	Council
	Monday, 7 September 2020

Subject: Treasury Management Annual Report 2019-20

Report by:	Assistant Director Finance, Business Support and Property Services (S151)
Contact Officer:	Caroline Capon Corporate Finance Team Leader caroline.capon@west-lindsey.gov.uk
Purpose / Summary:	To report on Annual Treasury Management activities and prudential indicators for 2019/20 in accordance with the Local Government Act 2003

RECOMMENDATION(S):

1. Members recommend the Annual Treasury Management Report and actual Prudential Indicators 2019/20 to Full Council for approval.

IMPLICATIONS

Legal: This report complies with the requirement of the Local Government Act 2003.

Financial : FIN/55/20/CC

Treasury Investment activities have generated £0.269m of investment interest at an average rate of 1.655%.

Non-Treasury investments (Investment Property acquisitions) have totalled £5.681m in 2019/20 and the full portfolio has generated a gross yield of 6.53%

Financing activities has resulted in a total of £20m of external borrowing at a cost in year of £0.355m.

Staffing : None from this report

Equality and Diversity including Human Rights : None from this report

Data Protection Implications : None from this report

Climate Related Risks and Opportunities: None from this report

Section 17 Crime and Disorder Considerations: None from this report

Health Implications: None from this report

Title and Location of any Background Papers used in the preparation of this report :
CIPFA Code of Treasury Management Practice CIPFA The Prudential Code Local Government Act 2003 Located in the Finance Department, Guildhall, Gainsborough

Risk Assessment :
The Treasury Management Strategy sets our assessment of Treasury risks.

Call in and Urgency:

Is the decision one which Rule 14.7 of the Scrutiny Procedure Rules apply?

i.e. is the report exempt from being called in due to urgency (in consultation with C&I chairman)	**Yes**		**No**	**x**

Key Decision:

A matter which affects two or more wards, or has significant financial implications	**Yes**		**No**	**x**

1. Executive Summary

The Council are required to receive as a minimum the following reports;

- an annual treasury strategy in advance of the year (March 2019)
- a mid-year, (minimum), treasury update report (November 2019)
- an annual review following the end of the year describing the activity compared to the strategy, (this report)

In addition, this Corporate Policy and Resources Committee has received quarterly treasury management update reports.

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

This Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by either the Governance and Audit Committee who provide scrutiny of the Treasury Management Strategy and the Corporate Policy and Resources Committee who monitor in year performance and mid-year updates. Member training on treasury management issues was undertaken during the year in order to support members' scrutiny role.

During 2019/20, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Prudential and treasury indicators	**2018/19 Actual £000**	**2019/20 Original £000**	**2019/20 Actual £000**
Capital expenditure	21,709	21,698	18,029
Capital Financing Requirement: Of which – Investment Properties	23,082 *15,984*	43,184 22,999	37,905 *21,602*
Gross borrowing (External)	**11,000**	**33,863**	**20,000**
Finance Lease	0	0	0
Investments • Longer than 1 year • Under 1 year • **Total**	 3,000 11,200 **14,200**	 3,000 6,527 **9,527**	 3,000 8,670 **11,670**
Net borrowing	**(3,200)**	**24,336**	**8,330**

Other prudential and treasury indicators are to be found in the main body of this report. The Chief Executive (S151 Officer) also confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit, (the authorised limit), was not breached.

The financial year 2019/20 continued the challenging investment environment of previous years, namely low investment returns.

This report summarises the following:-

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness, (the Capital Financing Requirement);
- The actual prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity.

2. Capital Expenditure and Financing

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

Capital and Financing	2018/19 Actual £000's	2019/20 Original Budget £000's	2019/20 Actual £000's
Capital expenditure	**21,079**	**21,698**	**18,029**
Financed in year by:			
Capital Receipts	0	687	359
Capital grants/contributions	1,578	3,340	734
Revenue	1,053	3,614	1,801
Leases	0	0	0
S106	0	360	202
Prudential Borrowing	18,448	13,697	14,933

3. The Council's overall borrowing need

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2019/20 unfinanced capital expenditure (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies, (such as the Government, through the Public Works Loan Board [PWLB], or the money markets), or utilising temporary cash resources within the Council.

Reducing the CFR – the Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to reduce the CFR. This is effectively a repayment of the) borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources, (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

The Council's 2019/20 MRP Policy, (as required by MHCLG Guidance), was approved as part of the Treasury Management Strategy Report for 2019/20 on 04 March 2019.

In respect of Commercial Investment Properties, which are funded from borrowing, no MRP will be payable, however this will be determined on a case by case basis. Instead the Council has created a Valuation Volatility Reserve with a minimum balance of 5% of purchase price of the portfolio. This Reserve will be utilised to mitigate any loss on the investment upon sale of the assets if the capital receipt does not meet the debt outstanding. This is considered a prudent approach for these specific assets.

The Council's CFR for the year is shown below, and represents a key prudential indicator. It includes leasing schemes on the balance sheet, which increase the Council's borrowing need. No borrowing is actually required against these schemes as a borrowing facility is included in the contract.

Capital Financing Requirement (CFR)	31 March 2019 Actual £000's	31 March 2020 Actual £000's
Opening balance	4,715	23,082
Add adjustment for the inclusion of on-balance sheet leasing arrangements and Prudential Borrowing	18,448	14,933
Less Adjustment for Non Capital Loans	(45)	0
Less MRP/Finance Lease Repayments	(36)	(110)
Closing balance	**23,082**	**37,905**
Movement on CFR	*18,367*	*14,823*

Borrowing activity is constrained by prudential indicators for gross borrowing and the CFR, and by the authorised limit.

Gross borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council ensures that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2018/19) plus the estimates of any additional capital financing requirement for the current (2019/20) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allowed the Council some flexibility to borrow in advance of its immediate capital needs in 2019/20. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2019 Actual £000's	31 March 2020 Actual £000's
Prudential borrowing position	18,403	33,381
CFR	23,082	37,905

The Authorised Limit - 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 table below demonstrates that during 2019/20 the Council has maintained gross borrowing within its authorised limit.

The Operational Boundary – 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 are acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital, (borrowing and other long term obligation costs net of investment income), against the net revenue stream.

	2019/20 £000's
Authorised limit	48,519
Operational boundary	37,906
Financing costs as a proportion of net revenue stream	1.6%

4. Treasury Position as at 31 March 2020

The Council's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the end of 2019/20 the Council's treasury, (excluding borrowing and finance leases), position was as follows:

4.1 Borrowing

TABLE 1	31 March 2019 Principal £000's	Rate/ Return	Average Life yrs.	31 March 2020 Principal £000's	Average Rate/ Return	Average Life yrs.
Fixed rate funding:						
-PWLB	11,000	2.28%	26.67	16,500	2.14%	27
-Other LA	0	0	0	3,500	1.02%	1
Total debt	**11,000**	**2.28%**	**26.67**	**20,000**	**1.95%**	***22***
CFR	**23,082**		**-**		**-**	**-**
Over / (under) borrowing	**(12,082)**	**-**	**-**		**-**	**-**
Investments:						
	14,200	1.57%	-	11,600	1.655%	-
Total investments	**14,200**	**1.57%**	**-**	**11,600**	**1.655%**	**-**
Net debt	**(3,200)**	**-**	**-**			**-**

Under borrowing reflects Internal Borrowing from the Council's cash balances.

The maturity structure of the debt portfolio was as follows:

	31 March 2019 Actual £000's	31 March 2020 Actual £000's	%
Less than 5 years	0	6,000	30%
5 years and within 10 years	2,500	3,000	15%
10 years and within 20 years	0	0	0
20 years and within 30 years	2,500	2,500	12.5%
30 years and within 40 years	0	0	0
40 years and within 50 years	6,000	8,500	42.5%

£16.5m of loans have been undertaken with the Public Works Loans Board at fixed rates on a maturity basis as detailed above.

One loan for £3.5m has been undertaken with another Local Authority at a fixed rate on a maturity basis for a period of 1 year.

Borrowing in advance of need

The Council has not borrowed more than, or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed.

The Council's capital investments and their subsequent financing costs as a % of the Net Revenue Stream is detailed below along with the impact on Council Tax (all other things being equal). The indicators reflect our Borrowing Strategy, that we will only borrow where schemes are able to provide sustained support for the costs of borrowing and reflect new income generated is in excess of the cost of borrowing.

	31 March 2019 Actual	31 March 2019 Actual
Ratio of Financing Costs to Net Revenue Stream	(0.91%)	1.6%
Increase/(Reduction) in Council Tax	(£15.68)	(£7.26)

4.2 Investments

Investment Policy – the Council's investment policy is governed by MHCLG investment guidance, which has been implemented in the annual investment strategy approved by the Council on 04 March 2019. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data, (such as rating outlooks, credit default swaps, bank share prices etc.).

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

Resources – the Council's cash balances comprise revenue and capital resources and cash flow monies. The Council's core cash resources comprised as follows:

Balance Sheet Resources	31 March 2019 £000's	31 March 2020 £000's
General Fund Balance	3,848	4,234
Earmarked reserves	15,834	15,787
Provisions	1,196	947
Usable capital receipts	3,362	3,462
Capital Grants Unapplied	587	537
Total	**24,827**	**24,967**

Investments held by the Council

- The Council maintained an average balance of £16.403m of internally managed funds.
- The internally managed funds earned an average rate of return of 1.655%.
- The comparable performance indicator is the average 7-day LIBID rate, which was 0.7977%
- Total investment income was £0.269m compared to a budget of £0.206m

Types of investments	31 March 2019 Actual £000	31 March 2020 Actual £000
Deposits with banks and building societies	6,200	1,800
Money Market Funds	8,000	2,800
Other Local Authorities	0	4,000
Property funds	3,000	3,000
TOTAL TREASURY INVESTMENTS	**14,200**	**11,600**

4.3 Non Treasury Investments

YEAR OF ACQUISITION	Commercial Property Portfolio	Sector	Total Acquisition Cost £'m
2017/18	Bradford Road, Keighley	Hotel	2.490
2018/19	43 Penistone Roade, Sheffield	Leisure	2.700
2018/19	Unit 7 Drake House, Sheffield	Manufacturing	3.174
2018/19	5 Sandars Road, Gainsborough	Manufacturing	6.470
2018/19	Heaton Street, Gainsborough	Retail	1.150
2019/20	Wheatley Road, Doncaster	Commercial Unit	5.681
	TOTAL PORTFOLIO		**21.665**

The investments are held on the balance sheet at their Fair Value *(the price expected to be received in current market conditions).* Their Fair Value as at 31 March 2020 for the Commercial Property Portfolio is £20.949m, effectively reflecting a reduction for the costs of purchase.

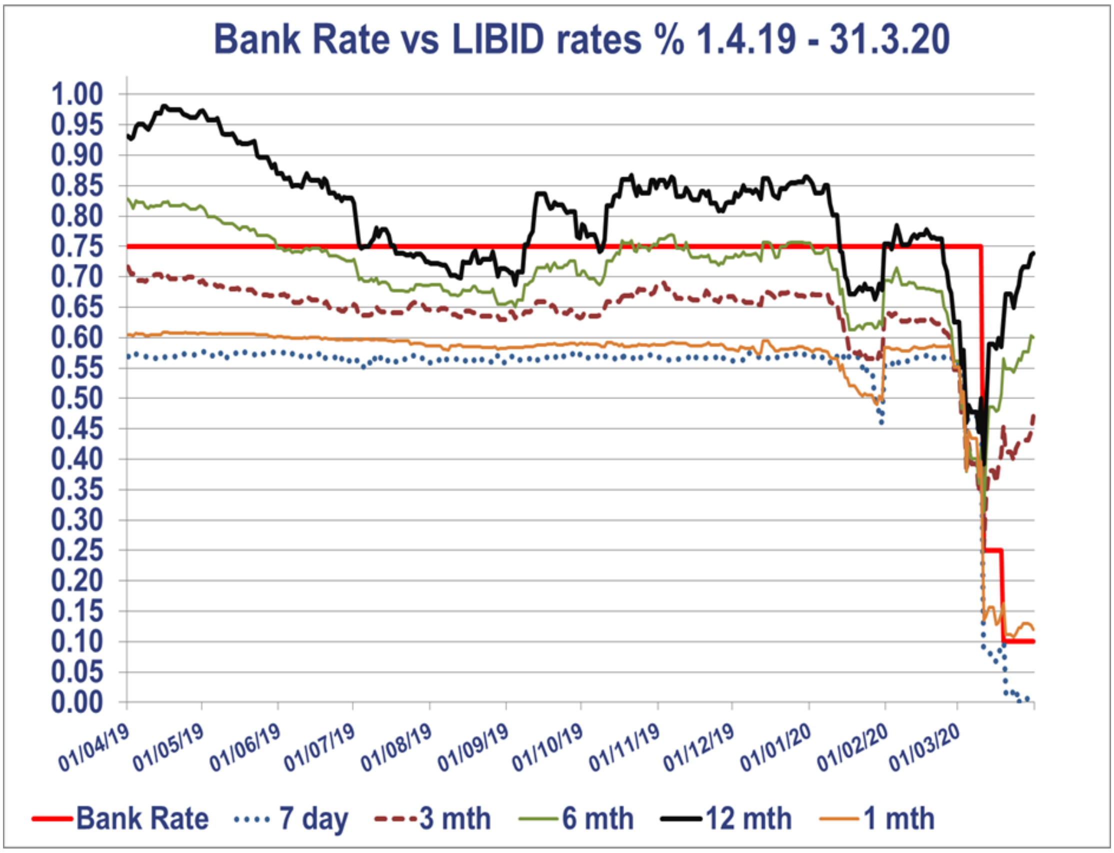
The actual net contribution to services for the year was £0.721m (net of borrowing costs).

This investment portfolio is generating a gross yield of 6.53%

The Council mitigates any loss on investment by holding a Valuation Volatility Reserve at a minimum of 5% of the purchase price of properties. The balance on this reserve as at 31 March 2020 is £1.767m.

5. The strategy for 2019/20

5.1 Investment strategy and control of interest rate risk



Investment returns remained low during 2019/20. The expectation for interest rates within the treasury management strategy for 2019/20 was that Bank Rate would stay at 0.75% during 2019/20 as it was not expected that the MPC would be able to deliver on an increase in Bank Rate until the Brexit issue was finally settled. However, there was an expectation that Bank Rate would rise after that issue was settled, but would only rise to 1.0% during 2020. Shorter term investment interest rates were fairly flat during most of the year until the two cuts in bank rate in March 2020 caused investment rates to fall sharply.

This authority does not have sufficient cash balances to be able to place deposits for more than a month so as to earn higher rates from longer deposits. Continued uncertainty in the aftermath of the 2008 financial crisis has promoted a cautious approach whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

5.2 Borrowing strategy and control of interest rate risk

During 2019-20, the Council maintained an under-borrowed position. This meant that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as investment returns were low and minimising counterparty risk on placing investments also needed to be considered.

A cost of carry remained during the year on any new long-term borrowing that was not immediately used to finance capital expenditure, as it would have caused a temporary increase in cash balances; this would have incurred a revenue cost – the difference between (higher) borrowing costs and (lower) investment returns.

The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this was kept under review to avoid incurring higher borrowing costs in the future when this authority may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.

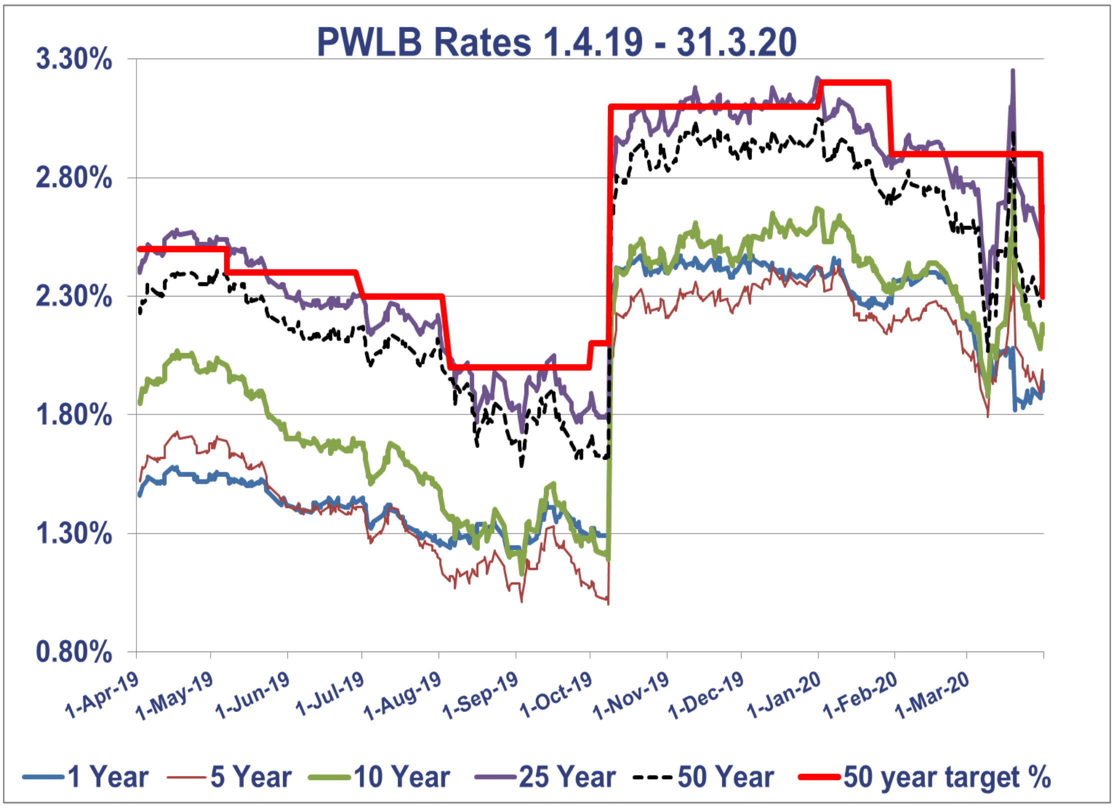
Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. The Director of Finance therefore monitored interest rates in financial markets and adopted a pragmatic strategy based upon the following principles to manage interest rate risks *(please adapt this outline to what you actually did in the year):*

- if it had been felt that there was a significant risk of a sharp FALL in long and short term rates, (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings would have been postponed, and potential rescheduling from fixed rate funding into short term borrowing would have been considered.

- if it had been felt that there was a significant risk of a much sharper RISE in long and short term rates than initially expected, perhaps arising from an acceleration in the start date and in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position would have been re-appraised. Most likely, fixed rate funding would have been drawn whilst interest rates were lower than they were projected to be in the next few years.

Interest rate forecasts expected only gradual rises in medium and longer term fixed borrowing rates during 2019/20 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period.

Link Asset Services Interest Rate View 31.3.20								
	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 Month LIBID	0.45	0.40	0.35	0.30	0.30	0.30	0.30	0.30
6 Month LIBID	0.60	0.55	0.50	0.45	0.40	0.40	0.40	0.40
12 Month LIBID	0.75	0.70	0.65	0.60	0.55	0.55	0.55	0.55
5yr PWLB Rate	1.90	1.90	1.90	2.00	2.00	2.00	2.10	2.10
10yr PWLB Rate	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30
25yr PWLB Rate	2.50	2.50	2.50	2.60	2.60	2.60	2.70	2.70
50yr PWLB Rate	2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50



PWLB rates are based on, and are determined by, gilt (UK Government bonds) yields through H.M.Treasury determining a specified margin to add to gilt yields. There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was heightened expectations that the US could have been heading for a recession in 2020, and a general background of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued; these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last 30 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 30 years. We have therefore seen, over the last year, many bond yields up to 10 years in the Eurozone turn negative. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of 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.

Gilt yields were on a generally falling trend during the last year up until the coronavirus crisis hit western economies. Since then, gilt yields have fallen sharply to unprecedented lows as investors have panicked in selling shares in anticipation of impending recessions in western economies, and moved cash into safe haven assets i.e. government bonds. However, major western central banks also started quantitative easing purchases of government bonds which will act to maintain downward pressure on government bond yields at a time when there is going to be a huge and quick expansion of government expenditure financed by issuing government bonds; (this would normally cause bond yields to rise). At the close of the day on 31 March, all gilt yields from 1 to 5 years were between 0.12 – 0.20% while even 25-year yields were at only 0.83%.

However, HM Treasury has imposed **two changes in the margins over gilt yields for PWLB rates** in 2019-20 without any prior warning; the first on 9 October 2019, added an additional 1% margin over gilts to all PWLB rates. That increase was then partially reversed for some forms of borrowing on 11 March 2020, at the same time as the Government announced in the Budget a programme of increased spending on infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins; this ends on 4 June. It is clear that the Treasury intends to put a stop to local authorities borrowing money from the PWLB to purchase commercial property if the aim is solely to generate an income stream.

Following the changes on 11 March 2020 in margins over gilt yields, the current situation is as follows: -

- **PWLB Standard Rate** is gilt plus 200 basis points (G+200bps)
- **PWLB Certainty Rate** is gilt plus 180 basis points (G+180bps)
- **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
- **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
- **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

There is likely to be little upward movement in PWLB rates over the next two years as it will take national economies a prolonged period to recover all the momentum they will lose in the sharp recession that will be caused during the coronavirus shut down period. Inflation is also likely to be very low during this period and could even turn negative in some major western economies during 2020-21.

6. Other Issues

6.1 Changes to Counterparty Limits

There have been no breaches of Prudential Indicators. However, on the 30 March 2020 an urgent Delegated Decision was signed off to increase our Treasury Counterparty limits:

- Upper investment limits with AAA rated Money Market Funds to be raised, £7.5m from £5m
- Lloyds Bank, our bankers, raised to £2m current account, £7.5m

deposit account (increased from £1m and £5m respectively)

These changes were required for effective cash management due to receiving circa £20m in Grants from Government in relation to Covid-19 initiatives.