Treasury Management Mid-Year Performance Report 2020/21

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 2020/21 was approved at a meeting of Isle of Wight Council's Audit Committee on 16 March 2020. 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.

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 26 February 2020.

External Context (Provided by Arlingclose Limited, based on data at 2 October 2020)

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 percent 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 percent (revised from first estimate minus 20.4 percent) in Q2 2020 (Apr-Jun) according to the Office for National Statistics, pushing the annual growth rate down to minus 21.5 percent (first estimate minus

21.7 percent). Construction output fell by 35 percent over the quarter, services output by almost 20 percent and production by 16 percent. Recent monthly estimates of GDP have shown growth recovering, with the latest rise of almost 7 percent 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 percent year/year in August 2020, further below the Bank of England's 2 percent 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 percent year/year.

In the three months to July 2020, labour market data showed the unemployment rate increased from 3.9 percent to 4.1 percent while wages fell 1 percent for total pay in nominal terms (0.2 percent regular pay) and was down 1.8 percent in real terms (minus 0.7 percent 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 (this has subsequently been extended to March 2021). On the back of this, the BoE has forecast unemployment could hit a peak of between 8 percent and 9 percent.

The US economy contracted at an annualised rate of 31.7 percent in Q2 2020 (Apr-Jun). The Federal Reserve maintained the Fed Funds rate at between 0 percent and 0.25 percent 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 percent 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 percent and deposit rate at negative 0.5 percent.

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 percent 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 negative 0.06 percent (with much volatility in between). The 10-year gilt yield also bounced around, starting at 0.21 percent and ending at 0.23 percent over the same period, while the 20-year rose from 0.56 percent to 0.74 percent. 1-month, 3-month and 12-month bid rates averaged 0.02 percent, 0.06 percent and 0.23 percent respectively over the period.
At the end of September, the yield on 2-year US treasuries was around 0.13 percent while that on 10-year treasuries was 0.69 percent. German bund yields remain negative across most maturities.

Credit review: Credit default swap (CDS) 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 an 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 31 December 2020 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.

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

	31.3.20 Actual £m
Total CFR	**405.7**
Less: Other debt liabilities*	(101.1)
Borrowing CFR	**304.6**
External borrowing**	(279.3)
Internal / (over) borrowing	**25.3**
Less: Usable reserves	(83.7)
Less: Working capital	(22.4)
(Investments) / New Borrowing	**(80.8)**

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

** shows only loans to which the council is committed and excludes optional refinancing

Lower official interest rates have lowered the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The council pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk.

The treasury management position on 30 September 2020 and the change over the six months is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.20 Balance £m	**Movement £m**	**30.9.20 Balance £m**	**30.9.20 Rate percent**
Long-term borrowing	209.3	(4.3)	205.0	3.23%
Short-term borrowing	70.0	5.0	75.0	0.98%
Total borrowing	**279.3**	**0.7**	**280.0**	**2.70%**
Short-term investments	67.0	31.2	98.2	0.27%
Total investments	**67.0**	**31.2**	**98.2**	**0.27%**
Net borrowing	**212.3**	**(30.5)**	**181.8**	**4.01%**

Borrowing did not reduce during the first half of the year as, due to uncertainty in the cashflows during April, the council committed to £5 million of additional borrowing. This was used to refinance PWLB borrowing that matured. The council has explored, with their treasury management advisors, the potential redemption of some of its short-term borrowing; this was unsuccessful, so the council was in a positive cash position and so advanced the additional funds to other local authorities, thereby reduced the cost of carry incurred. It is planned that short-term borrowing will be repaid before any further borrowing is undertaken.

Borrowing Update

On 9 October 2019 the Public Works Loan Board (PWLB) raised the cost of certainty rate borrowing to 1.8 percent above UK gilt yields making it relatively expensive. Market alternatives are available 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 Housing Revenue Account (HRA) loans to 0.80 percent above equivalent gilt. £1.15 billion of additional "infrastructure rate" funding at gilt yields plus 0.60 percent has been made available 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" allows stakeholders to contribute to developing a system whereby PWLB loans can be made available at improved margins to support qualifying projects. It contains proposals to allow 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. The

consultation also broaches the possibility of slowing, or stopping, individual authorities from borrowing large sums in specific circumstances.

The consultation closed on 31 July 2020 with the announcement and implementation of the revised lending terms expected in the latter part of this calendar year or early next year.

Municipal Bonds Agency (MBA): The MBA revised its standard loan terms and framework agreement. Guarantees for the debt of other borrowers are now proportional and limited and a requirement to make contribution loans in the event of a default by a borrower has been introduced. The agency has issued 5-year floating rate and 40-year fixed rate bonds in 2020, in both instances Lancashire County Council is the sole borrower and guarantor.

If the council intends future borrowing through the MBA, it will first ensure that it has thoroughly scrutinised the legal terms and conditions of the arrangement and is satisfied with them.

Borrowing Strategy during the period

At 30 September 2020 the council held £280.0 million of loans, (an increase of £0.7 million since 31 March 2020) as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30 September are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.20 Balance £m	**Net Movement £m**	**30.9.20 Balance £m**	**30.9.20 Weighted Average Rate percent**	**30.9.20 Weighted Average Maturity (years)**
Public Works Loan Board	204.3	(4.3)	200.0	3.31%	15.81
Banks (LOBO)	5.0	-	5.0	4.27%	21.17
Banks (fixed term)	-	-	-		
Local authorities (long-term)	-	-	-		
Local authorities (short-term)	70.0	5.0	75.0	0.98%	0.36
Total borrowing	**279.3**	**0.7**	**280.0**	**2.70%**	**11.77**

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, the council considered it to be more cost effective in the near term to use internal resources or borrowed short-term loans instead. The net movement in short-term loans in this period is shown in table 3 above.

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 some short-term borrowing during this period. The council borrowed an additional £5 million short-term fixed rate loans during the first half of the year.

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 was maintained.

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 percent, i.e. the PWLB Housing Revenue Account (HRA) borrowing rate. The council will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.

LOBO loans: 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 quarter.

Other Debt Activity

Although not classed as borrowing, the council has not raised any additional capital finance for Highway Improvements via Private Finance Initiative during this period. Total debt other than borrowing stood at £ 129.9 million on 30 September 2020, taking total debt to £409.2 million

Treasury Investment Activity

On 27 March 2020 the council received central government funding to support small and medium businesses during the coronavirus pandemic through grant schemes. £62.7 million was received, temporarily invested in short-dated, liquid instruments such as call accounts and Money Market Funds. £51.2 million was disbursed by the end of September.

The council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the council's investment balances ranged between £87.2 and £139 million due to timing differences between income and expenditure. The investment position is shown in table 4 below. In addition, the council maintained balances of up to £10 million in the council's current bank account

Table 4: Treasury Investment Position

	31.3.20 Balance £m	Net Movement £m	30.9.20 Balance £m	30.9.20 Income Return percent	30.9.20 Weighted Average Maturity days
Banks & building societies (unsecured)	10.0	0.0	10.0	0.12%	1.0
Covered bonds (secured)	-	-	-	-	-
Isle of Wight Pension Fund	8.0	(1.8)	6.2	1.02%	121.7
Government (incl. local authorities)	45.0	(8.0)	37.0	0.34%	137.7
Corporate bonds and loans	-	-	-	-	-
Money Market Funds	4.0	41.0	45.0	0.15%	1.0
Other Pooled Funds	-	-	-	-	-
Real Estate Investment Trusts	-	-	-	-	-
Total investments	**67.0**	**31.2**	**98.2**	**0.27%**	**60.0**

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.

Continued downward pressure on short-dated cash rate brought net returns on sterling low volatility net asset value (LVNAV) money market funds (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.

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 negative 0.03 percent, the rate was 0 percent for 3-week deposits and 0.01 percent for longer maturities.

The return on Money Market Funds net of fees also fell over the six months and for many funds net returns range between 0 percent and 0.1 percent. In many instances, the fund management companies have temporarily lowered or waived fees to maintain a positive net return.

Given the continuing risk and low returns from short-term unsecured bank investments, the council has continued in the more secure investment of lending to other local authorities as shown in table 4 above.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure %	Weighted Average Maturity (days)	Rate of Return %
31.03.2020	3.65	AA-	22%	147	0.77%
30.06.2020	3.81	AA-	29%	44	0.38%
30.09.2020	4.08	AA-	56%	60	0.24%
Similar LAs	**4.32**	**AA-**	**72%**	**31**	**0.21%**
All LAs	**4.16**	**AA-**	**64%**	**18**	**0.27%**

In a relatively short period since the onset of the COVID-19 pandemic in March 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, to some extent, real estate echoing lockdown-induced paralysis and the uncharted challenges for governments, business and individuals.

In 2020/21 the council expects to receive significantly lower yields from its cash and short-dated money market investments than it did in 2019/20 and earlier years. Income paid will ultimately depend on many factors including but not limited to the duration of COVID-19 and the extent of its economic impact, the fund's sectoral asset allocation, securities held/bought/sold and, in the case of equities, the enforced or voluntary dividend cuts or deferral.

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 the Ministry of Housing, Communities and Local Government (MHCLG) and Welsh Government, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

As at 30 September 2020 the council held £38.1 million of such investments in

- directly owned property £33.1 million
- shared ownership housing £3.7 million
- loans to local businesses £1.3 million

A full list of the council's non-treasury investments is available in the Isle of Wight Council Statement of Accounts 2019/20. Since the year end a loan of £1.7 million that was made to a community energy company has been repaid. There have been no additional long-term loans made to date during 2020/21.

During the six months to 30 September 2020 these investments generated £0.6 million of investment income for the council, after taking account of direct costs, representing a rate of return of 3.4 percent. These figures do not include any accruals for income not yet received or expenses not yet incurred as these figures are not yet available.

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 6 below.

Table 6: Performance

	Actual as at 30 September 2020 £m	**Actual as at 30 September 2020 %**	**Forecast to 31 March 2021 £m**	**Full year Budget* £m**	**Over/ Under £m**
Total cost of borrowing	(1.7)	2.65%	(8.7)	(9.7)	1.0
PFI and Finance leases	-*		(9.1)	(9.1)	-
Total debt	**(1.7)**	**-**	**(17.8)**	**(18.8)**	**1.0**
Total treasury investments	**0.1**	**0.39%**	**0.3**	**0.2**	**0.1**
	(1.6)	-	(17.5)	(18.6)	1.1

*the year to date figures are not yet available due to staff capacity issues

Estimates for income 2020/21

The corporate world is still adjusting to the economic shock, with probably more to come, and it is still too early to tell which companies will withstand the economic damage in the short- to medium-term or which will choose to conserve cash in very difficult economic conditions simply to survive.

Investment income in the council's 2020/21 budget was set against a very different economic backdrop. The Bank Rate, which was 0.75 percent in February 2020, now stands at 0.1 percent. Although interest earned from short-dated money market investments is at a significantly lower rate, the large grants received by the council in advance of disbursement, has ensured that the actual interest earned is currently in line with the budgeted figure.

Compliance

The Director of Finance and S151 Officer is pleased to report that all treasury management activities undertaken during the six months to 30 September 2020 complied fully with the CIPFA Code of Practice and the council also adhered to the approved Treasury Management Strategy.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below.

Table 7: Debt Limits

	Maximum balance in period to 30.09.20 £m	30.9.20 Actual £m	2020/21 Operational Boundary £m	2020/21 Authorised Limit £m	Complied?
Borrowing	284.3	379.3	352.0	440.0	✓
PFI and Finance Leases	101.7	101.7	120.0	150.0	✓
Total debt	**386.0**	**381.0**	**472.0**	**590.0**	✓

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

Table 8: Investment Limits

	Maximum balance in period to 30.09.20 £m	30.9.20 Actual £m	2020/21 Limit £M	Complied?
Any single organisation, except the UK Government	10	2	10	✓
Any group of organisations under the same ownership	10	4	10	✓
Money Market Funds	50	45	50	✓

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.

	30.9.20 Actual	2020/21 Target	Complied?
Portfolio average credit score	4.08	4.15	✓

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, without additional borrowing

	30.9.20 Actual	2020/21 Target	Complied?
Total cash available within 3 months	£65.7m	£18.5m	✓

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 percent rise or fall in interests was:

Interest rate risk indicator	30.9.20 Actual	2020/21 Limit	Complied?
Upper limit on one-year revenue impact of a 1 percent rise in interest rates	-£0.3m	-£0.5m	✓
Upper limit on one-year revenue impact of a 1 percent fall in interest rates	+£0.3m	+£0.5m	✓

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:

	30.9.20 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	30%	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%	75%	0%	✓
10 years and above	50%	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:

	2020/21	2021/22	2022/23
Actual principal invested beyond year end	-	-	-
Limit on principal invested beyond year end	£35m	£40m	£45m
Complied?	✓	✓	✓

Other

IFRS 16: The implementation of the new IFRS 16 Leases accounting standard has been delayed until 2021/22.

Arlingclose's Outlook for the remainder of 2020/21

	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.15	0.15	0.15	0.15	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Downside risk	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50

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. The 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 the Bank Rate to remain at the current 0.10 percent level and additional monetary loosening in the future most likely through further financial asset purchases (Quantitative Easing). While Arlingclose's central case for the Bank Rate is no change from the current level of 0.1 percent, further cuts to the 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.