



**Audit & Standards Advisory Committee**  
29 July 2020

**Report from the Director of Finance**

**2019/20 Treasury Management Outturn Report**

Wards Affected:	All
Key or Non-key Decisions	Key
Open or part/fully exempt: (If exempt, please highlight relevant paragraph of Part 1, Schedule 12A of 1972 Local Government Act)	Open
Number of Appendices:	Three: 1. Debt and Investment Portfolio 2. Prudential Indicators 3. Internal Investments: Average Rate vs Credit Risk
Background Papers:	None
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**1. INTRODUCTION**

- 1.1 This report updates members on Treasury Management activity and confirms that the Council has complied with its Prudential Indicators for 2019/20.

**2. RECCOMENDATIONS**

- 2.1 The Audit and Standards Advisory Committee is asked to consider and note the 2019/20 Treasury Management outturn report, in compliance with CIPFA's Code of Practice on Treasury Management (the Code).
- 2.2 Note that for 2019/20 the Council has complied with its Prudential Indicators which were approved by Full Council on 25 February 2019 as part of the Council's Treasury Management Strategy Statement and Capital Strategy Statement.

### **3. BACKGROUND**

- 3.1 The Council's treasury management activity is underpinned by the CIPFA Code, which requires authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities at least twice a year.
- 3.2 This report also fulfils the Council's obligations under the Local Government Act 2003 to have regard to both the CIPFA Code and the CLG Investment Guidance.
- 3.3 The Council has borrowed money over the long term to support investment in the Council's infrastructure and also invests cash balances held for short periods. It 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 are central to the Council's treasury management strategy.

#### **Economic Background**

- 3.4 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 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.
- 3.5 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%.
- 3.6 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 shift to quality into sovereign debt and other perceived 'safe' assets. 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.
- 3.7 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 an entire lockdown of the UK.

- 3.8 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 20. 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.
- 3.9 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 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%.
- 3.10 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.
- 3.11 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-.

### **Local Context**

- 3.12 On 31<sup>st</sup> March 2019, the Authority had borrowing of £396.3m arising from its revenue and capital income and expenditure. The table below summarises the Council's borrowing activity during 2019/20. The Council's underlying need to

borrow as measured by the Capital Financing Requirement (CFR) was £821.8m at 31/03/2020 and had net borrowing of £598.8m.

**Table 1: CFR and Borrowing Summary**

	Balance on 01/04/2019	Borrowing Repaid	New Borrowing	Balance on 31/03/2020	Average Rate	Average Life
	£m	£m	£m	£m	%	Years
CFR	<b>688.7</b>			<b>821.8</b>		
Short Term Borrowing	<b>0.0</b>	(15.0)	148.0	<b>133.0</b>	0.93%	0.34
Long Term Borrowing	<b>396.3</b>	(10.4)	80.0	<b>465.8</b>	4.34%	33.1
<b>TOTAL BORROWING</b>	<b>396.3</b>	<b>(25.4)</b>	<b>228.0</b>	<b>598.8</b>		

- 3.13 As demonstrated in the September 2019 Cabinet report “Brent Council Borrowing Strategy 2018/19 – 2020/21” the Council has a borrowing requirement during 2019/20. In recent years, the Council’s strategy has been to maintain borrowing at the lowest level possible unless interest rate prospectus presents a clear case for taking long-term borrowing ahead of immediate requirements. However the current interest rate forecasts along with the significant levels of planned and actual capital investment means that this approach was no longer suitable and new borrowing was required.
- 3.14 Throughout the year, the Council worked with specialist Treasury Advisors to find a funding solution in the Private Placement (PP) market to provide a greater diversification of funds and reduce the risk of reliance on the PWLB.
- 3.15 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 remained available but the margin of 180bp above gilt yields was expensive relative to other options at the time. This allowed institutional investors to be in a better place to provide funding and prevent the full impact of the 1% increase by the PWLB being passed onto Local Authorities.
- 3.16 With short-term interest rates remaining much lower than long-term rates, the Council considered it more cost effective in the near term to utilise short-term loans throughout the year to fund the borrowing requirement and whilst the private placement was arranged.
- 3.17 The Council successfully executed the debut private placement transaction in March 2020. Strong investor demand enabled the transaction size to be increased to £80m at a rate of 65bps below the equivalent loan obtained through the PWLB. The new borrowing was split into two maturity profiles, £40m with a weighted average life of 20 years and £40m with a weighted average life of 25 years. This

maturity structure enables the Council to reduce the refinancing risk upon maturity. The Council was open to the opportunity to arrange forward starting loans, which secure the benefits of current low interest rate environment for drawdown at a point in the future however due to the successful progression of the Capital Programme during 2019/20, the Council opted for an immediate drawdown.

3.18 The detailed borrowing portfolio for the authority is shown in table 2 below.

Table 2: Borrowing Position

	Balance on 01/04/2019	Net Movement	Balance on 31/03/2020	Average Rate	Average Life
	£m	£m	£m	%	(years)
Public Works Loan Board	310.8	10.4	300.3	4.89%	30.7
Banks (LOBO)	70.5	0.0	70.5	4.53%	45.7
Banks (fixed-term)	15.0	0.0	15.0	4.27%	38.1
Other (fixed-term)	0.0	80.0	80.0	2.01%	23.5
Local authorities (short-term)	0.0	133.0	133.0	0.93%	0.3
<b>TOTAL BORROWING</b>	<b>396.3</b>	<b>223.4</b>	<b>598.8</b>		

3.19 The Authority has £70.5m exposure to LOBO loans - Lender's Option Borrower's Option of which £41m of these can be "called" during 2020/21. Under the LOBO arrangements lenders can exercise their rights at set times to amend the interest rate on the loan. At that point, the Borrower can accept the revised terms or reject them and repay the loan without penalty. LOBO loans present a potential refinancing risk to the Authority since the decision to call a LOBO is entirely at the lender's discretion. This risk is mitigated by the fact that the Council's current cash holdings mean that any repayment could be accommodated by reducing deposits. It is also unlikely that LOBO loans will be called at the present time due to low interest rates – although this may change in the future if rates rise.

3.20 The Chancellor's March 2020 Budget statement included significant proposed 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 HRA loans to 0.80% above equivalent gilt yields. As the Council has a HRA the value of this discount is 1% below the rate at which the authority usually borrows from the PWLB. This concession is available from 12th March 2020 along with £1.15bn of additional "infrastructure rate" funding at gilt yields plus 0.60% to support specific local authority infrastructure projects for England, Scotland and Wales for which there is a bidding process.

3.21 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, housing, and regeneration. The consultation also broaches the possibility of slowing, or stopping, individual authorities from borrowing large sums in specific circumstances.

- 3.22 The consultation closes on 31<sup>st</sup> July 2020 with implementation of the new lending terms expected in the latter part of this calendar year or financial year beginning 2021/22.

### **Investment Activity**

- 3.23 The Council 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 £20m and £130m due to timing differences between income and expenditure.
- 3.24 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. The table below summarizes investment activity during 2019/20.

	<b>Balance on 1/4/2019 £m</b>	<b>Investments made £m</b>	<b>Investments repaid £m</b>	<b>Balance on 31/03/2020 £m</b>	<b>Average Rate %</b>	<b>Average Life Days</b>
Fixed term deposits	<b>61.2</b>	5.0	(66.0)	<b>0.2</b>	0.98%	132
Deposits with the DMADF	<b>0.0</b>	235.5	(130.8)	<b>104.7</b>	0.10%	2
Money Market Funds and notice deposits	<b>42.0</b>	764.3	(801.3)	<b>5.0</b>	0.69%	
<b>TOTAL INVESTMENTS</b>	<b>103.2</b>	<b>1,004.8</b>	<b>(998.1)</b>	<b>109.9</b>	<b>0.77%</b>	<b>132</b>

- 3.25 Security of capital remained the Council’s main investment objective. This was maintained by following the Council’s counterparty policy as set out in its Treasury Management Strategy Statement for 2019/20 which defined “high credit quality organisations” as those having a long-term credit rating of A- or higher that are domiciled in the UK or overseas where the sovereign rating is AA+ or higher.

### **Credit developments and credit risk management**

- 3.26 In a 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.

- 3.27 March 2020 saw significant demand for cash as the coronavirus pandemic spread worldwide. Credit risk saw gilt yields fall as people looked for safe havens for their cash. Our Treasury Management Advisors undertook a stress testing exercise on UK banks and building societies to review the impact of a loss of the same magnitude as the global financial crisis of 2007-2009. This resulted in a reduction to the Council's approved counterparty list and bank deposits reduced to a maximum of 35 days.
- 3.28 The Council quickly reacted to the uncertainty of the global pandemic with a shift to deposits in the Debt Management Account Deposit Facility (DMDAF) which has the lowest credit risk of any deposit. The Council is also holding a small amount of funds across a range of money market funds to maintain a diverse portfolio and ensure availability of cash for unexpected payments.

### **Yield**

- 3.29 The Council's cash balances reduced throughout the year ahead of the new borrowing in March 2020. The average cash balance during 2019/20 was £85.2m and interest earned was £0.7m, an average return of 0.83% (2018/19 – average cash balance of £121.8m and interest earned was £1.0m or 0.85%). The low rates of return on the Council's short-dated money market investments reflect prevailing market conditions and the Council's objective during 2019/20 of optimising returns commensurate with the principles of security and liquidity.
- 3.30 In response to the coronavirus pandemic, the Bank of England's Monetary Policy Committee (MPC) cut official interest rates to a new all-time low of 0.1% in March 2020. The market had seen a significant downward trend from February onwards, which affected the investment return obtained at the end of 2019/20 and is expected to continue throughout 2020/21.

### **Update on Investments with Icelandic Banks**

- 3.31 The Council has recovered 98% of its £10 million deposit with Heritable Bank. The administrators have not made any further estimate of final recoveries yet, however they expect to conclude this during 2020/21.

### **Compliance**

- 3.32 The Council confirms that it has complied with its Prudential Indicators for 2019/20, which were approved by the Council on 25 February 2019 as part of the Council's Treasury Management Strategy Statement.
- 3.33 In accordance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2019/20. None of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

Further information is set out in Appendix 1, 2 and 3.

### **Investment Training**

- 3.34 The needs of the Council's treasury management staff for training in investment management are kept under review and considered as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.
- 3.35 During 2019/20 staff attended training courses, seminars and conferences provided by both Arlingclose and CIPFA.

## **4. FINANCIAL IMPLICATIONS**

- 4.1 Already noted within the report as this is the Treasury Management Outturn Report.

## **5. LEGAL IMPLICATIONS**

- 5.1 None identified.

## **6. DIVERSITY IMPLICATIONS**

- 6.1 None identified.

## **7. STAFFING IMPLICATIONS**

- 7.1 None identified.

## **8. BACKGROUND INFORMATION**

Treasury Management Strategy Report to Council – 25 February 2019

**Report sign off:**

**MINESH PATEL**

Director of Finance