TEES VALLEY COMBINED AUTHORITY | TEES VALLEY MAYOR

**AGENDA ITEM 10**

**REPORT TO THE TEES VALLEY AUDIT AND GOVERNANCE COMMITTEE**

**27th NOVEMBER 2020**

**REPORT OF GROUP DIRECTOR OF FINANCE AND RESOURCES**

# TREASURY MANAGEMENT MID YEAR REVIEW 2020/21

## SUMMARY

This report informs Members of the mid-year performance against the treasury management and prudential indicators set in the Treasury Management Strategy approved by the Authority in March 2020.

## 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 2020/21 was approved at Cabinet meeting on 13th March 2020. The Authority has 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 13th March 2020 meeting.

## DETAIL

### External Context

4. 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.

5. 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.

6. 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.

7. 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.

8. 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 Consumer Prices Index including owner occupiers' housing costs (CPIH) which includes owner-occupied housing was 0.5% y/y.

9. 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%.

10. 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.

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

12. 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.

13. 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.

14. 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.

15. 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.

16. 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.

17. 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.

## Local Context

18. The treasury management position on 30th September 2020 and the change in year is shown in Table 1 below.

Table 1: Treasury Management Summary

| | **31.3.20 Balance £m** | **Movement £m** | **30.9.20 Balance £m** |
|---|---|---|---|
| Long-term borrowing | 30.00 | -0.86 | 29.14 |
| Short-term borrowing | 0.00 | 0.00 | 0 |
| **Total Borrowing** | **30.00** | **-0.86** | **29.14** |
| Long-term investments | 0.00 | 0.00 | 0.00 |
| Short-term investments | 0.00 | 0.00 | 0.00 |
| Cash and cash equivalents | 62.65 | 30.85 | 93.50 |
| **Total Investments** | **62.65** | **30.85** | **93.50** |
| **Net Investments** | **32.65** | **31.71** | **64.36** |

19. 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

20. Due to grants being received from Government at the start of the financial year in full the level of investments has increased, this will reduce during the year as funding is expended.

## Borrowing Update

21. 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. 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.

22. At 30th June 2020 the Authority held £29.1m of loans, as part of its strategy for funding the capital programmes within the Investment Plan. Outstanding loans on 30th June are summarised in Table 2 below.

Table 2: Borrowing Position

| | 31.3.20 Balance £m | Net Movement £m | 30.9.20 Balance £m | 30.9.20 Weighted Average Rate % | 30.9.20 Weighted Average Maturity (years) |
|---|---|---|---|---|---|
| Public Works Loan Board | 30.00 | -0.86 | 29.14 | 2.67 | 24.63 |
| **Total borrowing** | **30.00** | **-0.86** | **29.14** | **2.67** | **24.63** |

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. Having considered the appropriate duration and structure of the Authority's borrowing need based on realistic projections, the Authority took out no further borrowing during the period April to September 2020.

**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 September is shown in table 3 below.

Table 3: Treasury Investment Position

| Counterparty | Amount | Start | Maturity |
|---|---|---|---|
| | **£** | **Date** | **Date** |
| Aberdeen City Council | 5,000,000 | 11-May-20 | 08-Feb-21 |
| Suffolk County Council | 5,000,000 | 12-Jun-20 | 14-Dec-20 |
| Blackrock | 15,000,000 | 07-Dec-16 | Money Market Fund |
| Aberdeen | 15,000,000 | 06-Oct-16 | Money Market Fund |
| Federated | 15,000,000 | 06-Oct-16 | Money Market Fund |
| Legal & General | 15,000,000 | 06-Oct-16 | Money Market Fund |
| Insight | 15,000,000 | 07-Dec-16 | Money Market Fund |
| DMO | 8,500,000 | 30-Sep-20 | 05-Oct-20 |
| | **93,500,000** | | |

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 %** |
|---|---|---|---|---|---|
| 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 |
| 30.09.2020 | 4.15 | AA- | 81% | 12 | 0.06 |
| Similar LAs | 4.12 | AA- | 60% | 55 | 0.17 |
| All LAs | 4.16 | AA- | 64% | 18 | 0.27 |

**Non-Treasury Investments**

28. 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.

29. 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.

30. As at the end of September 2020 also held £85.5m of such investments in;
    - loans to subsidiaries £72.8m
    - loans to constituent local authorities £8.7m
    - loans to local businesses £4.0m

**Compliance**

31. 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

Table 5: Debt Limits (£m)

| | **Maximum in Year** | **30.9.20 Actual** | **2020/21 Operational Boundary** | **2020/21 Authorised Limit** | **Complied? Yes/No** |
|---|---|---|---|---|---|
| Borrowing | 30.00 | 29.14 | 122.90 | 147.48 | Yes |

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

Table 6: Investment Limits

| | **Maximum in Year** | **30.9.20 Actual** | **2020/21 Limit** | **Complied? Yes/No** |
|---|---|---|---|---|
| Any single organisation, except the UK Central Government | £10m | £11.9m | £15m per organisation | Yes |
| UK Central Government | £25m | £8.5m | 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 | £37.4m | 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 | £75m | £75m | £75m | Yes |
| Real estate investment trusts | £0 | £0 | £37.5m | Yes |

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

34. 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

| | **30.9.120 Actual** | **Upper Limit** | **Lower Limit** | **Complied?** |
|---|---|---|---|---|
| Under 12 months | 0% | 25% | 0% | Yes |
| 12 months and within 24 months | 0% | 40% | 0% | Yes |
| 24 months and within 5 years | 0% | 60% | 0% | Yes |
| 5 years and within 10 years | 0% | 80% | 0% | Yes |
| 10 years and above | 100% | 100% | 0% | Yes |

35. 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:

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 | £60m | £40m | £20m |
| Complied? | Yes | Yes | Yes |

**Outlook for the remainder of 2019/20**

| | 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 |

36. 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.

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

38. 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.

39. 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.

40. 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.

41. 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.

42. 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.

43. 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.

**FINANCIAL IMPLICATIONS**

44. None

**LEGAL IMPLICATIONS**

45. None

**CONSULTATION & COMMUNICATION**

46. None

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