Agenda Item No 6(c)

DERBYSHIRE COUNTY COUNCIL

CABINET

16 January 2020

Report of the Director of Finance & ICT

TREASURY MANAGEMENT MID-YEAR REPORT 2019-20
(CORPORATE SERVICES)

1 Purpose of the Report

To report on Treasury Management activities during the first half of 2019-20 (to 30 September 2019) and to indicate the Council's compliance with the prudential indicators set by Council at its meeting of 6 February 2019, in accordance with the Treasury Management in the Public Services: Code of Practice and Cross-Sectorial Guidance Notes 2017 (the Code).

2 Information and Analysis

(i) Introduction

Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code) which requires the Council to approve a Treasury Management Strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the Council's obligation under the CIPFA Code to produce a Treasury Management Mid-Year Report.

The Council's Treasury Management Strategy for 2019-20 was approved by Council on 6 February 2019, as part of the Capital Programme Approvals, Treasury Management and Capital Strategies Report. The Council has borrowed and invested substantial sums of money and is therefore potentially 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 Council's Treasury Management Strategy.

(ii) External Context

Economy

UK Consumer Price Inflation (CPIH) fell to 1.7% year on year in August 2019. This is below the Bank of England's 2% target.

The labour market data for the three months to July 2019 showed that the unemployment rate edged back down to 3.80%, whilst the employment rate remained at 76.1%, the joint highest since records began in 1971. Nominal annual wage growth measured by the 3-month average, excluding bonuses, was 3.8%. Adjusting for inflation, real wages were up 1.9%, excluding bonuses, and 2.1% including.

The Quarterly National Accounts for Quarter 2 GDP confirmed that the UK economy contracted by 0.2%, following the 0.5% gain in Quarter 1, which was distorted by stockpiling ahead of the UK leaving the European Union (EU).

In the UK, politics continue to be a big driver of financial markets over the last quarter. The Conservative Party leadership contest was held and the new Prime Minister committed to leaving the EU on 31 October 2019, regardless of whether a deal is reached with the EU. However, Britain's exit from the European Union remains an area of uncertainty.

The Bank of England's Bank Rate (Base Rate) remained at 0.75% and its August 2019 Inflation Report noted the deterioration in global activity and sentiment and confirmed that monetary policy decisions related to the UK leaving the EU could be in either direction, depending on whether or not a deal is ultimately reached by 31 October 2019.

Overseas, tensions continued between the US and China, with no trade agreement in sight and both countries imposing further tariffs on each other's goods. The US Federal Reserve (Fed) cut its target Federal Funds rates by 0.25% in September 2019, to a range of 1.75% - 2.00%.
Market expectations are for further interest rate cuts from the Fed and in September 2019 the European Central Bank reduced its deposit rate to -0.5% and announced the recommencement of quantitative easing from 1 November 2019.

Financial markets:
After rallying early in 2019, financial markets have been adopting a more risk-averse approach in the following period as equities saw greater volatility and bonds rallied (prices up, yields down) in a flight to quality and anticipation of more monetary stimulus from central banks. The Dow Jones, FTSE 100 and FTSE 250 are broadly back at the same levels seen in March/April 2019.

Gilt yields remained volatile over the period on the back of ongoing economic and political uncertainty. From a yield of 0.63% at the end of June 2019, the 5-year benchmark gilt yield fell to 0.32% by the end of September 2019. There were falls in 10-year and 20-year gilts over the same period, with the former dropping from 0.83% to 0.55% and the latter falling from 1.35% to 0.88%. 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.65%, 0.75% and 1.00% respectively over the period.

Recent activity in bond markets and in PWLB interest rates highlight that weaker economic growth remains a global risk. The US yield curve remains inverted, with 10-year Treasury yields lower than shorter US 3-month bills. History has shown that a recession hasn't been far behind a yield curve inversion. Following the sale of 10-year Bonds at -0.24% in June, yields on German government securities continue to remain negative in the secondary market with 2 and 5-year securities currently both trading around -0.77%.

Credit background:

Credit Default Swap (CDS) spreads increased and then fell again during the quarter, continuing to remain low in historical terms.

(iii) Local Context

On 31 March 2019, the Council had net borrowing of £39.961m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31.3.19 Actual £m
General Fund CFR	536.209
Less: *Other debt liabilities	-72.822
Borrowing CFR	**463.387**
Less: Usable reserves	-366.731
Less: Working capital	-56.695
Net borrowing	**39.961**
Borrowing CFR is comprised:	
External borrowing	313.124
Internal borrowing	150.263
	463.387

** finance leases, PFI liabilities and transferred debt that form part of the Council's total debt*

The Council's strategy was to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 30 September 2019 and the in-year change is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.03.19 Balance £m	2019-20 Movement £m	30.09.19 Balance £m	30.09.19 Rate %
Long-term borrowing	286.624	-9.150	277.474	4.57
Short-term borrowing	26.500	30.500	57.000	0.75
Total borrowing	**313.124**	**21.350**	**334.474**	**3.95**
Long-term strategic pooled funds	68.244	0.068	68.312	4.59
Long-term investments	23.510	0.000	23.510	1.32
Short-term investments	144.709	19.651	164.360	1.16
Cash and cash equivalents	36.700	-10.273	26.427	0.46
Total investments	**273.163**	**9.446**	**282.609**	**1.94**
Net borrowing	**39.961**	**11.904**	**51.865**	

Borrowing Activity

At 30 September 2019, the Council held £334.474m of loans, an increase of £21.350m, as part of its strategy for funding previous and current years' capital programmes. The mid-year borrowing position and the in-year change is shown in Table 3 below.

Table 3: Borrowing Position

	31.03.19 Balance £m	**2019-20 Movement £m**	**30.09.19 Balance £m**	**30.09.19 Interest Rate %**	**30.09.19 WAM* Years**
Public Works Loan Board	271.624	-9.150	262.474	4.56	18.5
Banks (LOBO)	5.000	0.000	5.000	4.50	19.9
Banks (fixed-term)	10.000	0.000	10.000	4.69	22.7
Local authorities (long-term)	0.000	0.000	0.000	N/A	N/A
Local authorities (short-term)	26.500	30.500	57.000	0.75	0.3
Total borrowing	**313.124**	**21.350**	**334.474**	**4.30**	**18.2**

**WAM - Weighted Average Maturity*

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 being a secondary objective, should the Council's long-term plans change.

In furtherance of these objectives, no new long-term borrowing was undertaken in the first half of 2019-20, while £9.150m of existing loans were allowed to mature without replacement. 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, the Council considers it to be more cost effective in the near term to use both internal resources and borrowed short-term loans instead. The net movement in short term loans is shown in Table 3 above.

The Council continues to hold £5.000m 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 year.

Other Debt Activity

After £2.770m repayment of prior years' Private Finance Initiative contracts, finance leases and transferred debt liabilities, total debt other than borrowing stood at £72.822m on 30 September 2019, taking total debt to £407.296m.

Treasury Investment Activity

The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the first half of 2019-20, the Council's investment balance ranged between £275.666m and £402.998m because of timing differences between income and expenditure. The year-end investment position and the year-on-year change is shown in Table 4 below.

Table 4: Investment Position (Treasury Investments)

	31.03.19 Balance £m	**2019-20 Movement £m**	**30.09.19 Balance £m**	**30.09.19 Income Return %**	**30.09.19 Weighted Average Maturity days**
Banks and building societies (unsecured)	56.201	33.757	89.958	1.08	67
Government (including local authorities)	138.010	-44.500	93.510	1.26	149
Corporate Bonds	10.709	0.000	10.709	1.38	140
Money Market Funds	0.000	20.120	20.120	0.44	3
Pooled Funds – Strategic Bond Funds	4.865	0.123	4.988	3.26	N/A
Pooled Funds – Equity Income Funds	14.362	-0.507	13.855	7.08	N/A
Pooled Funds – Property Funds	24.106	0.150	24.256	4.23	N/A
Pooled Funds – Multi Asset Income Funds	24.910	0.303	25.213	3.83	N/A
Total investments	**273.163**	**9.446**	**282.609**	**1.94**	**101**

**Weighted average maturity will apply to the first five categories above.*
Strategic *Pooled Funds have no maturity date, but are realised when all units are sold.*

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.

In furtherance of these objectives and given the increasing risk and low returns from short-term unsecured bank investments, the Council has diversified into a combination of either more secure, or higher yielding, asset classes since 2018-19, continuing in the first half of 2019-20, as shown in Table 4 above. As a result an additional 0.85% has been added on to total income return in 2019-20 and investment risk remains diversified.

The progression of credit risk and return metrics for the Council's investments managed in-house are shown in the extracts from the Council's external investment advisor's (Arlingclose) quarterly investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.3.2019	4.15	AA-	33%	201	1.92
30.9.2019	4.39	AA-	52%	111	1.94
Similar Local Authorities	3.97	AA-	54%	751	1.44
All Local Authorities	4.28	AA-	62%	29	1.34

At 30 September 2019, the Council's portfolio of externally managed pooled strategic bond, equity income, property and multi-asset funds amounted to £68.312m. The Council holds these funds with the aim of receiving regular revenue income and because over the long-term their prices are relatively stable. During the first half of 2019-20 these funds generated a net return of £0.866m (2.55%), comprising a £1.14m (3.37%) income return, which is being used to support services in 2019-20 and a £(0.274)m (-0.82%) unrealised capital loss.

These funds have no defined maturity date but are available for withdrawal after a notice period. Their performance and continued suitability in meeting the Council's investment objectives are regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down over months, quarters and even years; but with the confidence that over a three to five-year period total returns will exceed cash interest rates. In light of their performance over the medium-term and the Council's latest cash flow forecasts, investment in these funds has been maintained during the first half of 2019-20 (see Table 4).

Britain's exit from the European Union remains an area of uncertainty.

Non-Treasury Investments

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 the Ministry of Housing, Communities and Local Government's (MHCLG) Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return. This includes service investments for operational and/or regeneration, as well as commercial investments which are made mainly for financial reasons.

At 30 September 2019, the Council held £11.890m of investments in loans to local businesses and subsidiaries:

- £11.390m regeneration loan - Buxton Crescent &Thermal Spa Co Ltd
- £0.500m loan to subsidiary - Derbyshire Developments Ltd.

This represents an increase of £3.982m on the year-end balance because of further investment in Buxton Crescent & Thermal Spa Co Limited.

These investments generated £0.254m of investment income for the Council in first half of 2019-20, after taking account of direct costs, representing a rate of return of 5.09%.

Treasury Performance

The Council measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in Table 6 below. Investment benchmarking is performed quarterly and debt benchmarking is performed annually.

Table 6: Performance

	30.09.19 Actual £m	30.09.19 (CFR) Budget £m	Over/ (Under) £m	Interest Actual %	Interest Other LA Benchmark %	Interest Over/ (Under) %
Borrowing	6.374	8.095	(1.721)	3.95	3.65	0.30
Investments	3.109	3.000	0.109	1.94	1.34	0.60

The Council's average interest rate on long term borrowing is higher than the Other Local Authority Benchmark because the majority of the Council's borrowing was taken out at the higher rates prevalent prior to the financial crisis of 2008-09. The Council's policy has been to utilise its internal reserves rather than take additional external borrowing thus saving interest payments totalling millions of pounds.

The Council achieved its net investment income (gross investment income less short term borrowing costs) target of £3.000m by 30 September 2019.

Compliance Report

The Director of Finance & ICT reports that all treasury management activities undertaken during the first half of 2019-20 complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in Table 7 below and compliance with specific investment limits is demonstrated in Table 8 below.

Table 7: Debt Limits

	Half Year Maximum £m	30.09.19 Actual £m	2019-20 Operational Boundary £m	2019-20 Authorised Limit £m	Complied
Short Term Borrowing	99.000	57.000	N/A	100.000	✓
Long Term Borrowing	286.624	277.474	N/A	N/A	N/A
PFI and Finance Leases	72.822	72.822	N/A	N/A	N/A
Total debt	**458.446**	**407.296**	**625.000**	**655.000**	✓

Table 8: Investment Limits

	Half Year Maximum £m	30.09.19 Actual £m	2019-20 Limit £m	Complied
Any single organisation, except UK Central Government (Lloyds Bank (Main Bank) includes additional £30m Operational Limit)	50.361	34.958	60.000	✓
Any group of organisations under the same ownership (Lloyds Bank – as above)	50.361	34.958	60.000	✓
Any group of pooled funds under the same management (CCLA)	29.627	29.394	30.000	✓
Negotiable instruments held in a broker's nominee account (King & Shaxson)	10.709	10.709	100.000	✓
Non UK Banks (£10m/country)	0.000	0.000	50.000	✓
Registered providers	0.000	0.000	50.000	✓
Unsecured investments with Building Societies	0.000	0.000	100.000	✓
Money Market Funds – Total	90.037	20.120	200.000	✓
Non Treasury Investments (loans to unrated bodies)	11.890	11.890	11.890	✓
Non-Specified investments (Local Authority Loans > 365 days, Strategic Pooled Funds & Non-Treasury Loans)	92.956	91.822	150.000	✓

Treasury Management Indicators

The Council measures and manages its exposure to treasury management risks using the following indicators.

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	30.09.19 Actual	2019-20 Target	Complied
Portfolio average credit rating	AA-	A-	✓

Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available within a rolling three-month period and additional borrowing secured without giving prior notice.

	30.09.19 Actual £m	2019-20 Target £m	Complied
Total cash available within 3 months	140.078	30.000	✓
OR			
Total sum borrowed in past 3 months without prior notice	164.090	30.000	✓

Interest Rate Exposures: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed were:

	31.03.19 Actual %	2019-20 Limit %	Complied
Upper limit on fixed interest rate exposure	83	100	✓
Upper limit on variable interest rate exposure	17	40	✓

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year, or the transaction date if later. All other instruments are classed as variable rate.

Maturity Structure of Borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	30.09.19 Actual %	**Upper Limit %**	**Lower Limit %**	**Complied**
Under 12 months	19	40	0	✓
12 - 24 months	1	20	0	✓
24 months - 5 years	4	20	0	✓
5 - 10 years	12	20	0	✓
10 - 20 years	30	40	10	✓
20 - 30 years	26	40	10	✓
Over 30 years	8	40	0	✓

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than 365 days: The purpose of this indicator is to control the Council'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:

	Beyond 30.09.20 £m	**Beyond 30.09.21 £m**	**Beyond 30.09.22 £m**
Strategic Pooled Funds	68.312	68.312	68.312
Long Term Deposits	4.900	11.390	11.390
Total Invested	**103.212**	**79.702**	**79.702**
Limit on Long Term Funds	**150.000**	**125.000**	**100.000**
Complied	✓	✓	✓

Outlook for the remainder of 2019-20

The global economy is entering a period of slower growth in response to political issues, primarily the trade policy stance of the US. The UK economy has displayed a marked slowdown in growth because of uncertainty around the UK leaving the EU and the downturn in global activity. In response, global and UK interest rate expectations have eased dramatically.

There appears to be no near-term resolution to the trade dispute between China and the US. With the 2020 presidential election a year away, it is thought to be unlikely that this will change.

Britain's exit from the European Union remains an area of uncertainty.

Central bank actions and geopolitical risks will continue to produce significant volatility in financial markets, including bond markets.

The Council's Treasury Advisor, Arlingclose, expects the Bank of England's Bank Rate to remain at 0.75% for the foreseeable future but there remain substantial risks to this forecast, dependant on EU exit outcomes and the evolution of the global economy. Arlingclose also expects gilt yields to remain at low levels for the foreseeable future and judges the risks to be weighted to the downside and that volatility will continue to offer longer-term borrowing opportunities

3 Considerations

In preparing this report the relevance of the following factors has been considered:- financial, legal, prevention of crime and disorder, equality and diversity, human resources, environmental, health, property, transport and social value considerations.

4 Background Papers

Treasury Management Strategy 2019-20.

Papers held in Technical Section, Finance & ICT Division, Room 137.

5 Key Decision

No.

6 Is it necessary to waive the call-in period?

No.

7 Officer's Recommendation

That Cabinet notes the Treasury Management Mid-Year Report 2019-20 and notes the Council's compliance to date with the prudential indicators set by Council for 2019-20, in accordance with the terms of the Treasury Management in the Public Services: Code of Practice and Cross-Sectorial Guidance Notes 2017.

PETER HANDFORD

Director of Finance & ICT