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DERBYSHIRE COUNTY COUNCIL

AUDIT COMMITTEE

8 December 2020

Report of the Director of Finance & ICT

TREASURY MANAGEMENT ANNUAL REPORT 2019-20

1 Purpose of the Report

To report on Treasury Management activities during the last financial year 2019-20 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 Annual 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

The United Kingdom's exit from the European Union (Brexit) and associated future trading arrangements remained one of the major influences on the UK economy during 2019-20. The Brexit deadline of 29 March 2019 was extended to 12 April 2019, then to 31 October 2019 and finally to 31 January 2020. Politics played a major role in financial markets over the period, with negotiations, over Brexit and future trading arrangements, driving volatility, particularly in foreign exchange markets. The outcome of the December 2019 General Election removed much economic uncertainty, at that time, and looked set to provide a ‘bounce’ to confidence and activity.

The UK Consumer Price Inflation Index (CPI) fell to 1.7% year on year in February 2020, below the Bank of England’s target of 2%. UK labour market data remained positive. For the three months to January 2020 the unemployment rate was 3.9%, 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, providing some evidence that a shortage of labour had been supporting wages.

There was no growth in Annual UK Gross Domestic Product (GDP) in the last three months of 2019. 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 the coronavirus pandemic very rapidly 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.

In response to the spread of the virus and the sharp increase in those infected, governments enforced lockdowns and 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.

The Bank of England, which held its Base Rate steady at 0.75% through most of 2019-20, moved to cut rates to 0.25% in March 2020 and then swiftly reduced them further, to a record low of 0.10%. In conjunction with these cuts, the Government introduced a number of measures to help businesses and households impacted by a series of ever-tightening social restrictions, culminating in what was, in substance, the entire lockdown of the United Kingdom.

The United States economy grew at an annualised rate of 2.1% in the last there months of 2019. After escalating trade wars and a protracted stand-off, the signing of Phase One of the trade agreement between the United States and China in January 2020 was initially positive for both economies, but Covid-19 severely impacted sentiment and production in both countries.

Against a slowing economic outlook, the United States Federal Reserve began cutting rates in August 2019. Following a series of five cuts, the largest of which were in March 2020, the target interest rate fell from 2.5% to a range of 0% - 0.25%. The United States 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%.

Financial markets

Financial markets suffered a rapid sell-off of securities, such as shares and bonds, as the impact of Covid-19 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 2020 Sterling fell to its lowest level against the US dollar since 1985. The measures implemented by central banks and governments helped to restore a degree of confidence and financial markets regained some losses but remain extremely volatile. The flight to quality caused gilts yields to fall substantially. The 5-year benchmark gilt yield fell from 0.75% to 0.26% over the period. There were similar falls in the 10-year and 20-year gilt yields over the same period, dropping from 1% to 0.4% and from 1.47% to 0.76%, respectively. 1-month, 3-month and 12-month bid rates averaged 0.61%, 0.72% and 0.88% respectively over the period. In the first three months of 2020, the yield on 2-year US treasuries fell from 1.57% to 0.20% and for 10-year treasuries the fall was from 1.88% to 0.61%. German Bund yields remained negative.

Credit background

In the first three months of 2020, 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.

Credit Default Swap spreads rose sharply in March 2020, as the potential impact of Covid-19 on bank balance sheets gave cause for concern. Spreads declined from late March 2020 to mid-April but remained above their initial 2020 levels.

Fitch downgraded the UK sovereign rating to AA- in March, which was followed by a number of actions on UK and Non-UK banks. Although the UK and Non-UK banks on the counterparty list of the Council's Treasury Management Advisor remained in a strong and well-capitalised position, the duration advice on all these banks was cut to 35 days in mid-March 2020.

(iii) Local Context

On 31 March 2020, the Council had net borrowing of £103.094m 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

	31.3.20 Actual £m
General Fund CFR	525.169
Less: *Other debt liabilities	-68.878
Borrowing CFR	**456.291**
Less: Usable reserves	-305.525
Less: Working capital	-47.672
Net borrowing	**103.094**
Borrowing CFR is comprised:	
External borrowing	329.974
Internal borrowing	126.317
	456.291

* 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 31 March 2020 and the year-on-year change is shown in table 2 below.

Table 2: Treasury Management Summary

	31.3.19 Balance £m	2019-20 Movement £m	31.3.20 Balance £m	31.3.20 Rate %
Long-term borrowing	286.624	-9.150	277.474	4.57
Short-term borrowing	26.500	26.000	52.500	0.30
Total borrowing	**313.124**	**16.850**	**329.974**	**3.89**
Long-term strategic pooled funds	68.244	-7.776	60.468	4.32
Long-term investments	23.510	-8.510	15.000	1.78
Short-term investments	144.709	-61.797	82.912	1.42
Cash and cash equivalents	36.700	31.800	68.500	0.98
Total investments	**273.163**	**-46.283**	**226.880**	**2.13**
Net borrowing	**39.961**	**63.133**	**103.094**	

Borrowing Activity

At 31 March 2020, the Council held £329.974m of loans, an increase of £16.850m, as part of its strategy for funding previous and current years' capital programmes. The year-end external borrowing position and the year-on-year change is shown in table 3 below.

Table 3: External Borrowing Position

	31.3.19 Balance £m	2019-20 Movement £m	31.3.20 Balance £m	31.3.20 Interest Rate %	31.3.20 WAM* Years
Public Works Loan Board	271.624	-9.150	262.474	4.56	18
Banks (LOBO)	5.000	0	5.000	4.50	19
Banks (fixed-term)	10.000	0	10.000	4.69	24
Local authorities (short-term)	26.500	26.000	52.500	0.30	0
External Borrowing	**313.124**	**16.850**	**329.974**	**3.89**	**18**

*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 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 short-term loans instead. The net movement in short-term loans is shown in table 3 above.

The internal borrowing (reserves and working capital) of the Council at 31 March 2020 was £126.317m. If the Council had externally borrowed £126.317m over 18 years at a rate of 2.56% (the PWLB Certainty rate for 18 years, the average length of borrowing), the Council would have incurred additional interest of £3.234m. If the Council had invested this sum of £126.317m at 2.13% (the Council's investment return for 2019-20, including pooled funds), then the Council would have received £2.691m of interest. In 2019-20, the Council saved net interest of £0.543m by utilising internal borrowing.

The Council continues to hold a £5.000m LOBO (Lender's Option Borrower's Option) loan, 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 £4.104m repayment of prior years' Private Finance Initiative contracts, finance leases and transferred debt liabilities, total debt other than borrowing stood at £68.878m on 31 March 2020, taking total debt to £398.852m.

Treasury Investment Activity

The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2019-20, the Council's investment balance ranged between £218.195m and £403.008m, 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)

	31.3.19 Balance £m	2019-20 Movement £m	31.3.20 Balance £m	31.3.20 Income Return %	31.3.20 WAM* days
Banks and building societies (unsecured)	56.201	-18.799	37.402	1.02	23
Government (including local authorities)	138.010	-31.500	106.510	1.43	131
Corporate Bonds	10.709	-10.709	0	N/A	N/A
Registered Social Providers	0	5.000	5.000	2.15	696
Money Market Funds	0	17.500	17.500	0.71	1
Pooled Funds – Strategic Bond Funds	4.865	-0.377	4.488	2.19	N/A
Pooled Funds – Equity Income Funds	14.362	-4.034	10.328	5.31	N/A
Pooled Funds – Property Funds	24.106	-0.496	23.610	4.41	N/A
Pooled Funds – Multi Asset Income Funds	24.910	-2.868	22.042	4.21	N/A
Total investments	**273.163**	**-46.283**	**226.880**	**2.13**	**N/A**

*WAM – Weighted Average Maturity

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 diversified into higher yielding, asset classes. As a result, the average rate of income return on investments has increased to 2.13%. This compares to 1.26% on traditional investments.
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 %
31.03.2019	4.15	AA-	33%	201	1.92
31.03.2020	4.15	AA-	33%	110	2.13
Similar Local Authorities	3.83	AA-	41%	644	1.55
All Local Authorities	4.03	AA-	56%	20	1.23

The global economic fallout of the Covid-19 pandemic was sharp and large, impacting on 2019-20 returns. 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 was almost as high as during the global financial crisis of 2008-09, 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.

At 31 March 2020, the Council's portfolio of externally managed pooled strategic bond, equity, property and multi-asset funds amounted to £59.892m. The Council holds these funds with the aim of receiving regular revenue income and because over the long-term their prices are relatively stable. However, falls in the capital values of the underlying assets were reflected in 31 March 2020 fund valuations, with every fund registering negative capital returns over twelve months to March 2020. During 2019-20 the Council's pooled funds generated a net total loss of £5.232m (-7.68%), comprising a £3.120m (4.54%) income return, which has been used to support services in 2019-20, and a £8.352m (-12.22%) unrealised capital loss. The value of these pooled funds was £61.704m at 30 September 2020, which is an increase of £1.812m since 31 March 2020, reducing the unrealised capital loss.

These pooled 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. The Council is using the alternative fair value through profit and loss (FVPL) accounting method to account for these funds, which means that if there are any long term unrealised losses in the funds' fair values there will not be an impact on the Council's General Reserve balance until 2023-24 at the earliest. In light of their performance over the medium-term and the Council's latest cash flow forecasts, investment in these funds has been maintained.

Other Non-Treasury Holdings and Activity

The definition of investments in CIPFA's revised Treasury Management Code 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 31 March 2020, the Council held £12.268m of investments in loans to local businesses and subsidiaries, with the whole balance being in respect of a regeneration loan to Buxton Crescent Hotel & Thermal Spa Co Ltd. This represents an increase on the previous year of £4.860m because of further investment in the company. This investment generated £0.878m of interest for the Council, after taking account of direct costs, representing a rate of return of 4.65%. This interest has been capitalised and is included in the value of the outstanding loan at 31 March 2020. The loan will become repayable one year after the Buxton Crescent hotel opened, on 1 October 2021.

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. Debt benchmarking is performed less frequently than investment benchmarking because of the long term nature of debt the Council holds, as opposed to the shorter term nature of the Council's investments.

Table 6: Performance

	Actual £m	**Budget (CFR) £m**	**Over/ (Under) £m**	**Interest Actual %**	**Interest Other LA (Counties) Benchmark %**	**Interest Over/ (Under) %**
Borrowing	14.295	17.126	-2.831	4.30	3.42	0.98
Investments	-6.011	-6.000	-0.011	2.13	1.55	0.58

The Council's average interest rate on borrowing is higher than the Other Counties Benchmark as all the Council's longstanding debt was taken before the global financial crisis, when interest rates were significantly higher.
The Council uses a strategy of internal borrowing, as the saving from not borrowing is greater than the interest foregone on investments, even at the lower prevailing interest rates.

The Council achieved its 2019-20 investment target and continued to exceed the Other Counties Benchmark.

Compliance Report

The Director of Finance & ICT reports that all treasury management activities undertaken during 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

	2019-20 Maximum £m	**31 March 2020 Actual £m**	**2019-20 Operational Boundary £m**	**2019-20 Authorised Limit £m**	**Complied**
Total debt	454.502	398.852	625.000	655.000	✓

Table 8: Investment Limits

	2019-20 Maximum * £m	2019-20 Limit £m	March 2020 Actual £m	Complied
Any single organisation, except UK Central Government (+£30m Lloyds (Main Bank))	52.907	60.000	31.402	✓
Any group of organisations under the same ownership	30.000	30.000	17.500	✓
Any group of pooled funds under the same management	29.626	30.000	27.766	✓
Negotiable instruments held in a broker's nominee account	10.709	100.000	0	✓
Foreign countries	0	50.000	0	✓
Registered providers	5.000	50.000	0	✓
Unsecured investments with Building Societies	0	100.000	0	✓
Money Market Funds – Total	130.037	200.000	17.500	✓
Non Treasury Investments (loans to unrated bodies)	12.268	50.000	12.268	✓

*Maximum held at any one time.

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.

	31 March 2020 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.

	31 March 2020 Actual £m	2019-20 Target £m	Complied
Total cash available within 3 months	123.903	30.000	✓
Total sum borrowed in past 3 months without prior notice	72.500	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 March 2020 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:

	31 March 2020 Actual %	Upper Limit %	Lower Limit %	Complied
Under 12 months	19	40	0	✓
12 - 24 months	0	20	0	✓
24 months - 5 years	5	20	0	✓
5 - 10 years	12	20	0	✓
10 - 20 years	29	40	10	✓
20 - 30 years	30	40	10	✓
Over 30 years	5	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 31 March 2020 £m	Beyond 31 March 2021 £m	Beyond 31 March 2022 £m
Actual principal invested beyond the year end	87.160	72.160	72.160
Limit on principal invested beyond the year end	150	125	100
Complied	✓	✓	✓

Other

IFRS 16: CIPFA/LASAAC has proposed delaying the implementation of the new IFRS 16 Leases accounting standard for a further year to 2021-22.

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 electronically by Technical Section, Finance & ICT Division, Room 137.

5 Officer's Recommendation

That Audit Committee notes the Treasury Management Annual Report 2019-20 and notes the Council's compliance 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