Audit and Governance Committee
Monday, 28 September 20202
Treasury Management Annual Report

For Decision

Portfolio Holder: Cllr G Suttle, Finance, Commerical & Capital Strategy

Local Councillor(s): All

Executive Director: A Dunn, Executive Director, Corporate Development

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Report Status: Public

Recommendation:

That the Committee note and comment upon the report.

Reason for Recommendation:

To better inform members of treasury management activity, in accordance with the corporate requirement to ensure money and resources are used wisely.

1. Executive Summary

This report summarises the treasury management performance and position information for Dorset Council for the year ended 31 March 2020.

Treasury management at the Council is conducted within the framework of CIPFA's Treasury Management Code of Practice. In adopting the code, recommended best practice is for members to approve an annual treasury management strategy report, and to then receive a mid-year update on progress against the strategy and a year-end review of actual performance against the strategy (this report).

2. Financial Implications

This report summarises the performance of the Council's treasury management activity in 2019/20. There are no other financial implications arising from this report.

3. Climate implications

There are no equalities implications arising from this report.

4. Other Implications

There are no other implications arising from this report.

5. Risk Assessment

Having considered the risks associated with this decision, the level of risk has been identified as:
Current Risk: HIGH
Residual Risk: Medium

Treasury management is an inherently risky area of activity and a number of controls are embedded in its operation. The key treasury management risks are highlighted as part of the treasury management strategy approved by Council as part of the budget setting process. This report highlights any variances from this strategy and draws out any specific risks which have arisen

6. Equalities Impact Assessment

There are no equalities implications arising from this report.

7. Appendices

Appendix 1: Economic Background Commentary (Arlingclose)

8. Background Papers

9. Introduction

9.1 The Council has borrowed and 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 remains central to the Council's treasury management strategy.

9.2 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 2017 Edition (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 legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

9.3 The Council's treasury management strategy for 2019/20 was approved at a meeting of the Dorset Shadow Council in February 2019.

10. Treasury Management Advisers

10.1 The Council employs professionally qualified and experienced staff with responsibility for making borrowing and investment decisions. Officers are supported by external advisers who are specialists in their fields. The Council currently employs Arlingclose Limited as treasury management advisers.

10.2 This approach ensures that the Council has access to a wide pool of relevant market intelligence, knowledge and skills, that would be very difficult and costly to replicate internally. However, whilst advisers provide support to the internal treasury function, final decisions on treasury matters always remain with the Council.

11. Member and Officer Training

11.1 The high level of risk inherent in treasury management means officers need to be adequately experienced and qualified. Officers attend national treasury management events and training courses, and have regular strategy and review meetings with advisers, as well as regular telephone contact.

11.2 On 23 January 2020 a training session for all Dorset Council's elected members was provided by officers and advisers to explain the responsibilities that members have in relation to treasury management. Further training will also be provided from time to time as necessary.

12. External Context (Economic Background and Outlook)

12.1 Treasury management decisions made by the Council must take into consideration external factors, particularly the wider economic backdrop and the outlook for financial markets and interest rates.

12.2 The UK's exit from the European Union and future trading arrangements remained the major influence on the UK economy and market sentiment for most of 2019/20 as it had in previous recent years. However, towards the end of the year the coronavirus pandemic swiftly changed everything, with falls in financial markets not seen since the global financial crisis of 2008.

12.3 A detailed economic commentary provided by Arlingclose is included in Appendix 1.

13. Local Context

13.1 The Council's balance sheet summary and forecast are shown in table 1 below.

Table 1: Balance Sheet Summary

	01-Apr 2019 Actual £m	31-Mar 2020 Actual £m	31-Mar 2021 Budget £m	31-Mar 2022 Budget £m	31-Mar 2023 Budget £m
Capital Financing Requirement	**308**	**320**	**361**	**369**	**368**
External Debt (incl. PFI & leases):					
External borrowing	233	216	240	240	240
Long Term PFI Liabilities	25	24	25	25	25
Obligations under Finance Leases	5	3	5	5	5
Total External Debt	**263**	**243**	**270**	**270**	**270**
Internal Borrowing	45	77	91	99	98
Cash and Investments	**148**	**108**	**100**	**100**	**100**

13.2 The Council pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

13.3 The treasury management position at 31 March 2020 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.03.19 Balance £m	Net Movement £m	31.03.20 Balance £m
Long-term borrowing	201.0	-21.0	180.0
Short-term borrowing	31.3	4.7	36.0
Total Borrowing	**232.3**	**-16.3**	**216.0**
Investments	80.5	-4.8	75.7
Cash and cash equivalents	67.0	-35.5	31.5
Total Cash and Investments	**147.5**	**-40.3**	**107.2**
Net Borrowing	**84.8**	**24.0**	**108.8**

14. Borrowing

14.1 At 31 March 2020 the Council held £216m of loans, (a decrease of £16m from 31 March 2019), as part of its strategy for funding previous and current years' capital programmes. Outstanding loans as at 31 March 2020 are summarised in Table 3 below.

Table 3: Borrowing Position

	31.03.19 Balance £m	Net Movement £m	31.03.20 Balance £m
Public Works Loan Board	86.4	-1.5	84.9
Banks (fixed-term)	25.6	0.0	25.6
Banks (LOBO)	31.0	-20.0	11.0
Local authorities (long-term)	15.0	0.0	15.0
Local authorities (short-term)	30.0	-15.0	15.0
Other lenders (fixed-term)	25.0	20.0	45.0
Other lenders (LOBO)	19.5	0.0	19.5
Total Borrowing	**232.5**	**-16.5**	**216.0**

14.2 The chief objective of the Council (and its predecessors) 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 long-term plans change being a secondary objective.

14.3 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 internal resources or borrow rolling short-term loans instead. This strategy has enabled the Council to reduce net borrowing costs (despite foregone investment income) and to reduce overall treasury risk. The Council's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short and long-term borrowing has been maintained.

14.4 The Council holds £30.5m of Lender's Option Borrower's Option (LOBO) 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 options during the year.

14.5 However, on assessment of the LOBO portfolio by Arlingclose, loans from some banks presented restructuring opportunities with substantial value from a negotiated settlement with the bank. The risks and benefits, including restructuring savings, were assessed and £20m LOBOs were repaid during the year which has also helped reduce exposure to medium/long-term optionality.

14.6 In addition, capital finance may be raised by the following methods that are not borrowing but are classed as other debt liabilities: leasing, hire purchase, Private Finance Initiative (PFI) and sale and leaseback.

15. Investments

15.1 The Council holds significant levels of invested funds, representing income received in advance of expenditure plus balances and reserves held and money borrowed in advance of need. Cash, cash equivalents and treasury investments held on 31 March 2020 are summarised in Table 4 below.

Table 4: Cash and Treasury Investments Position

	31.03.19 Balance £m	Net Movement £m	31.03.20 Balance £m
Cash and Cash Equivalents:			
Banks & Building Societies (unsecured)	46.2	-33.1	13.1
Covered bonds (secured)	0.0	0.0	0.0
Government (including local authorities)	19.4	-19.4	0.0
Corporate bonds and loans	0.0	0.0	0.0
Money Market Funds	33.7	13.7	47.4
Less 'co-mingled' Dorset LEP Balances*	-32.3	3.3	-29.0
Total Cash and Cash Equivalents	**67.0**	**-35.5**	**31.5**
Investments:			
Short-dated bond funds	3.0	-0.2	2.8
Strategic bond funds	10.7	-0.8	9.9
Equity income funds	42.0	-5.2	36.8
Property funds	18.1	2.3	20.4
Multi asset income funds	6.7	-1.0	5.7
Real Estate Investment Trusts (REITS)	0.0	0.0	0.0
Total Investments	**80.5**	**-4.8**	**75.7**
Total Cash and Investments	**147.5**	**-40.3**	**107.2**

**The Dorset Local Enterprise Partnership NatWest bank balances are 'co-mingled' in the same interest group with Dorset Council's balances.*

15.2 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.

15.3 £76m of the Council's investments are held in externally managed strategic pooled investment vehicles (bond, equity, multi-asset and property funds) where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability.

15.4 Such investments are held for the longer term with the acceptance that capital values will fluctuate over the short term but with the expectation that over a three to five-year period total returns will exceed cash interest rates.

15.5 Correlations between asset classes which should in ‘normal’ times help diversify investment risk, can break down in times of severe market stress and returns for all asset classes can move in the same direction. This was seen in the reactions of financial markets to the global coronavirus pandemic in March and April 2020.

16. Treasury Performance

16.1 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 5 below.

Table 5: Treasury Performance

	Budget £m	Actual £m	Variance £m	
Interest Payable	10.6	7.4	3.2	F
Interest and Investment Income	-4.3	-3.6	-0.7	A
Net Payable / (Receivable)	**6.3**	**3.8**	**2.5**	**F**
Unrealised (Gains) / Losses in Fair Value	0.0	8.8	-8.8	A
Net (Surplus) / Deficit	**6.3**	**12.6**	**-6.3**	**A**

16.2 The unrealised losses in the fair value of investments relate to the Council’s investments in strategic pooled investment vehicles. Unrealised gains or losses in the fair value of these investments are accounted for through reserves and do not have an impact on the general fund.

17. Compliance

17.1 All treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the Council’s approved Treasury Management Strategy.

17.2 Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 6 below.

Table 6: Debt Limits

	Maximum £m	31.03.20 Actual £m	Operational Boundary £m	Authorised Limit £m	Complied Yes/No
Borrowing	233.0	216.0	388.0	398.0	Yes
PFI & Finance Leases	30.0	27.0	37.0	37.0	Yes
Total Capital Financing	**263.0**	**243.0**	**425.0**	**435.0**	

18. Treasury Management Indicators

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

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

Table 7: Security

	31.03.20 Actual	2019/20 Target	Complied Yes/No
Portfolio average credit rating or score	4.0	6.0	Yes

18.3 Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period. In addition, the Council aims to hold a minimum of £10m readily available in same day access bank accounts and Money Market Funds.

Table 8: Liquidity

	31.03.20 Actual	2019/20 Target	Complied Yes/No
Total cash available within 3 months	80%	30%	Yes

18.4 Interest Rate Exposure: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interests were:

Table 9: Interest Rate Exposure

	31.03.20 Actual £000s	2019/20 Target £000s	Complied Yes/No
Upper limit on one-year revenue impact of a 1% rise in interest rates	60	500	Yes
Upper limit on one-year revenue impact of a 1% fall in interest rates	60	500	Yes

18.5 The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates.

18.6 Sums invested for periods longer than a year: 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:

Table 10: Investments beyond year end

	2019/20 £m	2020/21 £m	2021/22 £m
Actual principal invested beyond year end	0.0	0.0	0.0
Limit on principal invested beyond year end	20.0	20	20
Complied (Yes/No)	Yes	Yes	Yes

18.7 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 borrowing were:

Table 11: Maturity Structure of Borrowing

	31.03.20 Actual £m	% of Total Borrowing	Upper Limit	Lower Limit	Complied Yes/No
Under 12 months	36.0	16.7%	25%	0%	Yes
12 Months to 2 Years	1.0	0.5%	25%	0%	Yes
2 Years to 5 Years	11.1	5.1%	25%	0%	Yes
5 Years to 10 Years	10.0	4.6%	35%	0%	Yes
10 Years to 15 Years	19.5	9.0%	35%	0%	Yes
15 Years to 20 Years	0.0	0.0%	35%	0%	Yes
20 Years to 25 Years	0.0	0.0%	45%	0%	Yes
25 Years to 30 Years	0.0	0.0%	45%	0%	Yes
30 Years to 35 Years	41.8	19.4%	45%	0%	Yes
35 Years to 40 Years	15.0	6.9%	45%	0%	Yes
40 Years to 45 Years	0.0	0.0%	45%	0%	Yes
45 Years to 50 Years	56.0	25.9%	45%	0%	Yes
50 Years and above	25.6	11.9%	75%	0%	Yes
Total	**216.0**	**100.0%**			

18.9 Time periods start on the first day of each financial year, so borrowing maturing “under 12 months” is all borrowing that may mature before the end of this financial year. The maturity date used is the earliest date on which the lender can demand repayment or the borrower has the option to repay without penalty.

Footnote:
Issues relating to financial, legal, environmental, economic and equalities implications have been considered and any information relevant to the decision is included within the report.

Appendix 1: Economic Background Commentary (Arlingclose April 2020)

Economic background: The UK's exit from the European Union and future trading arrangements, had remained one of major influences on the UK economy and sentiment during 2019/20. The 29th March 2019 Brexit deadline was extended to 12th April, then to 31st October and finally to 31st January 2020. Politics played a major role in financial markets over the period as the UK's tenuous progress negotiating its exit from the European Union together with its future trading arrangements drove volatility, particularly in foreign exchange markets. The outcome of December's General Election removed a lot of the uncertainty and looked set to provide a 'bounce' to confidence and activity.

The headline rate of UK Consumer Price Inflation 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.

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%.

Then coronavirus swiftly 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 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.

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 pretty much the entire lockdown of the UK.

The US economy grew at an annualised rate of 2.1% in Q4 2019. 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 sentiment and 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%.

Financial markets: 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 touch 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. 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. 1-month, 3-month and 12-month bid rates averaged 0.61%, 0.72% and 0.88% respectively over the period.

Since the start of the calendar 2020, the yield on 2-year US treasuries had fallen from 1.573% to 0.20% and from 1.877% to 0.61% for 10-year treasuries. German bund yields remain negative.

Credit review: 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.

After remaining flat in January and February and between a range of 30-55bps, Credit Default Swap spreads rose sharply in March as the potential impact of the coronavirus on bank balance sheets gave cause for concern. Spreads declined in late March and through to mid-April but remain above their initial 2020 levels. NatWest Markets Plc (non-ringfenced) remains the highest at 128bps and

National Westminster Bank Plc (ringfenced) still the lowest at 56bps. The other main UK banks are between 65bps and 123bps, with the latter being the thinly traded and volatile Santander UK CDS.

While the UK and Non-UK banks on the Arlingclose counterparty list remain in a strong and well-capitalised position, the duration advice on all these banks was cut to 35 days in mid-March.

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-. Having revised their outlooks to negative, Fitch upgraded the long-term ratings on Canadian and German banks but downgraded the long-term ratings for Australian banks. HSBC Bank and HSBC UK Bank, however, had their long-term ratings increased by Fitch to AA-.

Borrowing Update

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 remains available but the margin of 180bp above gilt yields appears relatively very expensive. Market alternatives are available and new products will be developed; however, the financial strength of individual authorities will be scrutinised by investors and commercial lenders.

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. Announcements included a reduction in the margin on new HRA loans to 0.80% above equivalent gilt yields (the value of this discount is 1% below the rate at which the authority usually borrows from the PWLB), available from 12th March 2020 and £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.

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.

The consultation closed on 4th June 2020 with implementation of the new lending terms expected in the latter part of this calendar year or financial year beginning 2021/22.