



**Cabinet**  
12<sup>th</sup> January 2020

**Report from the Director of Finance**

## **Treasury Management Mid-Year Report 2020-21**

|                                   |   |
|-----------------------------------|---|
| <b>Wards Affected:</b>            | All   |
| <b>Key or Non-Key Decision:</b>   | Non-key   |
| <b>Open or Part/Fully Exempt:</b> | Open  |
| <b>No. of Appendices:</b>         | One:<br>Appendix 1: Treasury Management Indicators  |
| <b>Background Papers:</b>         | None  |
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### **1.0 Purpose of the Report**

1.1 This report updates Members on treasury activities for the first half of the financial year 2020-21.

### **2.0 Recommendation(s)**

2.1 Cabinet is asked to note the 2020-21 Mid-Year Treasury report and ask that it be forwarded to Council, in compliance with CIPFA's Code of Practice on Treasury Management (the Code).

### **3.0 Detail**

#### **Background**

3.1 The Council's Treasury Management Strategy is underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

3.2 The Code also recommends that Members be informed of Treasury Management activities at least twice a year. This update report therefore

ensures the Council is embracing best practice in accordance with CIPFA's recommendations.

- 3.3 Treasury Management is defined as: "The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."
- 3.4 In addition to reporting on risk management, the Code requires the Council to report on any financial instruments entered into to manage treasury risks.

### **Economic Background**

- 3.5 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. At the end of the period, an 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.
- 3.6 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.
- 3.7 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.
- 3.8 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.
- 3.9 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.
- 3.10 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 was

expected to pick up sharply over the coming months with the planned ending of the job retention scheme in October however this has been mitigated by its extension. On the back of this, the BoE has forecast unemployment could hit a peak of between 8% and 9%.

- 3.11 The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25% but announced a change to its inflation-targeting regime. The European Central Bank maintained its base rate at 0% and deposit rate at -0.5%.
- 3.12 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 economic outlook will continue to depend significantly on the road to recovery out of the pandemic and the impact of a second wave and a potential vaccine.
- 3.13 The movement in standard rates at which local authorities can borrow from the Public Works Loans Board (PWLB) on maturity loans is shown in the table below including the highest and lowest rates during the period.

#### **PWLB Rates %**

| <b>Period</b>  | <b>Mar-20</b> | <b>Jun-20</b> | <b>Sep-20</b> | <b>Period Low</b> | <b>Period High</b> |
|----------------|---------------|---------------|---------------|-------------------|--------------------|
| <b>1 year</b>  | 2.14          | 1.97          | 1.96          | 1.90              | 2.38               |
| <b>5 year</b>  | 2.20          | 1.95          | 1.96          | 1.88              | 2.68               |
| <b>10 year</b> | 2.42          | 2.21          | 2.26          | 2.10              | 2.99               |
| <b>30 year</b> | 2.80          | 2.64          | 2.75          | 2.42              | 3.40               |

#### **Debt Management**

- 3.14 On 9th October 2019 the Public Works Loan Board (PWLB) raised the cost of certainty rate borrowing to 1.8% above UK gilt yields making it relatively expensive. Alternative sources of long term funding to long-dated PWLB borrowing are available and 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.
- 3.15 The Chancellor's March 2020 Budget statement included significant changes to 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 Council usually borrows from the PWLB.
- 3.16 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 raises the possibility

of slowing, or stopping, individual authorities from borrowing large sums in specific circumstances. The consultation closed on 31<sup>st</sup> 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.

- 3.17 The Municipal Bonds Agency (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.

As can be seen in the table below no new long term loans have been raised so far this year:

|                             | Balance on 01/04/2020<br>£m | Debt repaid<br>£m | New Borrowing<br>£m | Balance on 30/09/2020<br>£m |
|-----------------------------|-----------------------------|-------------------|---------------------|-----------------------------|
| Short Term Borrowing        | 133.0                       | 118.0             | 30.0                | 45.0                        |
| Long Term Borrowing         | 465.8                       | 2.2               | 0.0                 | 463.7                       |
| <b>TOTAL BORROWING</b>      | <b>598.8</b>                | <b>120.2</b>      | <b>30.0</b>         | <b>508.7</b>                |
| Average Rate of Borrowing % | 3.6%                        | 1.0%              | 0.3%                | 4.0%*                       |

*\* £16m of the PWLB loans are referred to as Equal Instalments of Principal (EIP), whereby the Council pays down the loans in half-yearly equal installments over the lifetime of the loan. The marginal increase in the average interest rate can be attributed to the Council paying back its EIP loans and short-term borrowing. This is because the EIP loans have a much lower average interest rate of 2.62% and the short-term borrowing had an average interest rate of 0.93% compared with the rest of the debt, which is 5.04%.*

- 3.18 The Council'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 Council's long-term plans change being a secondary objective.
- 3.19 In keeping with these objectives, new external borrowing was kept to a minimum of £30m to meet cash flow requirements. This strategy enabled the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. With short-term interest rates remaining much lower than long-term rates and temporary investments earning Bank Rate or lower, the Council considered it more cost effective in the near term to use internal resources and borrowing short-term loans to manage cash flow.
- 3.20 The Council has an increasing Capital Financing Requirement due to the elements of the capital programme funded by borrowing. An estimated borrowing requirement is determined by the liability benchmark, which takes into account the Council's usable reserves, planned capital expenditure and minimum revenue provision. This has shown that further borrowing will be required during 2020/21.

- 3.21 PWLB funding margins have fluctuated quite substantially and there remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields plus 0.80%, i.e. the PWLB HRA borrowing rate. The Council will evaluate and pursue these lower cost solutions and opportunities as they arise and will look to take advantage of the low borrowing rates for the HRA to provide certainty for its business plan.
- 3.22 The persistence of low interest rates (see para 3.13) means that it would be uneconomic to reschedule PWLB debt, because early retirement of the loan would incur a heavy penalty, to compensate the PWLB for having to lend the money on at lower rates. The cost of re-financing our loans under the Government's approach means is not economical however, this analysis might change if interest rates returned to historically normal levels.
- 3.23 The Council continues to hold £70.5m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council 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.

### Investment Activity

- 3.24 The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Council's investment balances ranged between £182.4m and £19.5m due to timing differences between income and expenditure. On 1<sup>st</sup> April 2020, the Council received central government funding to support small and medium businesses during the coronavirus pandemic through grant schemes. £64.4m was temporarily invested in the UK Debt Management Account Deposit Facility. This money had all been disbursed to eligible businesses by the end of September.
- 3.25 Both the CIPFA Code and government guidance require the Council 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 Council'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.
- 3.26 The Council's investment position is shown in the table below.

|   | Balance on<br>01/04/2020<br>£m | Investments<br>Repaid<br>£m | Investments<br>Made<br>£m | Balance on<br>30/09/2020<br>£m | Average<br>Rate of<br>Return |
|---|--------------------------------|-----------------------------|---------------------------|--------------------------------|------------------------------|
| Debt Management Account<br>Deposit Facility | 104.7                          | 3,163.8                     | 3,059.1                   | 0.0                            | 0.1%                         |
| Money Market Funds                          | 5.0                            | 250.0                       | 269.1                     | 24.1                           | 0.1%                         |
| <b>TOTAL INVESTMENTS</b>                    | <b>109.7</b>                   | <b>3,413.8</b>              | <b>3,328.2</b>            | <b>24.1</b>                    | <b>0.1%</b>                  |

- 3.27 Throughout the first three months of the pandemic, the Council moved the majority of its investments into highly secure deposits with the UK Debt

Management Account Deposit Facility whilst the impact of financial markets was uncertain. The investments are made for a fixed duration to ensure liquidity. This has led to a high value of investments made and repaid during the first half of the year. The Council also maintained £5m in high quality money market funds to ensure liquidity for urgent payments including procuring Personal Protective Equipment (PPE). As markets stabilised, the Council moved its investment balance back into money market funds.

- 3.28 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.
- 3.29 On 25th September the overnight, 1- and 2-week deposit rates on Debt Management Account Deposit Facility (DMADF) deposits dropped below zero percent to -0.03%, the rate was 0% for 3-week deposits and 0.01% for longer maturities.
- 3.30 The inter-local authority market has remained above zero throughout the first half of the year but rates have remained extremely low. There is limited availability for investments with local authorities for less than one-month so the Council utilised money market funds to manage these short-term differences between income and expenditure.
- 3.31 There was a £85.6m downward movement in short-term investments as short-term borrowing matured throughout the first half of the year. Investment balances are expected to remain low over the next 6 months as the Council's internal resources have been utilised and new borrowing is required. The Council is reviewing its borrowing options which may include short-term loans, PWLB borrowing and forward borrowing.
- 3.32 Security of capital has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2020/21. In accordance with the policy, new investments can be made with the following classes of institutions:
- A- or above rated banks;
  - AAA rated Money Market Funds;
  - Other Local Authorities;
  - Housing Associations;
  - UK Debt Management Office;
  - Corporate Bonds
  - Collective Investment Schemes (Pooled Funds)
  - Real Estate Investment Trusts

A short summary of the investment products available to the Council along with an indication of relative risk is provided below:

3.33 The table below shows the different assets classes available to the Council for its investment portfolio together with the major driver of the return and a summary of the key risks for each asset class.

| Asset Classes (approx. return) | Cash (0.7%)               | Bonds (2.5%)               | Equities (4.1%)  | Property (4.8%)                           |
|--------------------------------|---------------------------|----------------------------|--|---|
| <b>Income driven by</b>        | Short term interest rates | Medium term interest rates | Dividends / share prices                                 | Rental income / vacancies                 |
| <b>Key Risk(s)</b>             | Bank defaults             | Company defaults           | Company performance and perception of future performance | Property prices, least liquid asset class |

3.34 Detailed consideration of the other asset classes would need to be undertaken by the Council prior to investment in conjunction with its treasury advisors. However, it is fair to say that that Equities and Property classes tend to be considered over a longer time frame, which may not be suitable for the Council given its significant capital spending plans.

### Risks

3.35 Regardless of the approach taken, the Council will be required to manage significant risks in relation to its treasury investment portfolio. Some key risks are: -

- Liquidity risk – the risk that the Council has funds tied up in long-term investments when it needs to use that money. Increasing the duration of fixed cash deposits increases liquidity risk, however this can be mitigated through good cash flow management.

Mitigation – see Prudential Indicator 2 – Appendix 1

- Credit risk - the risk that a bank or other institution will not be able to pay back the money invested with it. For longer term investments, the Council is more exposed to credit risk. Should a counterparty's credit worthiness change, the Council may not be able to get all their money back or may face heavy penalties if it can do so.

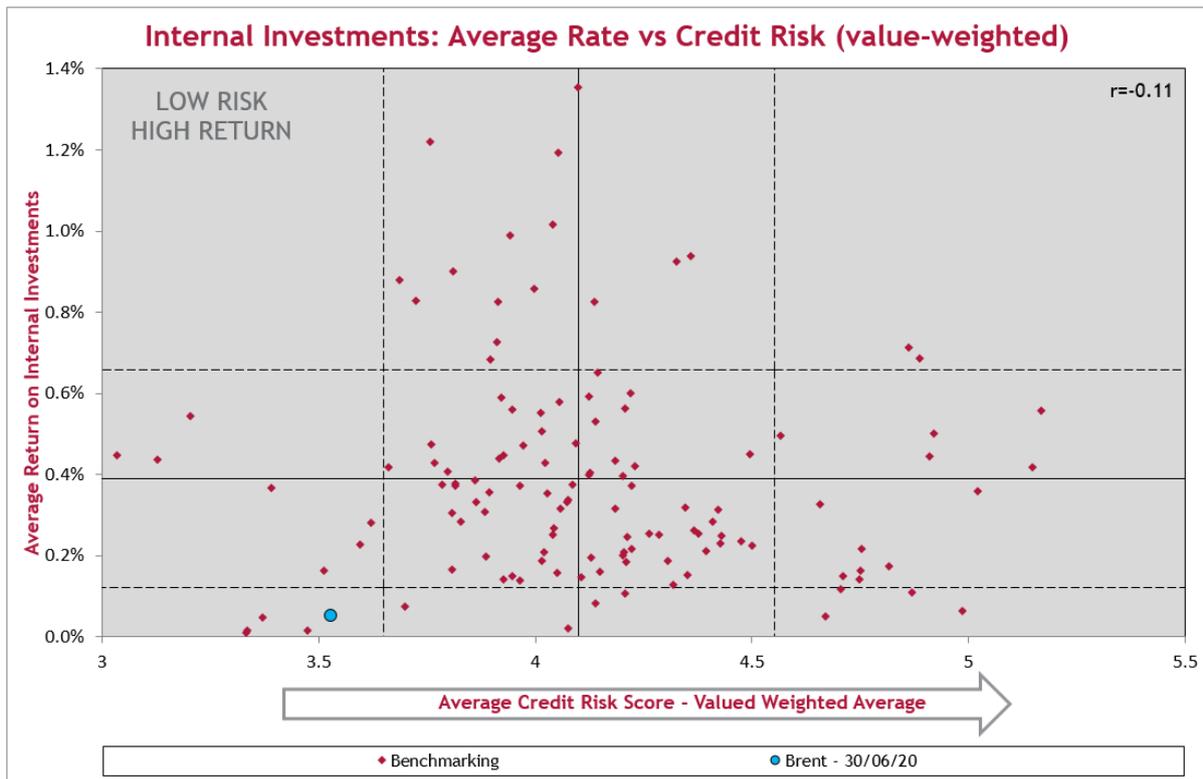
Mitigation – see Prudential Indicator 1 – Appendix 1

- Interest rate risk – the risk of the Council's budget being affected by unforeseen changes in interest rates. Longer term cash deposits increase this risk and will negatively affect the council should interest rates rise. On the other hand, the Council may benefit should interest rates fall.

Mitigation – see prudential Indicator 3 – Appendix 1

## Benchmarking to other councils

- 3.36 The graph below shows a comparison between Brent's investment portfolio and that of Arlingclose's (the Council's treasury advisor) other Local Authority clients. Brent's portfolio has a very low risk profile compared with many of the others and has a much shorter dated, which also equates to a lower yield. However, many authorities are to the right of Brent, obtaining similar yields for much higher risk.



## Budgeted Income And Outturn

- 3.37 The Council's external interest budget for the year is £23.5m, and for investment income is £7.6m. The average cash balances, representing the Council's reserves and working balances, were £107m during the period to 30 September 2020. The Council expects to receive significantly lower income from its cash and short-dated money market investments than it did in 2019/20 and earlier years due to the low interest rate environment and the immediate cash requirements, which only allow for short-term investments. Dividends and income paid will ultimately depend on many factors including but not limited to the duration of COVID-19 and the extent of its economic impact.

## Icelandic Bank Investment Update

- 3.38 A final distribution was made in August 2020 contributing to a total recovery rate of 99% on our initial £10m deposit. Under a cross-party guarantee, the Council has a small claim against LBI ehf as the full amount was not recovered.

However the amount is unlikely to have a significant impact on the recovery rate once concluded.

## **Compliance**

- 3.39 Officers confirm that they have complied with its Treasury Management Indicators for 2020/21, which were set in February 2020 as part of the Council's Treasury Management Strategy Statement (TMSS). Details can be found in Appendix 1.

## **Summary**

- 3.40 In compliance with the requirements of the CIPFA Code of Practice, this report provides Members with a summary report of the treasury management activities during the first half of 2020/21. As indicated in this report, 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.

## **4.0 Financial Implications**

- 4.1 These are covered throughout the report.

## **5.0 Legal Implications**

- 5.1 There are no direct legal implications.

## **6.0 Equality Implications**

- 6.1 No direct implications.

## **7.0 Consultation with Ward Members and Stakeholders**

- 7.1 None.

## **8.0 Human Resources/Property Implications**

- 8.1 No direct implications.

Related documents:

Treasury Management Strategy – Report to Full Council as part of the Budget Report – February 2020.

**Report sign off:**

**Minesh Patel**  
Director of Finance