Audit and Governance Committee
Monday, 16 November 2020
Banking and Treasury Management Update

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 banking and 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 to 30 September 2020. It also provides an update on the transition of banking services to one provider.

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 (this report) and a year-end review of actual performance against the strategy.

2. Financial Implications

This report summarises the performance of the Council's treasury management activity in the financial year to date. There are no other financial implications arising from this report.

3. Climate implications

Dorset Council owns holdings in a number of pooled investment vehicles. These pooled investment vehicles will have holdings in companies in all sectors of the economy, including the extraction and supply of fossil fuels.

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

Dorset Council Treasury Management Strategy 2020/21

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 2020/21 was approved at a meeting of Dorset Council in February 2020.

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 be provided in early.

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 biggest external factor remains the impact of the COVID-19. Whilst financial markets have seen substantial improvements since the large falls in March and April, the outlook for the remainder of the financial year and beyond is volatile with concerns growing about the scale of the 'second wave'.

12.3 The outcome of negotiations regarding the future trading arrangements between the UK and the European Union remain another external source of external uncertainty.

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

13. Local Context

13.1 The Council's balance sheet is summarised in Table 1 below.

Table 1: Balance Sheet Summary

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

13.2 The Council continued 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 30 September 2020 and the change during the year to date is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.03.20 Balance £m	Net Movement £m	30.09.20 Balance £m
Long-term borrowing	180.0	0.0	180.0
Short-term borrowing	36.0	-5.5	30.5
Total Borrowing	**216.0**	**-5.5**	**210.5**
Investments	75.7	2.8	78.5
Cash and cash equivalents	31.5	72.8	104.3
Total Cash and Investments	**107.2**	**75.6**	**182.8**
Net Borrowing	**108.8**	**-81.1**	**27.7**

14. Borrowing

14.1 At 30 September 2020 the Council held £210.5m of loans (a net decrease of £5.5m from 31 March 2020) as part of its strategy for funding previous and current years' capital programmes. Outstanding loans as at 30 September 2020 are summarised in Table 3 below.

Table 3: Borrowing Position

	31.03.20 Balance £m	Net Movement £m	30.09.20 Balance £m
Public Works Loan Board	84.9	-0.5	84.4
Banks (fixed-term)	25.6	0.0	25.6
Banks (LOBO)	11.0	0.0	11.0
Local authorities (long-term)	15.0	0.0	15.0
Local authorities (short-term)	15.0	-5.0	10.0
Other lenders (fixed-term)	45.0	0.0	45.0
Other lenders (LOBO)	19.5	0.0	19.5
Total Borrowing	**216.0**	**-5.5**	**210.5**

14.2 The chief objective of the Council (and its predecessor authorities) 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 lenders exercised their options during the year to date.

14.5 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. No new financing from these sources has been raised during the year to date.

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 30 September 2020 are summarised in Table 4 below.

Table 4: Cash and Treasury Investments Position

	31.03.19 Balance £m	Net Movement £m	30.09.20 Balance £m
Cash and Cash Equivalents:			
Banks & Building Societies (unsecured)	13.1	16.4	29.5
Covered bonds (secured)	0.0	0.0	0.0
Government (including local authorities)	0.0	0.0	0.0
Corporate bonds and loans	0.0	0.0	0.0
Money Market Funds	47.4	52.1	99.5
Less Dorset LEP Balances*	-29.0	4.3	-24.7
Total Cash and Cash Equivalents	**31.5**	**72.8**	**104.3**
Investments:			
Short-dated bond funds	2.8	0.1	2.9
Strategic bond funds	9.9	0.5	10.4
Equity income funds	36.8	1.8	38.7
Property funds	20.4	0.0	20.4
Multi asset income funds	5.7	0.3	6.0
Real Estate Investment Trusts (REITS)	0.0	0.0	0.0
Total Investments	**75.7**	**2.8**	**78.5**
Total Cash and Investments	**107.2**	**75.6**	**182.8**

**The Dorset Local Enterprise Partnership's bank balances with are held in the same NatWest Bank interest group as Dorset Council's bank balances. Interest is only charged if the interest group as a whole is overdrawn.*

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 Continued downward pressure on short-dated cash rate brought net returns on sterling low volatility net asset value money market funds (LVNAV MMFs) close to zero even after some managers have temporarily lowered their fees. At this stage net negative returns are not the central case of most MMF managers over the short-term, and fee waivers should maintain positive net yields, but the possibility cannot be ruled out.

15.4 On 25 September 2020 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.

15.5: In the light of the pandemic crisis and the likelihood of unexpected calls on cash flow, the Council kept more cash available at very short notice than is normal. Liquid cash was diversified over several counterparties and Money Market Funds to manage both credit and liquidity risks.

15.6 Approximately £80m 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.

15.7 Such investments are held for the longer term with the understanding 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.

15.8 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.

15.9 In a relatively short period since the onset of the COVID-19 pandemic and the ensuing enforced lockdown in many jurisdictions, the global economic fallout has been sharp and large. Market reaction was extreme with large falls in equities, corporate bond markets and real estate.

15.10 The falls in the capital values of the underlying assets were reflected in the 31 March 2020 fund valuations with all funds registering negative capital returns over a 12-month period. Since April there here has been improvement in market sentiment which is reflected in an increase in capital values of most of the funds in the Council's portfolio. However, the outlook for the remainder of the financial year and beyond is volatile with growing concerns about the impact of the 'second wave'.

16. Treasury Performance

16.1 The Council measures the financial performance of its treasury management activities on the revenue budget as shown in table 5 below.

Table 5: Treasury Performance

	Budget £m	Forecast £m	Variance £m	
Interest Payable	9.5	8.3	1.2	F
Interest and Investment Income	-4.0	-3.6	-0.4	A
Net Payable / (Receivable)	**5.5**	**4.7**	**0.8**	**F**

16.2 In 2020/21 the Council expects to receive significantly lower income from its cash and short-dated money market investments and from its externally managed funds than budget, primarily due to the impact of COVID-19. The Council will continue to monitor, review and report its expectations for investment income in 2020/21.

17. Treasury Management Indicators

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

17.2 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 6: Security

	30.09.20 Actual	2020/21 Target	Complied Yes/No
Portfolio average credit rating or score	4.0	6.0	Yes

17.3 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 7: Liquidity

	30.09.20 Actual	2020/21 Target	Complied Yes/No
Total cash available within 3 months	57%	30%	Yes

17.4 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 8: Interest Rate Exposure

	30.09.20 Actual £000s	2020/21 Target £000s	Complied Yes/No
Upper limit on one-year revenue impact of a 1% rise in interest rates	370	500	Yes
Upper limit on one-year revenue impact of a 1% fall in interest rates	370	500	Yes

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

17.6 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 9: Investments beyond year end

	2020/21 £m	2021/22 £m	2022/23 £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

17.7 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 10: Maturity Structure of Borrowing

	30.09.20 Actual £m	% of Total Borrowing	Upper Limit	Lower Limit	Complied Yes/No
Under 12 months	30.5	14.5%	25%	0%	Yes
12 Months to 2 Years	1.0	0.5%	25%	0%	Yes
2 Years to 5 Years	11.1	5.3%	25%	0%	Yes
5 Years to 10 Years	10.0	4.8%	35%	0%	Yes
10 Years to 15 Years	19.5	9.3%	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	19.9%	45%	0%	Yes
35 Years to 40 Years	15.0	7.1%	45%	0%	Yes
40 Years to 45 Years	0.0	0.0%	45%	0%	Yes
45 Years to 50 Years	56.0	26.6%	45%	0%	Yes
50 Years and above	25.6	12.2%	75%	0%	Yes
Total	**210.5**	**100.0%**			

18. Banking

18.1 The predecessor councils to Dorset Council all had different providers of banking services. Dorset County Council (DCC) banked with NatWest, Purbeck District Council (PDC) banked with Lloyds, and East Dorset District Council (EDDC), North Dorset District Council (NDDC), West Dorset District Council (WDDC) and Weymouth and Portland Borough Council (WPBC) all banked with HSBC.

18.2 Now that the predecessor councils have come together as one organisation, having multiple bankers is clearly not the most efficient and effective way to operate. Following a procurement exercise, NatWest Bank was awarded the contract to provide banking services for Dorset Council for an initial period of five years with the option to extend for a further three years.

18.3 All payroll and accounts payable banking activity was moved across from HSBC and Lloyds to NatWest before 31 March 2020 and we are now focusing on the transfer of Revenues and Benefits (R&B) activity which is currently going through the legacy bank accounts of the five former district and boroughs. R&B was always expected to be the biggest challenge due to the complexity, value and sheer volume of transactions.

18.4 The R&B banking changes were planned to dovetail where possible with the merger of the databases of the five former district and boroughs which was originally intended to complete by the end of December 2020. Completion of the data merge project has just been repositioned to the summer of 2021, however, we are still moving forward with the transfer of banking activity. Colleagues from R&B, IT and Finance are currently working through the complex details with NatWest and the legacy banks.

18.5 All R&B banking activity currently actioned through the former PDC, WDDC and WPBC accounts will move to NatWest December 2020/ January 2021. We are working closely with Stour Valley and Poole Partnership (SVPP) to assess the optimum time for the transfers from the former EDDC and NDDC bank accounts which are likely to be as part of the end of year and billing process.

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 and Outlook (Arlingclose October 2020)

The medium-term global economic outlook is weak. While the strict initial lockdown restrictions have eased, coronavirus has not been supressed and second waves have prompted more restrictive measures on a regional and national basis. This ebb and flow of restrictions on normal activity will continue for the foreseeable future, at least until an effective vaccine is produced and importantly, distributed.

The global central bank and government responses have been significant and are in many cases on-going, maintaining more stable financial, economic and social conditions than otherwise. This has supported a sizeable economic recovery in Q3.

However, the scale of the economic shock to demand, on-going social distancing measures, regional lock downs and reduced fiscal support will mean that the subsequent pace of recovery is limited. Early signs of this are already evident in UK monthly GDP and PMI data, even before the latest restrictions.

This situation will result in central banks maintaining low interest rates for the medium term. In the UK, Brexit is a further complication. Bank Rate is therefore likely to remain at low levels for a very long time, with a distinct possibility of being cut to zero. Money markets have priced in a chance of negative Bank Rate.

Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid inflation expectations. There is a chance yields may follow a slightly different path in the medium term, depending on investor perceptions of growth and inflation, or if the UK leaves the EU without a deal.

Arlingclose expects Bank Rate to remain at the current 0.10% level and additional monetary loosening in the future most likely through further financial asset purchases (QE). While Arlingclose's central case for Bank Rate is no change from the current level of 0.1%, further cuts to Bank Rate to zero or even into negative territory cannot be completely ruled out.

Gilt yields are expected to remain very low in the medium term. Shorter-term gilt yields are currently negative and will remain around zero or below until either the Bank of England expressly rules out negative Bank Rate or growth/inflation prospects improve.

Downside risks remain in the near term, as the government dials down its fiscal support measures, reacts to the risk of a further escalation in infection rates and the Brexit transition period comes to an end.

Economic background: 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. After a relatively quiet few months of Brexit news it was back in the headlines towards the end of the period as 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.

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.

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.

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.

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. The Office for National Statistics' preferred measure of CPIH which includes owner-occupied housing was 0.5% y/y.

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 is expected to pick up sharply in the coming months as the furlough scheme ends in October. On the

back of this, the BoE has forecast unemployment could hit a peak of between 8% and 9%.

The US economy contracted at an annualised rate of 31.7% in Q2 2020 (Apr-Jun). The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25% but announced a change to its inflation targeting regime. The move is to a more flexible form of average targeting which will allow the central bank to maintain interest rates at low levels for an extended period to support the economy even when inflation is 'moderately' above the 2% average target, particularly given it has been below target for most of the last decade.

The European Central Bank maintained its base rate at 0% and deposit rate at -0.5%.

Financial markets: Equity markets continued their recovery, with the Dow Jones climbing to not far off its pre-crisis peak, albeit that performance being driven by a handful of technology stocks including Apple and Microsoft, with the former up 75% in 2020. The FTSE 100 and 250 have made up around half of their losses at the height of the pandemic in March. Central bank and government stimulus packages continue to support asset prices, but volatility remains.

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 5-year UK benchmark gilt yield started and ended the June–September period at -0.06% (with much volatility in between). The 10-year gilt yield also bounced around, starting at 0.21% and ending at 0.23% over the same period, while the 20-year rose from 0.56% to 0.74%. 1-month, 3-month and 12-month bid rates averaged 0.02%, 0.06% and 0.23% respectively over the period.

At the end of September, the yield on 2-year US treasuries was around 0.13% while that on 10-year treasuries was 0.69%. German bund yields remain negative across most maturities.

Credit review: Credit default swap spreads eased over most of the period but then started to tick up again through September. In the UK, the spreads between ringfenced and non-ringfenced entities remains, except for retail bank Santander UK whose CDS spread remained elevated and the highest of those we monitor at 85bps while Standard Chartered was the lowest at 41bps. The ringfenced banks are currently trading between 45 and 50bps.

After a busy second quarter of the calendar year, the subsequent period has been relatively quiet for credit changes for the names on our counterparty list. Fitch assigned a AA- deposit rating to Netherlands lender Rabobank with a negative

outlook and prior to that, while not related to our counterparty list but quite significant, revised the outlook on the US economy to Negative from Stable while also affirming its AAA rating.

There continues to remain much uncertainty around the extent of the losses banks and building societies will suffer due to the impact from the coronavirus pandemic and for the UK institutions on our list there is the added complication of the end of the Brexit transition period on 31st December and what a trade deal may or may not look like. The institutions on Arlingclose's counterparty list and recommended duration remain under constant review, but at the end of the period no changes had been made to the names on the list or the recommended maximum duration of 35 days.