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances fluctuated due to timing differences between income and expenditure. The investment position at the end of March 2020 is shown in table 3 below.

Table 3: Treasury Investment Position

Counterparty	**Amount**	**Start**	**Maturity**
	£	**Date**	**Date**
Natwest SIBA	1,150,000	n/a	Call Account
Santander	7,500,000	12-Oct-16	19-Jun-20
Blackrock	5,000,000	07-Dec-16	Money Market Fund
Aberdeen	11,500,000	06-Oct-16	Money Market Fund
Federated	11,500,000	06-Oct-16	Money Market Fund
Legal & General	10,000,000	06-Oct-16	Money Market Fund
Insight	11,000,000	07-Dec-16	Money Market Fund
Redcar & Cleveland Council	5,000,000	23-Mar-20	13-Apr-20
	62,650,000		

26. 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.

27. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 4 below.

Table 4: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	**Credit Rating**	**Bail-in Exposure**	**Weighted Average Maturity (days)**	**Rate of Return %**
31.03.2019	4.23	AA-	42%	52	0.79
30.06.2019	4.60	A+	100%	13	0.76
30.09.2019	4.75	A+	66%	82	0.69
31.12.2019	4.30	AA-	100%	18	0.76
31.03.2020	4.30	AA-	92%	11	0.50
Similar LAs	3.98	AA-	46%	44	1.02
All LAs	4.03	AA-	56%	20	1.23

28. In the relatively short period since the onset of the COVID-19 pandemic, the global economic fallout was sharp and large. Market reaction was extreme with large falls in equities, corporate bond markets and, to some extent, real estate echoing lockdown-induced paralysis and the uncharted challenges for governments, businesses and individuals. Volatility measured by the VIX index was almost as high as during the global financial crisis of 2008/9 and evidenced in plummeting equity prices and the widening of corporate bond spreads, very close to rivalling those twelve years ago. Gilt yields fell but credit spreads widened markedly reflecting the sharp deterioration in economic and credit conditions associated with a sudden stagnation in economies, so corporate bonds yields (comprised of the gilt yield plus the credit spread) rose and prices therefore fell.

Non-Treasury Investments

29. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council 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.

30. The Authority can lend money to its subsidiaries, constituent Local Authorities and local businesses to support delivery of the Strategic Economic Plan and stimulate local economic growth. Loans are not issued by the Authority for purely financial return, they are provided if the proposal meets the priorities set out in the Investment Plan and related strategies. Loans may be given in order to comply with state aid

regulations, or alternatively it may be that the applicant has the ability to repay the support via increased revenues as a result of the investment.

31. As at the end of March 2020 also held £80.5m of such investments in;
- loans to subsidiaries £67.8m
- loans to constituent local authorities £8.7m
- loans to local businesses £4.0m

Compliance

32. The Group Director of Finance and Resources reports that all treasury management activities undertaken during complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 5 below.

Table 5: Debt Limits

	Maximum in Year	**31.3.20 Actual**	**2019/20 Operational Boundary**	**2019/20 Authorised Limit**	**Complied? Yes/No**
Borrowing	£30m	£30m	£77.51m	£81.38	Yes

33. Compliance with specific investment limits is demonstrated in table 6 below.

Table 6: Investment Limits

	Maximum in Year	**31.3.20 Actual**	**2019/20 Limit**	**Complied? Yes/No**
Any single organisation, except the UK Central Government	£14.75m	£14.75m	£15m per organisation	Yes
UK Central Government	£0	£0	Unlimited	Yes
Any group of organisations under the same ownership	£0	£0	£15m per organisation	Yes
Any group of pooled funds under the same management	£0	£0	£37.5m	Yes

Negotiable instruments held in a broker's nominee account	£0	£0	£37.5m	Yes
Foreign countries	£0	£0	£15m	Yes
Registered providers and registered social landlords	£0	£0	£37.5m	Yes
Unsecured investments with building societies	£0	£0	£15m	Yes
Loans to unrated corporates	£0	£0	£15m	Yes
Money Market Funds	£68m	£49m	£75m	Yes
Real estate investment trusts	£0	£0	£37.5m	Yes

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

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 are set out in table 7 below.

Table 7: Borrowing Maturity

	31.3.20 Actual	**Upper Limit**	**Lower Limit**	**Complied?**
Under 12 months	0%	100%	0%	Yes
12 months and within 24 months	0%	100%	0%	Yes
24 months and within 5 years	0%	100%	0%	Yes
5 years and within 10 years	0%	100%	0%	Yes
10 years and above	100%	100%	0%	Yes

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.

Table 8: Long Term Investments

	2020/21	2021/22	2022/23
Actual principal invested beyond year end	£0	£0	£0
Limit on principal invested beyond year end	£15m	£10m	£5m
Complied?	Yes	Yes	Yes

FINANCIAL IMPLICATIONS

37. None

LEGAL IMPLICATIONS

38. None

CONSULTATION & COMMUNICATION

39. None

Name of Contact Officer: Gary Macdonald
Post Title: Group Director of Finance and Resources
Telephone Number: 01642 526527
Email Address: gary.macdonald@teesvalley-ca.gov.uk