# Treasury Management Performance Report 2019/20

## Introduction

In February 2011 the council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the council to approve treasury management semi-annual and annual reports.

The council's treasury management strategy for 2019/20 was approved at the audit committee meeting on 18 February 2019. 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.

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.

The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full council covering capital expenditure and financing, treasury management and non-treasury investments. The council's Capital Strategy, complying with CIPFA's requirement, was approved by full council on 27 February 2019.

## External Context (provided by Arlingclose Limited)

**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 29 March 2019 Brexit deadline was extended to 12 April, then to 31 October and finally to 31 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% year/year in February, below the Bank of England's target of 2%. Labour market data remained positive. The International Labour Organisation (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 the fourth quarter of 2019 was reported as flat by the Office for National Statistics and service sector growth slowed whilst 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 the fourth quarter of 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 31 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 the fourth quarter of 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-.

**Local Context**

On 31 March 2020, the council had net borrowing of £212.3 million arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

| | 31.03.2020 Actual £m |
|---|---|
| **Total CFR** | 405.7 |
| Less Other Debt Liabilities * | (101.1) |
| **Borrowing CFR** | **304.6** |
| External Borrowing | **(279.3)** |
| **Internal borrowing** | **25.3** |
| Less Usable Reserves | (83.7) |
| Less Working Capital | 22.8 |
| **Net Investments** | **(35.6)** |

* finance leases, PFI liabilities and transferred debt that form part of the council's total debt

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.

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

| | 31.03.2019 Balance £m | Movement £m | 31.03.2020 Balance £m | 31.03.2020 Rate % |
|---|---|---|---|---|
| Long-term borrowing | 162.9 | 46.4 | 209.3 | 3.22% |
| Short-term borrowing | 99.0 | (29.0) | 70.0 | 1.08% |
| **Total borrowing** | **261.9** | **17.4** | **279.3** | **2.76%** |
| Short term Investments | 63.4 | 3.6 | 67.0 | 0.55% |
| **Total investments** | **63.4** | **3.6** | **67.0** | **0.55%** |
| **Net borrowing** | **198.5** | **13.8** | **212.3** | **3.45%** |

## Borrowing Update

On 9 October 2019 the Public Works Loan Board (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 council 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 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 also available from 12 March 2020 an £1.15bn of additional “infrastructure rate” funding at gilt yields plus 0.60% to support specific local council 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 4 June 2020 with implementation of the new lending terms expected in the latter part of this calendar year or financial year beginning 2021/22.

**Borrowing strategy during the year**

At 31 March 2020 the council held £279.3 million of loans, (an increase of £17.4 million), as part of its strategy for funding previous and current years’ capital programmes. Outstanding loans on 31 March are summarised in Table 3 below.

Table 3: Borrowing Position

| | 31.03.19 Balance £m | Net Movement £m | 31.03.20 Balance £m | 31.03.20 Weighted Average Rate % | 31.03.2020 Weighted Average Maturity (years) |
|---|---|---|---|---|---|
| Public Works Loan Board | 157.9 | 46.4 | 204.3 | 3.30% | 16.25 |
| Banks (LOBO) | 5.0 | - | 5.0 | 4.27% | 21.67 |
| Banks (fixed term) | - | - | - | | |
| Local authorities (long-term) | - | - | - | | |
| Local authorities (short-term) | 99.0 | (29.0) | 70.0 | 1.08% | 0.58 |
| **Total borrowing** | **261.9** | **17.4** | **279.3** | **2.76%** | **12.03** |

The council’s chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the council’s long-term plans change being a secondary objective.

In keeping with these objectives, it was decided that the council would take advantage of the reduction in PWLB rates at specific periods in order to obtain the certainty of the relatively low interest rates. In addition, a number of short-term loans have not been renewed when they matured.

The council has an increasing CFR due to the capital programme and an estimated borrowing requirement as determined by the Liability Benchmark which also takes into account usable reserves and working capital. Having considered the appropriate duration and structure of the borrowing need based on realistic projections, it was decided to take a combination of short-term borrowing and longer-term Equal Instalment of Principal (EIP) loans. The council borrowed £55 million longer-term fixed rate loans, details of which are below. These loans provide some longer-term certainty and stability to the debt portfolio.

Table 4: Long-dated Loans borrowed 2019-20

| Long-dated Loans borrowed | Amount £m | Rate % | Period Years |
|---|---|---|---|
| PWLB EIP Loan 1 | 20 | 1.89% | 25 |
| PWLB EIP Loan 2 | 15 | 1.06% | 11.5 |
| PWLB EIP Loan 3 | 20 | 1.89% | 20 |
| | **55** | | |

As this year has illustrated, PWLB funding margins have lurched quite substantially and there remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields plus 0.80%, i.e. the PWLB HRA borrowing rate. The council will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.

The council continues to hold £5 million of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the year.

## Other Debt Activity

Although not classed as borrowing, the council also raised £17.5 million of capital finance for Highway Improvements via Private Finance Initiative during the 2019/20 financial year. Total debt other than borrowing stood at £129.9 million on 31 March 2020, taking total debt to £409.2 million.

## Treasury Investment Activity

The council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the council's investment balances ranged between £41 and £105.6 million due to timing differences between income and expenditure. During the year the council maintained balances of up to £10 million in the council's current bank account, in addition to the amounts invested.

Due to the changes in council working practices at the end of the financial year, as a result of the pandemic situation, staff were unable to access the national portal for dealing in money market funds via the internet. Accordingly, the decision was taken to disinvest from all money market funds at year end, with the exception of one notice account, and invest all surplus funds with the central government Debt Management Office.

The investment position is shown in table 5 below.

Table 5: Treasury Investment Position

| | **31.03.2019 Balance £m** | **Net Movement £m** | **31.03.2020 Balance £m** | **31.03.2020 Income Return %** | **31.03.2020 Weighted Average Maturity days** |
|---|---|---|---|---|---|
| Banks & Building societies (unsecured) | 4.0 | 6.0 | 10.0 | 0.60% | 1 |
| Covered bonds (secured) | - | - | - | | |
| Govt (incl local authorities) | 28.8 | 16.2 | 45.0 | 0.50% | 191 |
| Isle of Wight Council Pension Fund | 10.4 | (2.4) | 8.0 | 1.02% | 232 |
| Corporate nonds and loans | - | - | - | | |
| Money Market Funds | 20.2 | (16.2) | 4.0 | 0.27% | 93 |
| Other Pooled Funds | - | - | - | | |
| **Total Investments** | **63.4** | **3.6** | **67.0** | **0.85%** | **104** |

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.

Given the increasing risk and low returns from short-term unsecured bank investments, the council has continued in the more secure investment of lending to other local as shown in table 5 above. As a result, investment risk was diversified. The 2018/19 average income return of 0.85% was maintained throughout 2019/20.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 6 below.

Table 6: Investment Benchmarking – Treasury investments managed in-house

| | Credit Score | Credit Rating | Bail-in exposure % | Weighted Average Maturity days | Rate of Return % |
|---|---|---|---|---|---|
| 31.03.2019 | 3.98 | AA- | 38% | 53 | 0.84% |
| 30.06.2019 | 3.99 | AA- | 38% | 60 | 0.81% |
| 30.09.2019 | 4.08 | AA- | 57% | 26 | 0.78% |
| 31.12.2019 | 3.89 | AA- | 55% | 102 | 0.82% |
| 31.03.2020 | 3.65 | AA- | 22% | 147 | 0.79% |
| **Similar LAs** | **4.26** | **AA-** | **62%** | **52** | **0.60%** |
| **All LAs** | **4.03** | **AA-** | **56%** | **20** | **0.64%** |

In a relatively short period following the onset of the COVID-19 pandemic, the global economic fallout was sharp and large. Market reaction was extreme with large falls in equities, corporate bond markets and, to some extent, real estate echoing lockdown-induced paralysis and the uncharted challenges for governments, businesses and individuals. Volatility, measured by the VIX index, was almost as high as during the global financial crisis of 2008/9 and evidenced in plummeting equity prices and the widening of corporate bond spreads, very close to rivalling those twelve years ago. Gilt yields fell but credit spreads widened markedly reflecting the sharp deterioration in economic and credit conditions associated with a sudden stagnation in economies, so corporate bonds yields (comprised of the gilt yield plus the credit spread) rose and prices therefore fell.

**Non-Treasury Investments**

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the council as well as other non-financial assets which the council holds primarily for financial return. This is replicated in the Investment Guidance issued by Ministry of Housing, Communities and Local Government's (MHCLG) and Welsh Government, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

The council also held £39.8 million of such investments in

- directly owned property £33.1 million
- shared ownership housing £3.7 million
- loans to local businesses £3.0 million

A full list of the council's non-treasury investments is available in the Isle of Wight Council Statement of Accounts 2019/20

These investments generated £0.6 million of investment income for the council after taking account of direct costs, representing a rate of return of 1.93%

## Treasury Performance

The council measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in table 7 below.

Table 7: Performance

| | Actual £m | Budget £m | Over / Under £m | Actual % | Benchmark % | Over / Under % |
|---|---|---|---|---|---|---|
| Total Investment Income | 0.5 | 0.2 | 0.3 | 0.85% | 0.64% | - |
| Total Cost of Borrowing | (7.5) | (8.7) | 1.2 | 2.97% | - | - |
| **GRAND TOTAL** | (7.0) | (8.5) | 1.5 | n/a | n/a | n/a |

## Compliance

The Director of Finance and Section 151 Officer reports that all treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the council's approved Treasury Management Strategy.

Compliance with specific investment limits is demonstrated in table 8 below.

Table 8: Investment Limits

| | 2019/20 Maximum | 31.03.2020 Actual | 2019/20 Limit | Complied? |
|---|---|---|---|---|
| Any single organisation, except the UK Government | 10 | 10 | 10 | ✓ |
| Any group of organisations under the same ownership | 10 | 4 | 10 | ✓ |
| Money Market Funds | 40 | 4 | 50 | ✓ |

The 2019-20 limit for total investment in Money Market Funds was increased to £50 million from £35 million, as reported at the December 2019 Audit Committee meeting.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 9 below.

Table 9: Debt Limits

| | 2019/20 Maximum | 31.3.2020 Actual | 2019/20 Operational Boundary | 2019/20 Authorised Limit | Complied? |
|---|---|---|---|---|---|
| Borrowing | 293.4 | 279.3 | 392.9 | 430.0 | ✓ |
| PFI and Finance Leases | 123.6 | 101.1 | 125.0 | 135.0 | ✓ |
| **Total Debt** | **417.0** | **380.4** | **517.9** | **565.0** | ✓ |

The 2019-20 operational boundary and the authorised limit for PFI and finance lease debt were increased to £125 million (from £101.2 million) and £135 million (from £110 million) respectively, as reported at the December 2019 Audit Committee meeting.

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

## Treasury Management Indicators

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

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

| | 31.03.20 Actual | 2019/20 Target | Complied ? |
|---|---|---|---|
| Portfolio average credit score | 3.65 | 4.03 | ✓ |

**Liquidity:** The council maintains detailed cash flow forecasts with a view to keeping minimum surplus cash balances. It addresses liquidity issues by restricting a significant proportion of its investment opportunities to short term and instant access deposits.

| | 31.03.2020 Actual £m | 2019/20 Target £m | Complied? |
|---|---|---|---|
| Total cash available within 3 months | 31.3 | 15 | ✓ |

**Interest Rate Exposures**: 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 was:

| Interest Rate Risk Indicator | 31.03.20 Actual £m | 2019/20 Limit £m | Complied? |
|---|---|---|---|
| Upper limit on one-year revenue impact of a 1% rise in interest rates | -0.01 | -0.05 | ✓ |
| Upper limit on one-year revenue impact of a 1% fall in interest rates | 0.01 | 0.05 | ✓ |

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

**Maturity Structure of Borrowing:** This indicator is set to control the council's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

| | 31.03.2020 Actual | Upper Limit | Lower Limit | Complied? |
|---|---|---|---|---|
| Under 12 months | 27% | 50% | 0% | ✓ |
| 12 months and within 24 months | 2% | 30% | 0% | ✓ |
| 24 months and within 5 years | 6% | 30% | 0% | ✓ |
| 5 years and within 10 years | 12% | 50% | 0% | ✓ |
| 10 years and above | 52% | 95% | 0% | ✓ |

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

**Principal Sums Invested for Periods Longer than 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:

| | 2019/20 | 2020/21 | 2021/22 |
|---|---|---|---|
| Actual principal invested beyond year end | Nil | Nil | Nil |
| Limit on principal invested beyond year end | 35 | 40 | 45 |
| Complied? | ✓ | ✓ | ✓ |

## Other

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