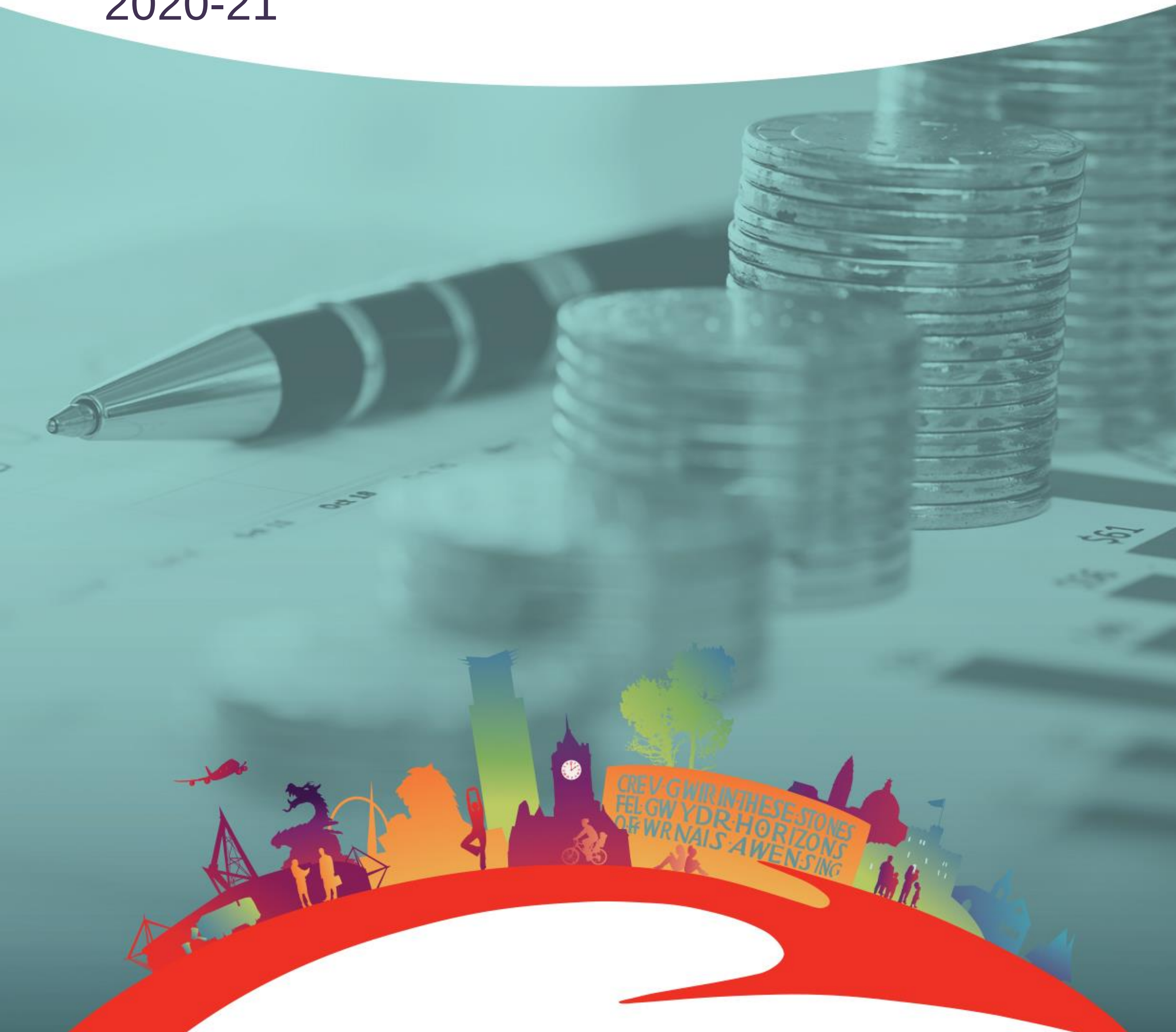
Appendix 1

Treasury Management Mid-Year Report

2020-21



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Introduction

1.1 Treasury management activities are the management of an organisation's borrowing, 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 The Council carries out its treasury management activities in accordance with a Treasury Management Code of Practice for public services, updated by CIPFA in 2017. This requires the Council to set out the policies and objectives of its treasury management activities and adopt four Clauses of Treasury Management (replicated in **Annexe A**).

1.3 Council received a report in February 2020 on the Council's Treasury Management and Capital Strategy for 2020/21. During 2020/21, Audit Committee has received periodic updates on the position and performance of treasury management and the issues included in the report below. In addition Council received in October 2020 the Annual Outturn Report for treasury management for 2019/20.

1.4 In accordance with Council policy, this report provides members with a mid-year update as at 30 September 2020 and covers:-

- the economic background to treasury activities
- investments
- borrowing
- debt rescheduling
- compliance with treasury limits and prudential indicators
- Treasury Strategy update for remainder of the year.

1.5 Annexe E includes a glossary which defines key terms used in this report.

Economic Background

2.1 The coronavirus outbreak has resulted in huge economic damage to the UK and economies around the world. As a result of Covid 19, the fall in UK growth for the first half of the year as measured by Gross Domestic Product (GDP) was 22%. Equity markets initially fell, but over the last few months have recovered some of those losses. Unemployment is expected to continue to increase as furlough ends, with inflation impacts currently projected to be minimal and only above its 2% target in 2023. Bank of England Base rate was reduced to 0.10 % and whilst the Bank initially quashed the idea of negative interest rates, this remains an option if deemed a useful tool to stimulate the economy. In the short term however the Bank has agreed to increase its quantitative easing programme from £745 billion, by a further £150 billion, but also acknowledged the difficulty in medium term forecasting as a result of the impact of second waves of the virus, longer term adjustments impacting on certain sectors of the economy, consumer caution in spending and also the uncertain impact of UK/EU trade negotiations. Indications overall suggest the pace of recovery will not be a rapid V shape, but a more elongated and prolonged one.

2.2 With these factors in mind, the table below shows the Council's treasury management advisors latest forecast for bank rate and Public Works Loan Board (PWLB) borrowing rates, based on their current lending policy. No increase in Bank Rate is expected within the forecast horizon ending on 31st March 2023 as economic recovery is expected to be only gradual and, therefore, prolonged.

	Actual 30/09/2020	March 2021	March 2022	March 2023
Bank Rate	0.10%	0.10%	0.10%	0.10%
5yr PWLB rate	1.74%	2.00%	2.00%	2.10%
10yr PWLB rate	2.02%	2.10%	2.20%	2.30%
25yr PWLB rate	2.56%	2.50%	2.60%	2.70%
50yr PWLB rate	2.40%	2.30%	2.40%	2.50%

2.3 PWLB rates are based on gilt (UK Government bonds) yields, however HM Treasury determine a specified margin to add to gilt yields for any local authority borrowing. UK Government Bond yields were on a falling trend during 2019/20 and for periods up to 10 years have fallen to unprecedented lows with negative yields in the shorter periods.

2.4 From the local authority borrowing perspective, HM Treasury imposed two changes of margins over gilt yields for PWLB rates in 2019/20 without any prior warning. The first took place on 9 October 2019, adding an additional 1% margin over gilts to all PWLB period rates. That increase was then at least partially reversed for borrowing in relation to housing on 11 March 2020, but not for mainstream General Fund capital schemes. It also announced and undertook a consultation, on possibly further amending these margins, which closed on 31 July 2020. Revised lending policies are expected to be announced by the end of the financial year, however what appears clear is that HM Treasury will no longer allow local authorities to borrow money from the PWLB to purchase commercial investments if the aim is solely to generate an income stream (assets for yield).

2.5 Having met eligibility requirements of the PWLB, the Council is entitled to undertake borrowing at a 'certainty rate', i.e. a discount of 0.20% from PWLB 'standard rates'. Following the changes on 11 March 2020 in margins over gilt yields, the current PWLB borrowing policy that would apply for Cardiff is as follows:

- PWLB Certainty Rate is gilt plus 180 basis points
- PWLB HRA Certainty Rate is gilt plus 80bps

2.6 The PWLB rate forecasts in the above table are based on the non HRA certainty rate (Gilts + 180 basis points) and shows that there is likely to be little upward movement in PWLB rates over the next two years as it will take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down period. This is against a background of increasing national debt, which would normally result in increasing rates for borrowing.

Investment

3.1 The management of the Council's cash flows may involve temporary lending of surplus funds to low risk counterparties or temporary borrowing pending receipt of income.

3.2 The Council's investment priorities remain the security and then liquidity of its Treasury investments. The Council also aims to achieve the optimum return appropriate to these priorities.

3.3 The Council invests with financial institutions in accordance with criteria approved in its Treasury Strategy. The categories, names, periods and size limits on this list can be extended, varied or restricted at any time by the Corporate Director Resources under delegated powers. Based primarily on Fitch credit criteria and a number of other factors which the Council takes into account, lending to these institutions is subject to time and size limits and credit worthiness continues to be carefully monitored.

3.4 There have been no changes made or required to be made to the list of eligible counterparties included as part of the 2020/21 Treasury Management Strategy approved by Council, but these will continue to be reviewed using data from Treasury advisors and will be updated in the 2021/22 Strategy. Although the credit rating agencies changed their outlook on many UK banks from stable to negative outlook during the quarter ended 30 June 2020 due to upcoming risks to banks' earnings and asset quality during the economic downturn caused by the pandemic, the majority of ratings were affirmed due to the continuing strong credit profiles of UK banks.

3.5 Following the introduction of The Markets in Financial Instruments Directive (MiFID) in January 2018, the Council opts to be classified as a professional client rather than a retail client by financial institutions.

3.6 Investments returns are likely to remain negligible during 2020 and in many cases market rates on deposits are currently negative for shorter periods. It is now impossible to earn the level of interest rates on deposits commonly seen in previous decades as all investment rates are barely above zero now that Bank Rate is at 0.10%. Given this risk environment and the fact that increases in Bank Rate are unlikely to occur before the end of the current 31 March 2023, investment returns are expected to remain low. The approach of deferring external borrowing by using temporary cash balances will continue to be used as part of the strategy.

3.7 At the 30 September 2020, investments stood at £165.8 million. These temporary funds fluctuate daily and arise for a number of reasons, including the timing differences between the receipt of grant and other income and the utilisation of these funds on salaries and other operating costs. They also include the level of reserves, provisions, and other balances. It is also affected by the timing of borrowing and capital expenditure transactions. The annual Outturn report for 2019/20, set out some of the reasons for higher temporary cash balances in the first half of the year such as receipt of grant funding from central government in advance as a result of Covid 19. **Annexe B** shows with whom these investments were held as at 30 September 2020. All investments are deemed recoverable.

3.8 A selection of performance indicators and benchmarking charts, is included in **Annexe C** as follows:-

- **Counterparty exposure** displays actual investment against the maximum permitted directly with an organisation. This demonstrates that we are not exceeding any exposure limits. As a response to the Covid crises, the Council activated use of the HM Treasury's Debt Management Office account in order to support the treasury team to manage the level of funds and to mitigate against counterparty risk. Options for reducing the use of the account will continue to be considered in the latter half of the year particularly to avoid any negative rates.
- **Remaining maturity profile of investments**. This shows the duration of investments over time. The Council will take advantage of longer term rates where reasonable to do so.
- **Investments by institution.** This expresses the investments held with different institutions as a percentage of the total and shows diversification is sought where possible.
- **Geographic spread of investments** as determined by the country of origin of relevant organisations. All countries are rated AA and above as per our approved criteria and are licensed to take UK deposits. Investments are in Sterling only.
- **Investments by Financial Sector.** The majority of investments continue to be with banks.

3.9 Whilst a difficult figure to forecast due to the uncertainty of the markets, cash flows and the number of variables that impact on the figure, the forecast level of interest receivable from treasury investments for 2020/21 is £380,000. The return achieved since the start of the year is 0.27% compared to the average of the benchmark rate since the 1st April for the 7 day London Interbank Bid Rate (LIBID) of -0.05% and 3 month LIBID 0.11%. This positive performance is primarily as a result of deposits placed at higher rates prior to the reduction in investment deposit rates.

Borrowing

4.1 Long term borrowing is undertaken to finance the Council's Capital Programme and the main sources of borrowing currently are the PWLB and the Money Markets. The Council does not separate General Fund and

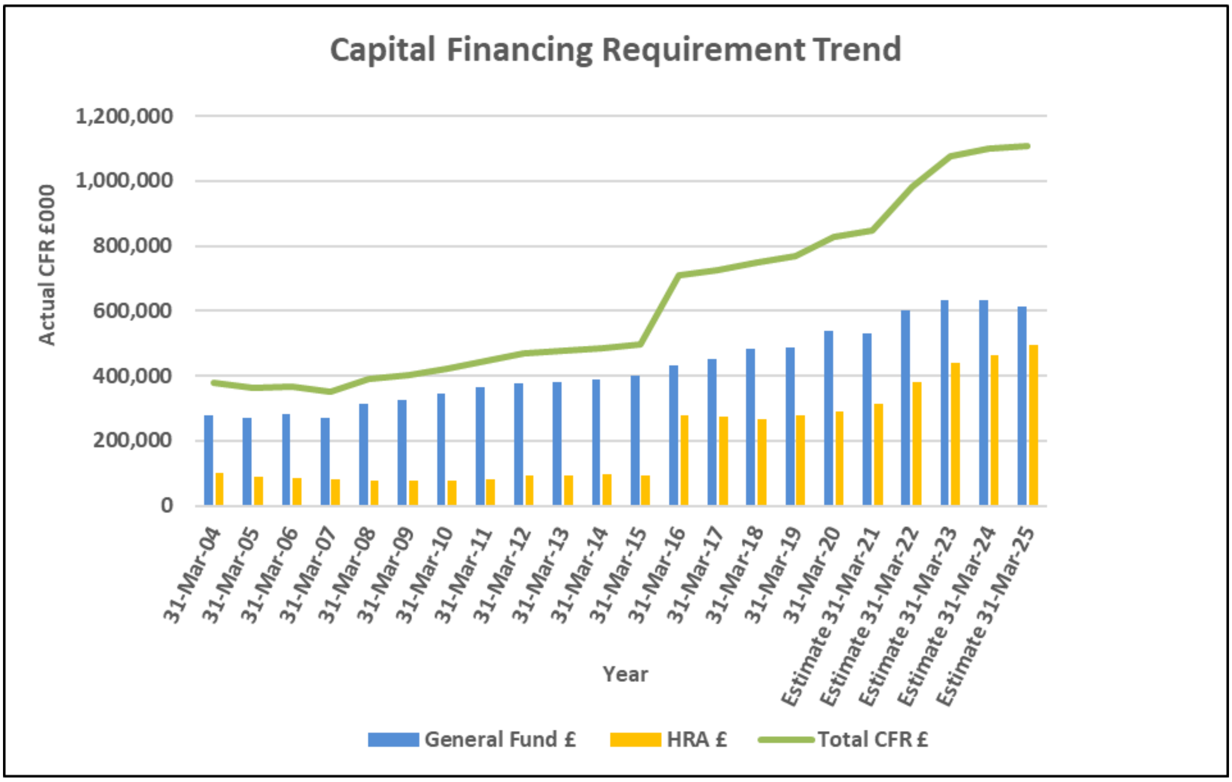
Housing Revenue Account borrowing as all borrowing is the liability of the Council i.e. borrowing is ‘pooled’.

4.2 Where capital expenditure has been incurred without a resource to pay for it i.e. when proposed to be paid for by supported or unsupported borrowing, this will increase what is termed the Council’s Capital Financing Requirement (CFR) which is the Council’s underlying need to borrow. The Council is required to make a prudent provision for the repayment of historic capital expenditure from its revenue budget in line with its agreed policy. This reduces the CFR and the policy in respect to provision in relation to supported borrowing was changed in the 2020/21 budget and applied retrospectively to the 2019/20 financial year. Calculation of the CFR is summarised in the table below and results in the need to borrow money.

Movement	**Opening Capital Financing Requirement (CFR)**
+	Capital expenditure incurred in year
-	Grants, contributions, reserves and receipts used for capital expenditure
-	Prudent Minimum Revenue Provision and Voluntary Repayment
=	**Closing Capital Financing Requirement (CFR)**

4.3 The CFR forecast is subject to the timing of capital expenditure, capital receipts and new schemes that may be considered for approval in future years. It can be seen that the Council’s underlying need to borrow is increasing and will need to be repaid from future revenue budgets either from savings, revenue income or Council Tax and Housing Rents.

4.4 The historic trend in the CFR is shown in the chart below, with the increase in 2015/16 reflecting the Housing Revenue Account subsidy buyout. Increases in the Capital Financing requirement for future years reflect assumptions made in the 2020/21 budget and to be updated in the budget report of February 2021 and include investment in the delivery of new affordable housing.



4.5 At 30 September 2020, the Council had £828.2 million of external borrowing predominantly made up of fixed interest rate borrowing payable on maturity.

31 March 2020			30 September 2020	
£m	**Rate (%)**		**£m**	**Rate (%)**
698.9		Public Works Loan Board	698.9	
51.0		Market (Lender Option Borrower Option)	51.0	
16.1		Welsh Government	16.1	
58.3		Local Authorities	58.3	
4.5		Other	3.9	
828.8	**4.11**	**Total External Debt**	**828.2**	**4.11**

The estimated total interest payable on borrowing for 2020/21 is £34.1 million which includes interest payable by the Housing Revenue Account.

<u>New borrowing undertaken during the first half of the year</u>

4.6 No new borrowing has been taken in the period to 30 September 2020.

Maturing Loans in year to date

4.7 **Annexe D** shows the maturity profile of the Council's borrowing as at 30 September 2020. Loans of £0.6 million have been repaid in the first half of this year, a further £20.7 million is due to be repaid by 31 March 2021.

4.8 (LOBO) products are loans to the Council where the lender can request a change in the rate of interest payable by the Council on pre-determined dates. The Council at this point has the option to repay the loan without penalty.

4.9 The Council has six such loans totalling £51 million. Apart from the option to increase rates, these loans are comparable to PWLB and have no other complications such as variation in interest rates or complex terms.

4.10 Interest rates on these loans range between 3.81% and 4.35% which are not unreasonable and are below the Council's average rate of interest payable. Details of the loans are shown in the table below.

£m	Rate	Potential Repayment Date	Option Frequency	Full Term Maturity
6	4.28%	21/11/2020	6 months	21/11/2041
6	4.35%	21/11/2020	6 months	21/11/2041
6	4.06%	21/11/2020	6 months	23/05/2067
6	4.08%	01/03/2020	6 months	23/05/2067
22	3.81%	21/11/2020	5 years	23/11/2065
5	4.10%	16/01/2023	5 years	17/01/2078

4.11 LOBO's to the value of £24 million are subject to the lender potentially requesting a change in the rate of interest payable every six months. A further £22 million has an option during this financial year, which could trigger early repayment. This is deemed unlikely and any risk is a manageable refinancing risk as LOBOs in total, form a relatively low proportion of the Council's overall borrowing at 6.16%.

Borrowing Strategy

4.12 As shown in the interest rate forecasts set out earlier in this report, borrowing rates are higher than investment rates which means that the cost of undertaking new borrowing would have a negative impact on the revenue budget. External borrowing may be deferred in order to minimise short term costs by using temporary cash balances to meet the Capital Financing Requirement rather than placing in an investment. This is termed 'internal borrowing'. However deferring borrowing is only a short term measure and could expose the Council to higher borrowing rates and costs in the future. The Council has taken an approach of regularly undertaking external borrowing for an element of any borrowing requirement to mitigate any such risk.

4.13 If no further borrowing is undertaken, the value of external loans at 31 March 2021 will be £808 million. At the same point, the Council's need to borrow for capital expenditure purposes, its Capital Financing Requirement (CFR), is currently forecast to be circa £852 million (General Fund £538 million and HRA £314 million). The Council will consider options in respect to any maturing loans in the last quarter of the financial year. Without any further borrowing this financial year internal borrowing would be £44 million.

4.14 The Council is also considering a number of projects that involve the Welsh Government providing interest free loans to the Council to undertake specified projects such as town centre loans and energy projects. Welsh Government take no risk in such projects and expect all loans to be repaid. Where the Council is taking on specific loans for the delivery of specified projects, robust business case processes and legal charges if appropriate should be in place to ensure any loans can be repaid following implementation of projects.

Debt Rescheduling

5.1 No debt rescheduling or early repayment of debt has been undertaken to date in 2020/21. The main obstacle remains the level of premium (penalty) that would be chargeable on early repayment by the PWLB. Of the existing PWLB loans of £699 million, £664 million are eligible for early repayment. However this would incur a premium of £625 million as at 30 September 2020. This premium is payable primarily because:

- Interest rates on loans of equivalent maturities compared to those held are currently lower
- A penalty rate or lower early repayment rate was introduced by HM Treasury in November 2007, which increased the cost of premiums and reduced the flexibility of Local Authorities to make savings. This remains an obstacle in the ability of local authorities to manage debt more effectively.

5.2 Whilst the cost of Premiums can be spread over future years, options for restructuring that have been considered result in an adverse Net Present Value (NPV). Whilst there may have been short terms savings, these were outweighed by potentially longer term costs and not deemed cost effective.

Compliance with treasury limits and prudential indicators

6.1 During the financial year to date, the Council has operated within the treasury limits and prudential indicators set out in the annual Treasury Management Strategy in February 2020. The treasury and capital prudential indicators will be updated as part of the 2021/22 Capital and Treasury Strategies in the Budget Report to Council in February 2021. Affordability of additional investment will need to be monitored closely as part of the Treasury Strategy and HRA Business Planning process.

Treasury strategy for the remainder of 2020/21

7.1 The Treasury Strategy approved in February 2020 remains valid despite the impact of Covid-19 and continued uncertainty in financial markets. The 7 day and 3 month LIBID investment rates are currently negative and the likelihood is they may remain so for a significant period. The use of temporary cash balances instead of borrowing to pay for capital expenditure continues will continue to result in short term savings, however with the outcome of the consultation on PWLB lending policy being unknown, consideration will need to be given to understanding the merits of alternative borrowing options such as bonds in meeting and diversifying the Council's borrowing requirement for the capital programme and major projects.

7.2 The Council will continue to look for good quality investment counterparties, where the focus remains security, liquidity and risk in that order, whilst trying avoid negative interest rates where possible. In addition, LIBOR which is used to derive LIBID will be phased out in 2021, so options will need to be considered to change the Investment Benchmark. These impact of these issues will be considered in the Treasury Management Strategy report to Council in February 2021.

<u>Annexes</u>

Annexe A – Treasury Management Policy and Four Clauses of Treasury Management
Annexe B – Investments at 30 September 2020
Annexe C – Investment Charts at 30 September 2020
Annexe D – Maturity Analysis of Borrowing as at 30 September 2020
Annexe E – Glossary of Treasury Management terms