

# Treasury Management Strategy Statement and Annual Investment Strategy

**Mid-Year Review Report 2019/20**

**Pendle Borough Council**

# 1. Background

## 1.1 Capital Strategy

In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued revised Prudential and Treasury Management Codes. As from 2019/20, all local authorities have been required to prepare a Capital Strategy which is to provide the following: -

- a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services;
- an overview of how the associated risk is managed;
- the implications for future financial sustainability.

## 1.2 Treasury Management

The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

Accordingly, treasury management is defined as:

“The management of the local authority'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.”

## 2. Introduction

This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).

The primary requirements of the Code are as follows:-

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report, (stewardship report), covering activities during the previous year.

4. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
5. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Policy and Resources Committee:

This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:-

- An economic update for the first part of the 2019/20 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure, as set out in the Capital Strategy, and prudential indicators;
- A review of the Council's investment portfolio for 2019/20;
- A review of the Council's borrowing strategy for 2019/20;
- A review of any debt rescheduling undertaken during 2019/20;
- A review of compliance with Treasury and Prudential Limits for 2019/20.

## **Key Changes to the Treasury and Capital Strategies**

There are no changes to report although the Counterparty List is kept under continual review to make sure there is enough headroom available within the limits set on each sector and institution to ensure the temporary investment of cash balances remains compliant with the Treasury Strategy. A few topical issues to note that may impact on the level of cash held are:

- Future borrowing to take advantage of lower interest rates - This has been impacted upon by the increase in PWLB rates on 09/10/2019 as previously referred to.
- Property Investment Strategy – If a financially viable proposal is implemented, the Council may initially chose to finance it partly or wholly by internal borrowing, thus reducing cash balances.
- Pensions Re-valuation – As in previous years, there may be an opportunity to pay contributions upfront each year or even three years in advance to obtain a discount on the amount required to be paid into the Pension Fund.

## 3. Economics and interest rates

### 3.1 Economics update

**UK.** This first half year has been a time of upheaval on the political front as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on or 31 October, with or without a deal. However, so far, there has been no majority of MPs for any one option to move forward on enabling Brexit to be implemented. At the time of writing, (first week in September), the whole political situation in the UK over **Brexit** is highly fluid and could change radically by the day. The vote in the Commons on 3 September looks likely to lead to a delay in the date for Brexit to 31 January 2020, but there is also likelihood that there will be an imminent general election. In such circumstances, any interest rate forecasts are subject to material change as the situation evolves. At present, if the UK does soon achieve an agreed deal on Brexit, including some additional clarification wording on the Irish border backstop, then it is possible that growth could recover quickly. The MPC could then need to address the issue of whether to raise Bank Rate when there is very little slack left in the labour market; this could cause wage inflation to accelerate which would then feed through into general inflation. On the other hand, if there was a no deal Brexit and there was a significant level of disruption to the economy, then growth could falter and the MPC would be likely to cut Bank Rate in order to support growth. However, with Bank Rate still only at 0.75%, it has relatively little room to make a big impact and the MPC would probably suggest that it would be up to the Chancellor to provide help to support growth by way of a fiscal boost by way of tax cuts and / or expenditure on infrastructure projects, to boost the economy. However, infrastructure projects generally take a long time to plan and to start up, and so to feed through into impacting the economy; tax cuts would be much quicker in impacting the level of consumption in the economy.

The first half of 2019/20 has seen UK **economic growth** fall as Brexit uncertainty took a toll. In its Inflation Report of 1 August, the Bank of England was notably downbeat about the outlook for both the UK and major world economies. This mirrored investor confidence around the world which is now expecting a significant downturn or possibly even a recession in some developed economies. It was therefore no surprise that the Monetary Policy Committee (MPC) left Bank Rate unchanged at 0.75% throughout 2019, so far, and is expected to hold off on changes until there is some clarity on what is going to happen over Brexit.

As for **inflation** itself, CPI has been hovering around the Bank of England's target of 2% during 2019, (July 2.1%), and is likely to shift only a little upwards over the rest of 2019/20. It does not therefore pose any immediate concern to the MPC at the current time.

With regard to the **labour market**, despite the contraction in quarterly GDP growth of -0.2%q/q, (+1.2% y/y), in quarter 2, employment rose by 115,000 in the same quarter: this suggests that firms are preparing to expand output and suggests there could be a return to positive growth in quarter 3. Unemployment has continued near to a 44 year low, edging up from 3.8% to 3.9% on the Independent Labour Organisation measure in June; however, that was caused by a rise in the participation rate to an all-time high. Job vacancies fell for a sixth consecutive month, hitting record levels, and indicating that employers are having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to a high point of 3.9%, (3 month average regular pay, excluding bonuses).

This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 1.8%. As the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This could mean that the MPC will need to take action to raise Bank Rate if there is an agreed Brexit deal as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.

In the **political arena**, if there is a general election soon, this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up although, conversely, a weak international backdrop could provide further support for low yielding government bonds and gilts.

### 3.2 Interest rate forecasts

The Council's treasury advisor, Link Asset Services, has provided the following forecast, however this will now need to be revised in the light of increased PWLB rates on 09/10/2019 and also again when the outcome of Brexit is known:

Link Asset Services Interest Rate View											
	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.25
3 Month LIBID	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.10	1.20
6 Month LIBID	0.80	0.80	0.80	0.80	0.90	1.00	1.10	1.10	1.20	1.30	1.40
12 Month LIBID	1.00	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60
5yr PWLB Rate	1.20	1.30	1.50	1.60	1.70	1.70	1.80	1.90	2.00	2.00	2.10
10yr PWLB Rate	1.50	1.60	1.80	1.90	2.00	2.00	2.10	2.20	2.30	2.30	2.40
25yr PWLB Rate	2.10	2.30	2.40	2.50	2.60	2.70	2.70	2.80	2.90	3.00	3.00
50yr PWLB Rate	2.00	2.20	2.30	2.40	2.50	2.60	2.60	2.70	2.80	2.90	2.90

It has been little surprise that the Monetary Policy Committee (MPC) has left Bank Rate unchanged at 0.75% so far in 2019 due to the ongoing uncertainty over Brexit. In its last meeting on 1 August, the MPC became more dovish as it was more concerned about the outlook for both the global and domestic economies. That's shown in the policy statement, based on an assumption that there is an agreed deal on Brexit, where the suggestion that rates would need to rise at a "gradual pace and to a limited extent" is now also conditional on "some recovery in global growth". Brexit uncertainty has had a dampening effect on UK GDP growth in 2019, especially around mid-year. If there were a no deal Brexit, then it is likely that there will be a cut or cuts in Bank Rate to help support economic growth.

The above forecasts have been based on an assumption that there is some sort of muddle through to an agreed deal on Brexit. Given the current level of uncertainties, this is a huge assumption and so forecasts may need to be materially reassessed in the light of events over the next few weeks or months.

### The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit, as well as a softening global economic picture.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are currently a little below those to the downside.

**Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:**

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- **Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis**, possibly **Italy**, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March 2018 of a government which has made a lot of anti-austerity noise. The EU has had sharp disagreements in successive years with Italy over setting a budget within the limits of EU rules. (Early September – a new coalition government may be formed which would be less anti-EU.) The rating agencies have already downgraded Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold Italian debt. Unsurprisingly, investors are becoming increasingly concerned by the actions of the Italian government and consequently, Italian bond yields have risen – at a time when the government faces having to refinance over €200bn of debt maturing in 2019. However, the biggest concern is the major holdings of Italian government debt held by Italian banks and insurers. Any downgrading of such debt would cause Italian bond prices to fall, causing losses on their portfolios, so reducing their capital and forcing them to sell bonds – which, in turn, would cause further falls in their prices etc. This is the so called ‘**doom loop**’. Due to the Italian government’s already high level of debt, it would not be able to afford to bail out the banking system. **Portugal** faces the same problem as its debt is also only one notch above junk level.
- Weak capitalisation of some **European banks**, particularly Italian banks.
- **German minority government**. In the German general election of September 2017, Angela Merkel’s CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD had a major internal debate as to whether it could continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party’s convention in December 2018. However, this makes little practical difference as she has continued as Chancellor, though more recently concerns have arisen over her health. Early September 2019 – the results of the Saxony and Brandenburg regional elections were again very disappointing for the CDU and SPD; this will rejuvenate the tensions of October 2018 between these two parties that form the current coalition government.
- **Other minority EU governments**. Sweden, Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Italy, Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been rising anti-immigration sentiment in Germany and France.



- The increases in interest rates in the US during 2018, combined with a trade war between the USA and China, sparked major volatility in equity markets during the final quarter of 2018 and into 2019. In mid-2019, investor fears of a looming recession have again sparked moves by investors out of riskier assets i.e. equities, into safe havens of government bonds of major western countries. Some **emerging market countries** which have borrowed heavily in dollar denominated debt could be particularly exposed to investor flight from equities to safe havens, typically US treasuries, German bunds and UK gilts.
- There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.
- **Geopolitical risks**, for example in North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

#### Upside risks to current forecasts for UK gilt yields and PWLB rates

- **Brexit** – if agreement was reached all round that removed all threats of economic and political disruption between the EU and the UK.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- **UK inflation**, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields

#### 4. Treasury Management Strategy Statement and Annual Investment Strategy Update

The Treasury Management Strategy Statement, (TMSS), for 2019/20 was approved by this Council on 26<sup>th</sup> March 2019. It was revised in August 2019 and subsequently approved by Council on 26<sup>th</sup> September 2019. This approval includes additional borrowing in support of the Councils Property Investment Strategy. TMSS changes are summarised below:

Prudential Indicator 2019/20	Original £'000	Revised Prudential Indicator £'000
Authorised Limit	30,500	35,500
Operational Boundary	28,500	33,500
Capital Financing Requirement	26,975	31,975

## 5. The Council's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

### 5.1 Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

Capital Expenditure by Service	2019/20 Original Estimate £'000	2019/20 Revised Estimate £'000
Private Sector Housing	2,325	2,325
Asset Renewal	516	516
Area Committees	351	351
Resource Procurement	3,229	3,229
Other General Schemes	1,490	1,490
Commercial Investments	-	5,000
<b>Total capital expenditure</b>	<b>7,910</b>	<b>12,910</b>

### 5.2 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements. The increase in the revised borrowing requirement relates to financing of commercial/non-financial investments.

Capital Expenditure	2019/20 Original Estimate £'000	2019/20 Revised Estimate £'000
<b>Total capital expenditure</b>	<b>7,910</b>	<b>12,910</b>
<i>Financed by:</i>		
Capital receipts	2,238	2,238
Capital grants	1,322	1,322
Revenue	206	206
<b>Total financing</b>	<b>3,766</b>	<b>3,766</b>
<b>Borrowing requirement</b>	<b>4,144</b>	<b>9,144</b>



### 5.3 Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period, which is termed the Operational Boundary.

#### Prudential Indicator – Capital Financing Requirement

We are on target to achieve the revised forecast Capital Financing Requirement

#### Prudential Indicator – the Operational Boundary for external debt

	Original Estimate 2019/20 £'000	Revised Estimate 2019/20 £'000
<b>Total CFR</b>	26,975	31,975
<b>Net movement in CFR</b>	3,607	8,607
Borrowing	28,000	33,000
Other long term liabilities	500	500
<b>Total Debt (year end position)</b>	<b>28,500</b>	<b>33,500</b>

### 5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose\*. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2019/20 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	Original Estimate 2019/20 £'000	Revised Estimate 2019/20 £'000
Total Debt B/Fwd	<b>20,359</b>	<b>20,359</b>
Borrowing	5,000	10,000
Other long term liabilities	112	112
<b>Total Debt</b>	<b>25,471</b>	<b>30,471</b>
<b>CFR* (year end position)</b>	<b>26,975</b>	<b>31,975</b>

The Chief Financial Officer reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

<b>Authorised Limit for External Debt</b>	<b>Original Indicator 2019/20 £'000</b>	<b>Revised Indicator 2019/20 £'000</b>
Borrowing	30,000	35,000
Other long term liabilities	500	500
<b>Total Debt</b>	<b>30,500</b>	<b>35,500</b>

## 6. Investment Portfolio 2019/20

In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As shown by forecasts in section 3.2, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the current 0.75% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

The Council held £21m of investments as at 30<sup>th</sup> September 2019 (£16m at 31<sup>st</sup> March 2019) and the investment portfolio yield for the first six months of the year is 0.83% against a the average 6 month LIBID six month benchmark of 0.74%.

The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2019/20.

The Council's budgeted investment return for 2019/20 is £65k, and performance for the year to date is in line with the budget.

### Investment Counterparty Criteria

The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function. No changes to the Annual Investment Strategy (AIS) were made when the TMSS was revised in August 2019.

## 7. Borrowing

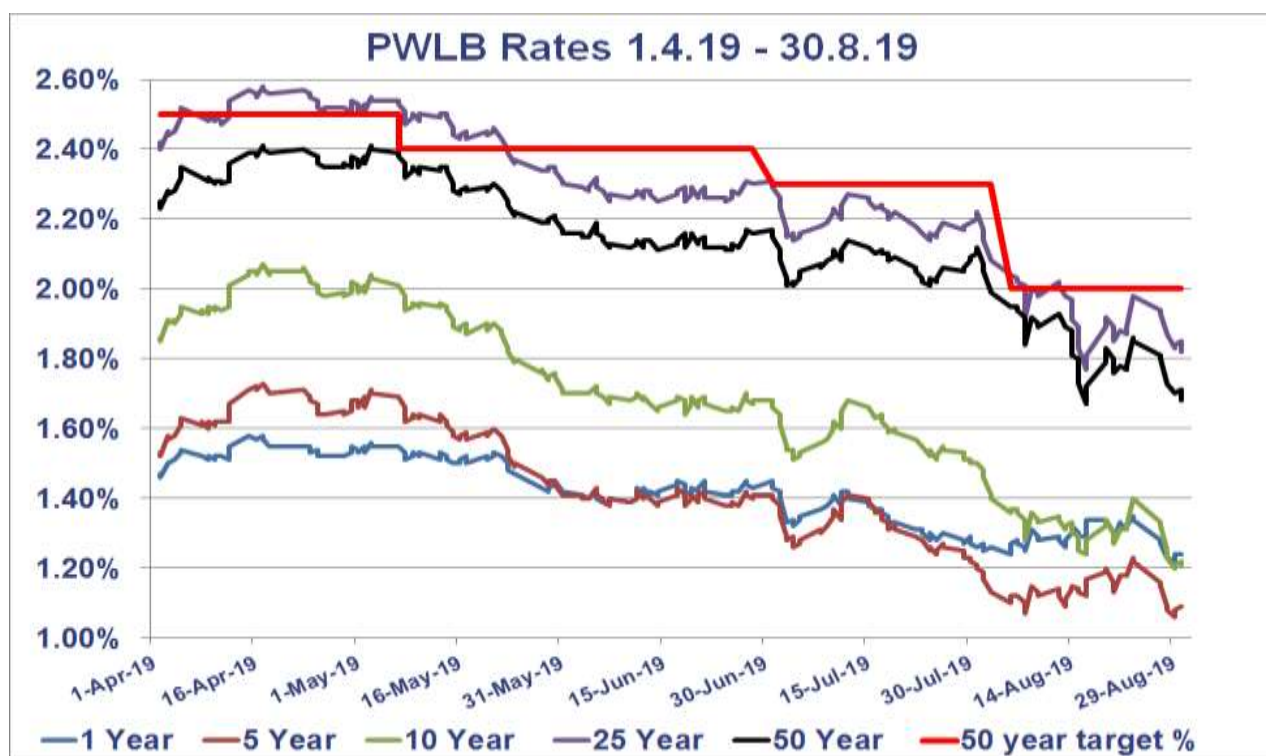
The Council's revised capital financing requirement (CFR) for 2019/20 is £31.975m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Table 5.4 shows the Council has revised borrowings of £31.96m and has utilised £1.50m of cash flow funds in lieu of borrowing.

This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails and the actions of the Government in increasing the PWLB interest rates.

Due to the overall financial position and the underlying need to borrow for capital purposes (the capital financing requirement - CFR), new external borrowing of £4m was undertaken from the PWLB in three separate loans as follows:-

- 21<sup>st</sup> June 2019 - £1m repayable on 31<sup>st</sup> March 2049 at a fixed rate of 2.28%
- 21<sup>st</sup> June 2019 - £1.5m repayable on 31<sup>st</sup> March 2056 at a fixed rate of 2.21%
- 13<sup>th</sup> September 2019 - £1.5m repayable on 31<sup>st</sup> March 2034 at a fixed rate of 1.76%

This borrowing above was carried out before the interest rates increase on 09/10/2019 and therefore secured the lower interest rate which in turn achieves budgetary savings for future years on the cost of debt. Council will continue to review the balance of its approved borrowing need throughout the year and any other movement in PWLB rates. The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date:



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.22%	1.06%	1.20%	1.77%	1.67%
Date	29/08/2019	29/08/2019	29/08/2019	16/08/2019	16/08/2019
High	1.58%	1.73%	2.07%	2.58%	2.41%
Date	15/04/2019	17/04/2019	17/04/2019	17/04/2019	17/04/2019
Average	1.41%	1.41%	1.68%	2.27%	2.13%

## **8. Debt Rescheduling**

Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling has been undertaken to date in the current financial year.