Northumberland
County Council

COUNCIL

8 JANUARY 2020

Treasury Management Mid-Year Review Report for Period 1 April to 30 September 2019

Report of Alison Elsdon, Service Director - Finance

Cabinet Member: Councillor Nicholas Oliver – Portfolio Holder for Corporate Services

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1. Purpose of the Report

This report provides a mid-year review of the activities of the Treasury Management function for the period 1 April to 30 September 2019, and, performance against the Treasury Management Strategy Statement (TMSS) 2019-20 - as approved by the County Council on 20 February 2019. The report provides a review of borrowing and investment performance for the period set in the context of the general economic conditions prevailing so far during the year. It also reviews specific Treasury Management prudential indicators defined by the (CIPFA) Treasury Management Code of Practice and CIPFA Prudential Code for Capital Finance in Local Authorities, (the Prudential Code), and approved by Council in the TMSS.

2. Recommendations

It is recommended that Council receive the report and note the performance of the Treasury Management function from 1 April to 30 September 2019.

3. Link to the Corporate Plan

This report supports the “We want to be efficient, open and work for everyone” priority included in the Council’s Corporate Plan 2018-21.

4. Key Issues

The Local Government Act 2003 (the Act) and supporting regulations require the Council to produce a mid-year review of treasury management activities and actual performance against prudential and treasury indicators. This report meets the requirements of both the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management Code of Practice, (the Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities, (the Prudential Code).

The report provides a review of the Treasury Management activities for the six month period from 1 April to 30 September 2019, and sets out performance against the Treasury Management Strategy Statement for 2019-20.

TREASURY MANAGEMENT MID-YEAR REVIEW REPORT FOR THE PERIOD 1 APRIL TO 30 SEPTEMBER 2019

1. INTRODUCTION

1.1. Background

This Treasury Management mid-year report provides a review of the activities of the Treasury Management function for the period 1 April to 30 September 2019, and, performance against the Treasury Management Strategy Statement (TMSS) for 2019-20. Its production and submission to Council is a requirement of the CIPFA Code of Practice on Treasury Management.

Treasury management is defined as:

"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

1.2. Statutory and Regulatory Requirements

The Local Government Act 2003 (the Act) and supporting Regulations requires the Council to produce an annual review of treasury management activities and the actual performance against prudential and treasury indicators. This report meets the requirements of both the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management Code of Practice, (the Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities, (the Prudential Code).

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is therefore, important as it provides details of the performance of the treasury management activities and highlights compliance with the Council's policies previously approved by Members.

1.3. Basis and Content of Treasury Management Mid-Year Review Report for 2019-20

The report covers:

- Overview of the Treasury Management Strategy for the financial year 2019-20;
- Economic conditions and interest rates for period 1 April to 30 September 2019;
- Overview of the treasury position at 30 September 2019;
- Borrowing activity;
- Investment activity; and,
- Treasury management limits and prudential indicators position.

2. BACKGROUND - TREASURY MANAGEMENT STRATEGY FOR 2019-20

2.1. Overview of the 2019-20 Strategy

The expectation for interest rates within the Treasury Management Strategy Statement for 2019-20 was for UK Bank Rate (often referred to as Base Rate) to remain low but gradually increase from 0.75% to 1.00% in May 2019 and then to 1.25% around February 2020. Longer term borrowing rates were also forecast to gently rise during the year, in line with increasing bond yields.

The forecasts were however predicated on an assumption of an agreement being reached on Brexit between the UK and the EU; and with the caveat that in the event of an orderly non-agreement exit, the Bank of England would likely take action to cut the Bank Rate in order to deal with the adverse effects of such a situation, which in turn could cause short to medium term gilt yields (and therefore PWLB borrowing rates) to fall.

Against this backdrop, the proposed strategy for 2019-20 was to continue to operate with an under borrowing position - i.e. use investments in lieu of external borrowing – and to meet the remaining external borrowing requirement for the year (estimated at that time at £130 million net of maturing loans) from medium to longer term borrowing.

2.2. Compliance

The Service Director Finance confirms that, throughout the period, all treasury activities have been conducted within the parameters and limits of the TMSS 2019-20, alongside best practice suggested by the CIPFA Treasury Management Code and Central Government.

3. ECONOMIC CONDITIONS AND INTEREST RATES FOR PERIOD 1 APRIL TO 30 SEPTEMBER 2019

3.1. Economy - At 5 October 2019

The first half of 2019-20 has seen UK economic growth fall as Brexit uncertainty took a toll. In its August Inflation Report the Bank of England was notably downbeat about the outlook for both the UK and major world economies. The Monetary Policy Committee (MPC) meeting in September reemphasised their concern about the downturn in world growth and also expressed concern that the prolonged Brexit uncertainty would contribute to a build-up of spare capacity in the UK economy, especially in the context of a downturn in world growth. This mirrored investor concerns around the world which are now expecting a significant downturn or possibly even a recession in some major developed economies. It is therefore no surprise that the MPC has, so far, left Bank Rate unchanged at 0.75% throughout 2019; and it is expected to hold off on changes until there is some clarity on what is going to happen with regard to Brexit.

If the UK does soon reach an agreement with the EU on Brexit, then it is possible that growth could recover relatively quickly. At a time when there is very little spare capacity in the labour market, this could cause wage inflation to accelerate which would then feed through into general inflation. The MPC may therefore need to

address the issue of whether to raise the Bank Rate. On the other hand, if there was a no deal Brexit and there was a significant level of disruption to the economy, then growth could weaken even further and the MPC would be likely to cut the Bank Rate in order to support growth. However, with the Bank Rate still only at 0.75%, it has relatively little room to make a big impact and the MPC would probably suggest that it would be up to the Chancellor to provide help to support growth by way of a fiscal boost by e.g. tax cuts, increases in government departments and services annual expenditure budgets and expenditure on infrastructure projects, to boost the economy.

World Growth

The trade war between the US and China is a major concern to financial markets and is depressing worldwide growth, as any downturn in China will spill over into impacting countries supplying raw materials to China. Concerns about a general weakening of growth in the major economies of the world are being compounded by fears that there could even be a recession looming in the US; although there are some suggestions this could be overblown. These concerns have resulted in government bond yields in the developed world falling significantly during 2019. The latest Purchasing Managers Index (PMI) survey statistics of economic health for the US, UK, EU and China have all been low which gives a forward indication of a downturn in growth; this confirms investor sentiment that the outlook for growth during the rest of this financial year is weak.

Bond/Gilt Yields and PWLB Rates

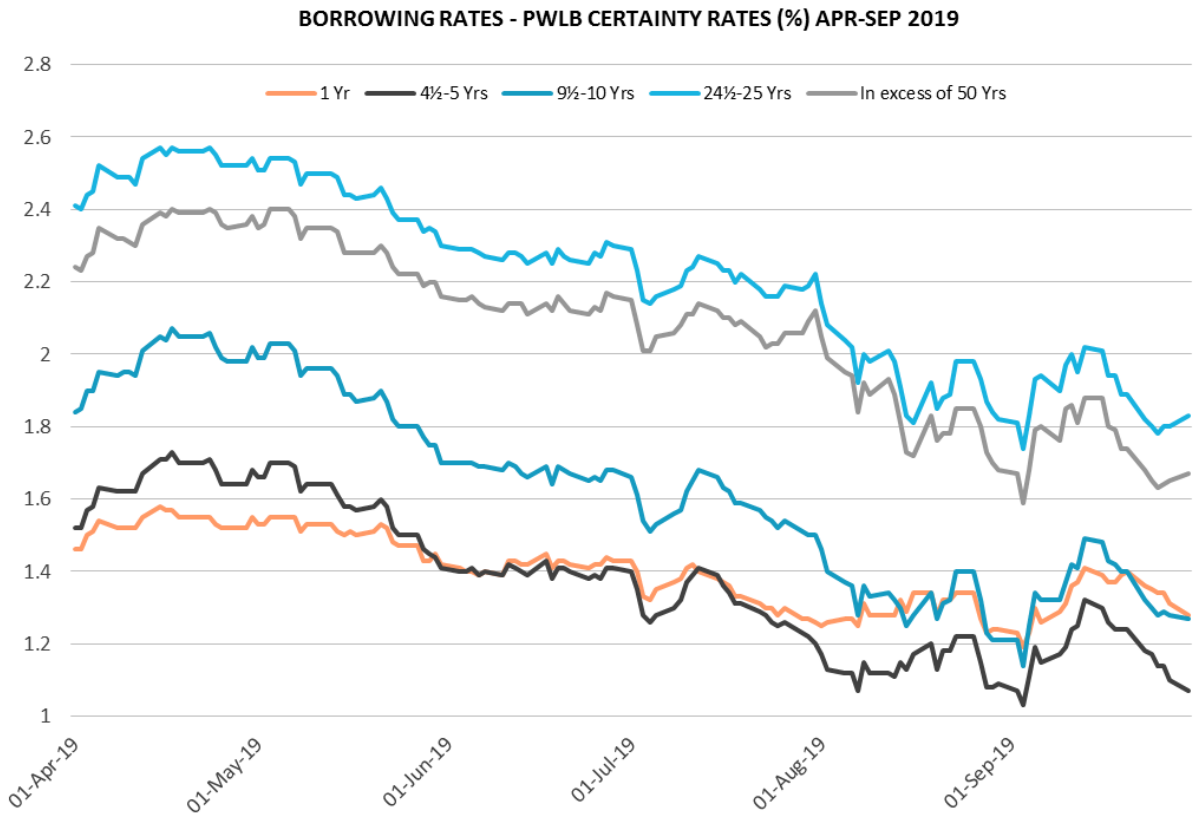
There has been much speculation recently that we are currently in a bond market bubble – where bonds are trading above their true worth (fuelled by a belief that no matter how high prices go, someone is likely to pay an even higher price), and that, eventually, this must come to an end. However, given the context that there are heightened expectations the US could be heading for a recession, and a general background of a downturn in world economic growth, together with inflation generally at low levels in most countries and expected to remain subdued, conditions are ripe for low bond yields. While inflation targeting by the major central banks has been successful over the last thirty years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers. This means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. This has pulled down the overall level of interest rates and bond yields in financial markets over the last thirty years. Over the last year we have seen many bond yields up to ten years in the Eurozone actually turn negative. In addition, there has at times been an inversion of bond yields in the US whereby ten year yields have fallen below shorter term yields. In the past, this has been a precursor to a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities. However, stock markets are also currently at high levels as some investors have focused on chasing returns in the context of dismal ultra-low interest rates on cash deposits.

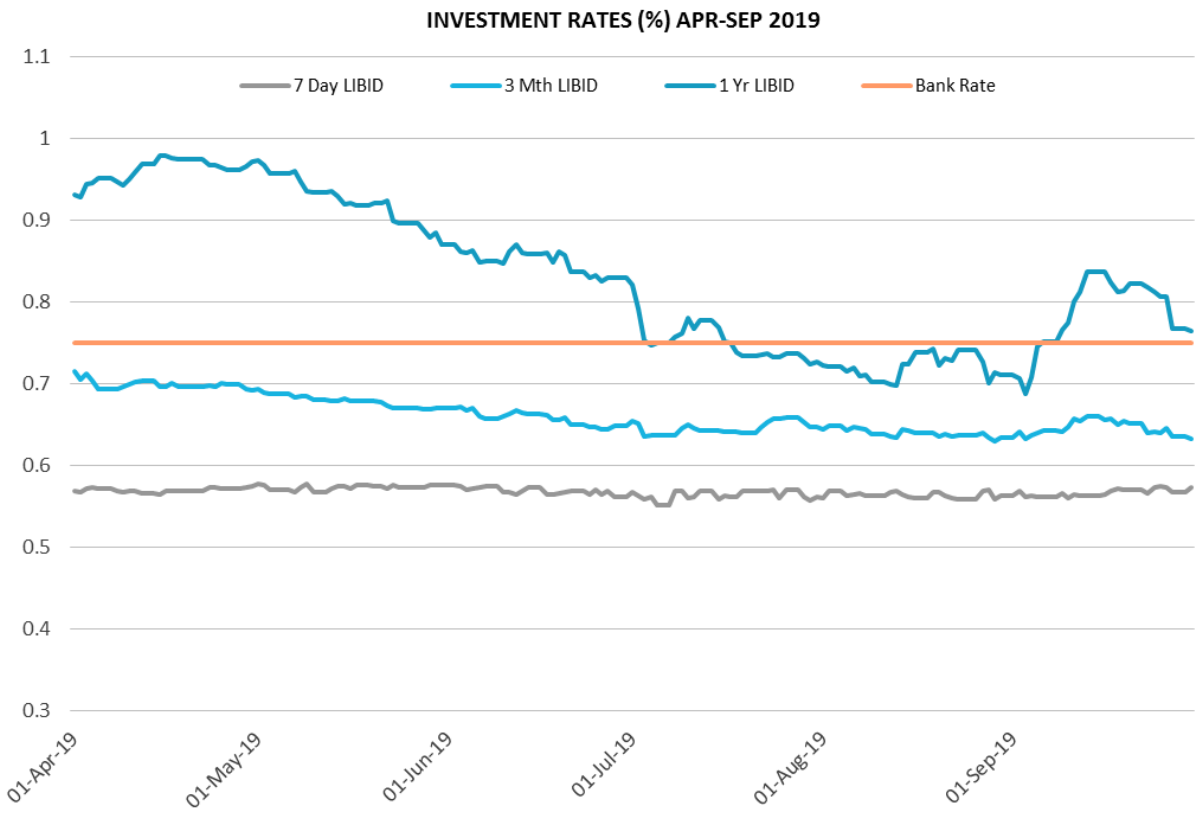
In line with bond yield movements, during the last half year there has been a near halving of longer term PWLB rates to completely unprecedented historic low levels. There is however a feeling that financial markets may have gone too far in their fears about the degree of the downturn in US and world growth. If the US only suffers a mild downturn in growth, bond markets in the US are likely to sell off and that would be expected to put upward pressure on bond yields - not only in the US but, due to a correlation between US treasuries and UK gilts, also in the UK. However, forecasting the timing of this and how strong the correlation is likely to be is very difficult to forecast with any degree of confidence.

Entirely unexpectedly, on 9 October 2019 HM Treasury announced that it was, with immediate effect, increasing the margin it charges between gilts yields and PWLB borrowing rates by 100 basis points (1%). This means that all future new PWLB borrowing will be significantly more expensive than before. As a result, beyond 2019-20, the Council will need to reassess how to finance its external borrowing needs. At the current time, this is a developmental area as this event has also taken the financial services industry by surprise. There is an expectation that other financial institutions will enter the market or make products available to local authorities. Members will be updated as this area evolves.

3.2. Actual Interest Rates 1 April to 30 September 2019

The following graphs show interest rate movements over the period, for various terms of borrowing and investment:





3.3. Forecast Interest Rates

The Council's treasury advisor, Link Asset Services, interest forecast is shown below:

	Quarter 3 2019-20 (Q/E Dec 2019)	Quarter 4 2019-20 (Q/E Mar 2020)	Quarter 1 2020-21 (Q/E Jun 2020)	Quarter 2 2020-21 (Q/E Sep 2020)
Bank Rate	0.75%	0.75%	0.75%	0.75%
5yr PWLB	2.30%	2.50%	2.60%	2.70%
10yr PWLB	2.60%	2.80%	2.90%	3.00%
25yr PWLB	3.30%	3.40%	3.50%	3.60%
50yr PWLB	3.20%	3.20%	3.40%	3.50%

This was accompanied with the following comments:

"In order to make any forecast we have, as previously mentioned, had to make one central assumption – a reasonable muddle through outcome for Brexit. If the facts change, our forecasts will also change. As events unfold it is possible we may see 50bps movement in rates and yields at any time e.g. a hard Brexit could result in an immediate 50 bps cut in Bank Rate. But that is not our central assumption.

The general situation is for volatility in bond yields to endure as investor fears and confidence ebb and flow between favouring relatively more "risky" assets i.e. equities, or the "safe haven" of government bonds. The overall longer run trend is for gilt yields

and PWLB rates to rise, albeit gently, although there are likely to also be periods of sharp volatility from time to time.

Our forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU, (apart from the departure of the UK), within our forecasting time period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and China / North Korea and Iran, which have a major impact on international trade and world GDP growth. However, the current round of increases in tariff rates sparked by President Trump, both actual and threatened, are causing on-going concern around the potential impact on world growth and also on inflationary pressures."

4. THE PORTFOLIO POSITION AT 30 SEPTEMBER 2019

4.1. Current Borrowing

The Council's debt at the beginning of the year and at 30 September 2019 is shown below:

TABLE 1: BORROWING	Total Principal 1 Apr 2019 £m	Weighted Average Rate %	Total Principal 30 Sep 2019 £m	Weighted Average Rate %
Public Works Loan Board Loans	351.872	3.07	462.608	2.70
LOBOs	176.500	3.95	176.500	3.95
Market / Local Authority (>1yr)*	181.100	2.18	181.100	2.18
Market / Local Authority (<1yr)*	22.000	0.95	2.000	1.10
Salix	0.050	0.00	0.043	0.00
TOTAL EXTERNAL BORROWING	**731.522**	**3.00**	**822.251**	**2.85**

* Note: above figures are based on the term of loans at their inception

4.2. Current Investments

The table below summarises the investment position at 30 September 2019:

TABLE 2: INVESTMENTS	Total Outstanding 1 Apr 2019 £m	Weighted Average Rate %	Total Outstanding 30 Sep 2019 £m	Weighted Average Rate %
Fixed Term Investments – Long Term (>1yr)*	33.250	3.24	33.250	3.24
Fixed Term Investments – Short Term (<1yr)*	0.000	0.00	92.000	0.79
Money Market Funds and Call Accounts	62.750	0.83	73.600	0.86
TOTAL INVESTMENTS (excl. Cash)	**96.000**	**1.66**	**198.850**	**1.23**

* Note: above figures are based on the term of investments at their inception

5. BORROWING ACTIVITY 2019-20

Given the dramatic falls in interest rates, and consequently the opportunity to lock into some longer term certainty at lower than expected levels, the majority of the forecast borrowing requirement for the year was secured between May and September 2019. This action was further justified given the increase in PWLB borrowing costs announced on 9 October 2019.

As shown in the above table, total external borrowing has increased by £90.729 million, from £731.522 million at the start of year to £822.251 million at 30 September 2019. This is as a result of maturing loans of £39.271 million and new / replacement borrowing of £130.000 million.

The new borrowing in the period was taken in 7 tranches, all with the Public Works Loan Board (PWLB), made up of 15 loans over various maturity periods between 7 and 50 years. The loans have a combined weighted average term of 17.5 years and an overall average interest rate of 1.76%. As well as reducing the overall average rate on all outstanding loans down to 2.85% at 30 September 2019, the new loans have led to an improvement in the maturity risk profile of the portfolio by reducing some of the previous gaps in the 10 to 40 year range.

A recent review of the 2019-20 capital programme has identified that a considerable proportion of the original budgeted capital expenditure will not now be spent until later years (see 7.1 below). As a result, no further borrowing is anticipated to be required between now and the financial year-end; at which point overall borrowing is projected to total £783.981 million (due to further maturities over the next 6 months of £38.270 million).

The reduced need to borrow, combined with the lower than expected interest rates are anticipated to generate an overall saving of around £0.904 million when compared to the original interest payable budget for 2019-20 of £23.584 million.

6. INVESTMENT ACTIVITY 2019-20

The Council's investment policy (as set out in the Treasury Management Strategy Statement for 2019-20) is governed by the Communities and Local Government's Guidance on Local Government Investments ("the Guidance") and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies (Moody's, Fitch Group and Standard and Poor's), supplemented by additional market data, (such as rating outlooks, credit default swaps, bank share prices etc.).

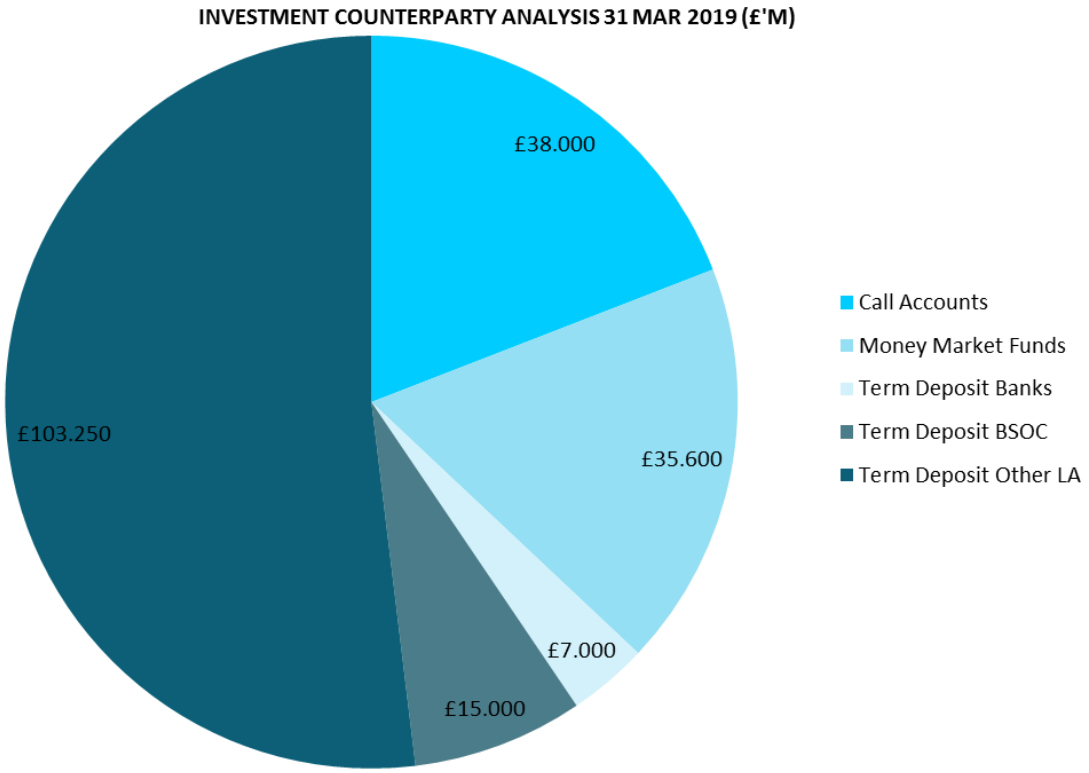
All investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

As identified above, the current policy is to use a significant proportion of available investment balances as 'internal borrowing' to support the financing of the Capital Financing Requirement (CFR).

Overall external investments (excluding cash) increased during the first six months of the year from £96.000 million to £198.850 million. This is in the main because of the borrowing that has been taken in advance of it being used later in the year, as well as other cash flow variances (i.e. the timing differences between income coming in and expenditure being incurred).

Based on the forecast revised capital spend for the year, investment balances are anticipated to reduce to around £75.000 million by 31 March 2020.

An analysis of the mid-year investment balance (excluding cash) by counterparty is shown in the following chart:



The internally managed funds earned an overall average rate of return of 1.34% during the first 6 months of 2019-20. This is mainly due to the (longer term) investments with other LA's, but nonetheless compares favourably against the average London Interbank Bid Rate (LIBID) benchmark indicators of:

- 7 Day - 0.57%
- 3 Month - 0.66%
- 1 Year – 0.83%

The Council's budgeted investment return for 2019-20 is £1.551 million (excluding interest of loans to thirds parties). Based on the current position and forecasts for the remainder of the year, it is estimated the actual interest earned will be around £0.159 million in excess of budget, at £1.710 million.

The improved performance is mainly due to higher than estimated level of balances in the early part of year, as well as higher than forecast interest rates.

The above figures are exclusive of interest received on loans from third parties, such as the facilities to Advance Northumberland and Northumbria Healthcare Trust etc. These loans are made for policy/service reasons, and not day-to-day treasury undertakings in relation to the investment of cash flows.

7. PRUDENTIAL INDICATORS AND TREASURY LIMITS 2019-20

The Prudential Code has been developed by CIPFA. The Code has a central role in capital finance decisions, including borrowing for capital investment. Its key objectives are to provide a framework for local authority finance that will ensure individual authorities' capital expenditure plans are affordable; all external borrowing is within prudent and sustainable levels; and, that treasury management decisions are taken in accordance with good professional practice.

Performance against the approved prudential indicators, as set out in the 2019-20 Treasury Management Strategy Statement, is outlined below. None of the indicators have been exceeded during the year to 30 September 2019.

7.1. Capital Expenditure

This table shows the original approved capital programme (as agreed as part of the MTFP), current expenditure and forecast outturn for the year:

Capital Expenditure	2019-20 Original Estimate £m	Position 30 Sept 2019 £m	2019-20 Forecast Outturn £m
Adult Social Care & Commissioning	4.320	0.611	2.286
Chief Executive's	1.000	0.100	0.931
Children's Services	40.020	15.887	35.854
Finance	50.563	7.438	50.480
Human Resources & OD	2.000	1.303	2.231
Place	61.103	27.143	58.328
TOTAL EXPENDITURE	**159.006**	**52.482**	**150.110**

7.2. Authorised Limit and Operational Boundary

The authorised limit - is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level.

The operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

The table below demonstrates that during 2019-20 the Council has maintained gross borrowing within its authorised limit and operational Boundary.

	Authorised Limit for External Debt £m	Operational Boundary for External Debt £m	Actual 30 September 2019 £m
Borrowing	1,022.338	851.948	822.251
Other Long Term Liabilities (PFI)	84.757	70.631	70.476
TOTAL EXTERNAL DEBT	**1,107.095**	**922.579**	**892.727**

7.3. Limits to Borrowing Activity

One of the key controls over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of Capital Financing Requirement (CFR) [i.e. the underlying need to borrow] in the preceding year plus the estimates of any additional CFR for 2019-20 and next two financial years.

CFR vs Borrowing	2019-20 Original Estimate £m	Position at 30 Sept 2019 £m	2019-20 Forecast Outturn £m
Borrowing	813.981	822.251	783.981
Other Long Term Liabilities (PFI)	67.298	70.476	68.792
TOTAL EXTERNAL DEBT	**881.279**	**892.727**	**852.773**
CFR	**1,043.557**	**N/A**	**1,015.494**

The Service Director Finance reports that no difficulties are envisaged for the current or future years in complying with this indicator.

The purpose of the following limit is to restrain the activity of the treasury function within certain limits; thereby managing risk; and, reducing the impact of any adverse movement in interest rates.

Interest Rate Exposure	Limit for 2019-20	Actual 30 Sep 2019
Fixed Rate Exposure	0% - 100%	89.18%
Variable Rate Exposure	0% - 50%	10.82%

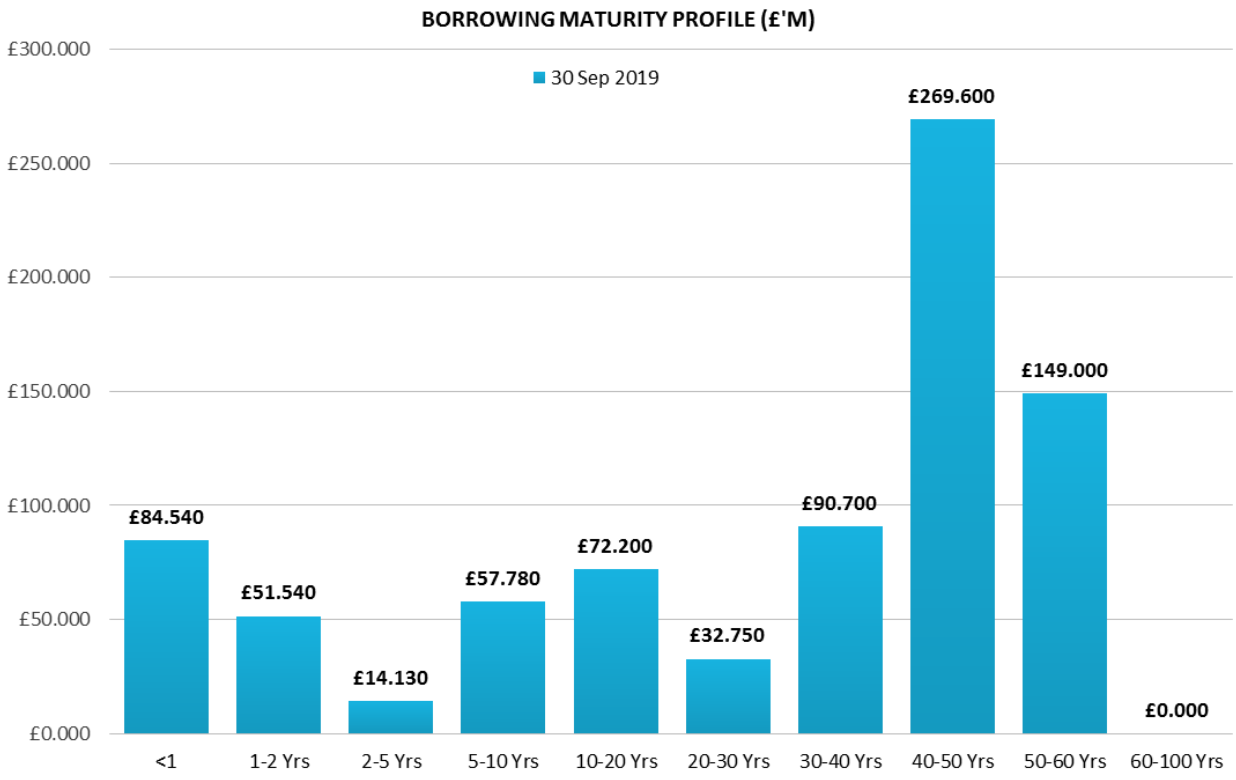
Lender option, borrower option loans (LOBOs) callable within 12 months are classed as variable; if the rate is fixed for a longer period they are classed as fixed. At 30 September 2019 the total of variable rate loans was £89.000 million and is within the set limit.

7.4. Maturity Structure of Borrowing

Measuring maturity structure of borrowing ensures a reasonable spread of maturing debt as a safety mechanism to ensure significant amounts of debt do not mature at a time when interest rates for refinancing the debt may be high.

Maturity Structure	Upper Limit for 2019-20	Actual 30 Sep 2019
Under 12 months	25%	10%
1 year - 2 years	40%	6%
2 years within 5 years	60%	2%
5 years within 10 years	80%	7%
10 years and above	100%	75%

The following graph shows maturity of loans by monetary value. LOBOs are shown as held to maturity. In the current climate it is not envisaged that loans would be called for repayment within the next 12 months, as rates are so low.



7.5. Investments for periods longer than 365 days

These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

	Limit 2019-2020 £m	Actual Highest £m	Actual 30 Sept 2019 £m
Principal sums invested > 364 days	120.000	33.250	33.250

8. Update on Treasury Management Annual Report for the Financial Year 2018-19

At the time of writing the Annual Report for 2018-19, comparison data for other local authorities from CIPFA's benchmarking club was not available.

The data has since been published and officers can confirm the authority's borrowing and investment rates compare favourably with those of other local authorities:

	NCC	Other LA Average	NCC Rank
Borrowing – average interest rate paid for 2018-19	2.97%	2.98%	3rd lowest (out of 13)
Investments – average interest rate received for 2018-19	1.39%	1.19%	4th highest (out of 17)

Implications

Policy	The report provides a half-year review of the Treasury Management activities for 2019-20, and sets out performance against the Treasury Management Strategy Statement for 2019-20. It is consistent with "We want to be efficient, open and work for everyone" priority included in the Council's Corporate Plan 2018-21.
Finance and value for money	The financial implications of the 2019-20 investment and borrowing transactions have been taken into account within the revenue budget for 2019-20. Northumberland County Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving best value in treasury management within the context of effective risk management, and to employing suitable performance measurement techniques, for example comparison with other members of the CIPFA and Capita benchmarking clubs.
Legal	Under Section 1 of the Local Government Act 2003 (the Act) the Council may borrow money for any purpose relevant to its functions under any enactment, or for the purpose of the prudent management of its financial affairs. The Act and supporting regulations also requires the Council to 'have regard to' the Chartered Institute of Public Finance and Accountancy (CIPFA) Prudential Code and the CIPFA Treasury Management Code of Practice (which were adopted by Northumberland County Council in February 2010).
Procurement	There are no direct procurement implications for the County Council.
Human Resources	There are no direct staffing implications for the County Council.
Property	There are no direct property implications for the County Council.
Equalities	There are no direct equalities implications for the County Council.
(Impact Assessment attached) Yes ☐ No ☐ N/A ☐	

Risk Assessment	The report highlights the principal financial risks within the Treasury Management function. The identification, monitoring and control of risk are the prime criteria by which the effectiveness of the County Council's Treasury Management activities will be measured. Accordingly, the analysis and reporting of Treasury Management activities will focus on their risk implications for the Council. The investment priority is security and liquidity rather than yield, which is a secondary aim.
Crime & Disorder	There are no Crime and Disorder implications for the County Council.
Customer Consideration	There are no Customer Considerations for the County Council.
Carbon reduction	There are no carbon reduction implications for the County Council.
Health & Wellbeing	There are no health and wellbeing implications for the County Council.
Wards	All divisions.

Background Papers:

Treasury Management Strategy Statement for 2019-20 – County Council 20 February 2019;

CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance notes (revised 2011);

CIPFA Prudential Code for Capital Finance in Local Authorities;

Guidance on Local Government Investments The Local Government Act 2003; and

Local Authorities (Capital Finance and Accounting) Regulations 2012 (S.I.2012/265)

Report sign off:

Authors must ensure that officers and members have agreed the content of the report:

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Monitoring Officer/Legal	Liam Henry
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Council, 8 January 2020