Annual Treasury Management Review

2019/20

Pendle Borough Council

August 2020

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1. Introduction

This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2019/20. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management, (the Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities, (the Prudential Code).

During 2019/20 the minimum reporting requirements were that the full Council and the Policy and Resources Committee should receive the following reports:

- an annual treasury strategy in advance of the year (Council 26/03/2019) and subsequently revised and approved in September 2019 to complement the Council's Property Investment Strategy;
- a mid-year (minimum) treasury update report (Policy and Resources Committee 24/10/2019);
- an annual review following the end of the year describing the activity compared to the strategy (this report)

In addition, the Accounts And Audit Committee received quarterly treasury management update reports in July, September and January. The March 2020 meeting of the Committee was cancelled due to the outbreak of Coronavirus.

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.

2. The Council's 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.

£m	2018/19 Actual	2019/20 Budget	2019/20 Actual
Capital expenditure			
Financed in year	2.7	16.8	3.0

3. The Council's Overall Borrowing Need

The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR).

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 should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2019/20) plus the estimates of any additional capital financing requirement for the current (2020/21) 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 £m	31 March 2020 Budget £m	31 March 2020 Actual £m
CFR General Fund (£m)	20.0	31.9	19.8
Gross borrowing position	20.4	30.4	23.4
(Under) / over funding of CFR	0.4	(1.5)	3.6

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
Authorised limit	£35.5m
Maximum gross borrowing position during the year	£24.4m
Operational boundary	£33.5m
Average gross borrowing position	£24.4m
Financing costs as a proportion of net revenue stream	7.89%

4. Treasury Position as at 31 March 2020

At the beginning and the end of 2019/20 the Council's treasury, (excluding borrowing by PFI and finance leases), position was as follows:

DEBT PORTFOLIO	31 March 2019 Principal £m	Rate/ Return	Average Life yrs	31 March 2020 Principal £m	Rate/ Return	Average Life yrs
Fixed rate funding:						
-PWLB	£20.4	3.11%	28	£23.4	2.91%	29
Total debt	**£20.4**			**£23.4**		
CFR	**£20.0**			**£19.8**		
Over / (under) borrowing	**£0.4**			**£3.6**		
Total investments	**£16.0**	**0.76%**	**All<1yr**	**£20.0**	**0.79%**	**All<1yr**
Net debt	**£4.4**			**£3.4**		

The maturity structure of the debt portfolio was as follows:

	31 March 2019 Actual £m	2019/20 original limits %	31 March 2020 Actual %	2019/20 Actual limits %
Under 12 months	£1.0	20%	£1.0	4.3%
12 months and within 24 months	nil	30%	£1.0	4.3%
24 months and within 5 years	£3.0	40%	£3.0	12.8%
5 years and within 10 years	£3.5	60%	£3.0	12.8%
10 years and above	£12.9	100%	£15.4	65.8%

INVESTMENT PORTFOLIO	Actual 31 March 2019 £m	Actual 31 March 2019 %	Actual 31 March 2020 £m	Actual 31 March 2020 %
Treasury investments				
Banks	3.0	18.7%	3.5	17.5%
Building Societies - rated	3.5	21.9%	4.5	22.5%
Local authorities	9.5	59.4%	12.0	60%
TOTAL TREASURY INVESTMENTS	16.0	100%	20.0	100%

The Council does not hold non-treasury investments.

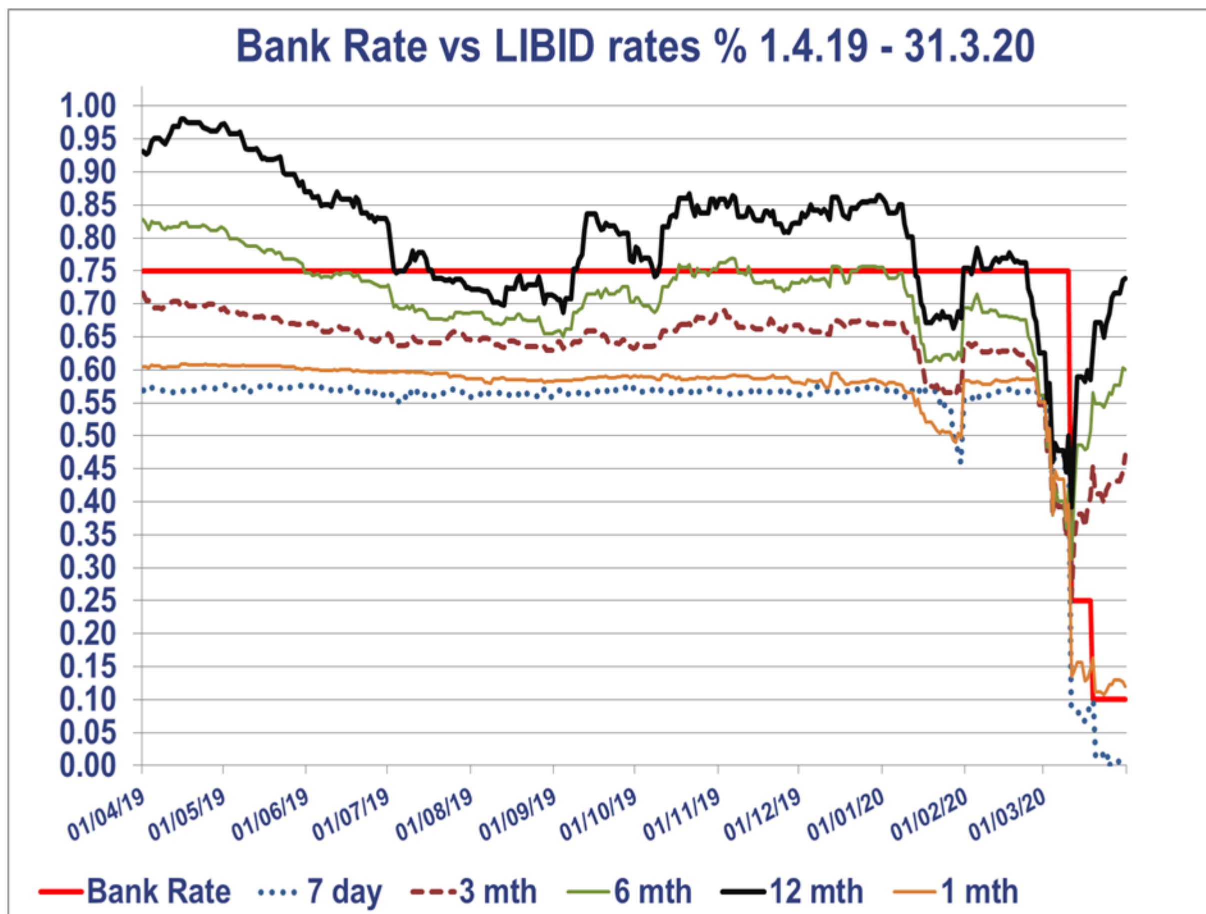
The maturity structure of the investment portfolio was as follows:

	2018/19 Actual £m	2019/20 Budget £m	31 March 2020 Actual £m
Investments All investments under 1 year*	16	20	20

**Maximum duration for qualifying investment is 364 days as per the approved AIS.*

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 1.0% 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 1.25% during 2020.

Rising concerns over the possibility that the UK could leave the EU at the end of October 2019 caused longer term investment rates to be on a falling trend for most of April to September. They then rose after the end of October deadline was rejected by the Commons but fell back again in January before recovering again after the 31 January departure of the UK from the EU. When the coronavirus outbreak hit the UK in February/March, rates initially plunged but then rose sharply back up again due to a shortage of liquidity in financial markets. 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, in response to the emerging Coronavirus pandemic at that time.

While the Council has taken a cautious approach to investing, it is also fully appreciative of changes to regulatory requirements for financial institutions in terms of additional capital and liquidity that came about in the aftermath of the financial crisis. These requirements have provided a far stronger basis for financial institutions, with annual stress tests by regulators evidencing how institutions are now far more able to cope with extreme stressed market and economic conditions.

Investment balances have been kept to a minimum through the agreed strategy of using reserves and balances to support internal borrowing, rather than borrowing externally from the financial markets. External borrowing would have incurred an additional cost, due to the differential between borrowing and investment rates as illustrated in the charts shown above and below. Such an approach has also provided benefits in terms of reducing the counterparty risk exposure, by having fewer investments placed in the financial markets.

5.2 Borrowing strategy and control of interest rate risk

At the end of 2019-20 the Council reported an outturn of an over-borrowed position in the context of gross external debt compared to its Capital Financing Requirement (CFR). The Council has not applied any ‘prudential’ borrowing to finance its capital expenditure during the year.

The Council has significant sums carried forward into 2020/21 (slippage) to support planned capital expenditure and anticipates this over-borrowed positon to unwind over the life of the medium term Capital Programme as capital projects conclude, and spend is incurred.

A cost of carry remained during the year on new long-term borrowing that was not immediately used to finance capital expenditure, causing 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 managing new borrowing in accordance with the approved Treasury Management Strategy and 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, as outlined above with regard to slippage on the approved capital programme.

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. Borrowing Outturn for 2019/20

Treasury Borrowing – the following loans were taken during the year:

Lender	Principal	Type	Interest Rate	Maturity
PWLB	£1.0m	Fixed interest rate	2.28%	30 years
PWLB	£1.5m	Fixed interest rate	2.21%	37 years
PWLB	£1.5m	Fixed interest rate	1.76%	15 years

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 borrowed where it was considered optimal to do so in order to finance capital expenditure which would be incurred within the time frame of the forward approved Capital Financing Requirement estimates. In taking this decision, the Council carefully considered achieving best value, the risk of having to borrow at higher rates at a later date, the carrying cost of the difference between interest paid on such debt and interest received from investing funds which would be surplus until used, and that the Council could ensure the security of such funds placed on temporary investment.

Rescheduling
No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

Repayments
On 31st March 2020 the Council repaid £1m of PWLB borrowing.

7. Investment Outturn

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 26th March 2019 (included without amendment in the revised Treasury Management Strategy, approved by Council in September 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 Council does not place sole reliance on the use of its external consultants, using also its own interpretation of market data and information in support of the decision making process.

The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties. However, as a result of significant sums of Central Government funding received in March 2020, in response to the then emerging Coronavirus pandemic, the Council

breached its counterparty limit with Lloyds Bank Plc. This was reported to the Accounts and Audit Committee in July 2020, under the Councils approved Treasury Management Scheme of Delegation and the Committee's scrutiny role.

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

Housing authorities should consider whether this table should be split between General Fund and HRA

Balance Sheet Resources (£m)	31 March 2019	31 March 2020
Balances	**1.0**	**1.0**
Earmarked reserves	**6.4**	**6.3**
Provisions	**2.1**	**2.3**
Usable capital receipts	**2.0**	**1.6**
Total	**11.5**	**11.2**

Investments held by the Council - The Council maintained an average balance of £22m of internally managed funds. The internally managed funds earned an average rate of return of 0.79%. Comparable performance indicators are the average 7-day LIBID rate which was 0.53% or the 3-month LIBID rate which was 0.63%. This compares with a revised budget assumption of £20m investment balances earning an average rate of 0.75%.

Appendix 1: Prudential and treasury indicators

In order to ensure that over the medium term debt will only be used for a capital purpose, the local authority should ensure that debt does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus estimates of any additional capital financing requirement for the current and next two financial years.

1. PRUDENTIAL INDICATORS	2018/19	2019/20	2019/20
Extract from budget setting report*	**actual**	**original**	**actual**
	£'000	**£'000**	**£'000**
Capital Expenditure			
General CAPEX and Commercial Investments	£2,712	£12,910	£3,047
Ratio of financing costs to net revenue stream			
General	7.24%	11.02%	7.89%
Capital Financing Requirement (CFR)			
brought forward 1 April	£20,965	£20,404	£20,404
carried forward 31 March	£20,404	£31,975	£19,830
in year borrowing requirement	(£561)	£11,571	(£574)
Gross debt	£20,359	£30,471	£23,359
(Under) / over funding of CFR	(£45)	(£1,504)	£3,529

2. TREASURY MANAGEMENT INDICATORS	2018/19	2019/20	2019/20
	actual	original	actual
	£'000	£'000	£'000
Authorised Limit for external debt -			
borrowing	£30,000	£35,000	£35,000
other long term liabilities	£500	£500	£500
TOTAL	£30,500	£35,500	£35,500
Operational Boundary for external debt -			
borrowing	£28,000	£33,000	£33,000
other long term liabilities	£500	£500	£500
TOTAL	£28,500	£33,500	£33,500
Actual external debt	£20,359	£30,471	£23,359

Maturity structure of fixed rate borrowing during 2019/20	upper limit	lower limit
under 12 months	20%	0%
12 months and within 24 months	30%	0%
24 months and within 5 years	40%	0%
5 years and within 10 years	60%	0%
10 years and above	100%	0%

*Source: Budget Setting Report: Revised TMSS, Council Sept 2019.

The authorised limit is the aggregate of gross borrowing (i.e. before investment) and other long term liabilities such as transferred debt.

The operational boundary is based on the authorised limit but without the additional headroom.

The authorised limit and operational boundary separately identify borrowing from other long-term liabilities.

GLOSSARY OF TERMS

ALMO: an Arm's Length Management Organisation is a not-for-profit company that provideshousing services on behalf of a local authority. Usually an ALMO is set up by the authority to manage and improve all or part of its housing stock.

LAS: Link Asset Services, Treasury solutions – the council's treasury management advisers.

CE: Capital Economics - is the economics consultancy that provides Link Asset Services, Treasury solutions, with independent economic forecasts, briefings and research.

CFR: capital financing requirement - the council's annual underlying borrowing need to finance capital expenditure and a measure of the council's total outstanding indebtedness.

CIPFA: Chartered Institute of Public Finance and Accountancy – the professional accounting body that oversees and sets standards in local authority finance and treasury management.

CPI: consumer price index – the official measure of inflation adopted as a common standard by countries in the EU. It is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

ECB: European Central Bank - the central bank for the Eurozone

EU: European Union

EZ: Eurozone -those countries in the EU which use the euro as their currency

Fed: the Federal Reserve System, often referred to simply as "the Fed," is the central bank of the United States. It was created by the Congress to provide the nation with a stable monetary and financial system.

FOMC: the Federal Open Market Committee – this is the branch of the Federal Reserve Board which determines monetary policy in the USA by setting interest rates and determining quantitative easing policy. It is composed of 12 members--the seven members of the Board of Governors and five of the 12 Reserve Bank presidents.

GDP: gross domestic product – a measure of the growth and total size of the economy.

G7: the group of seven countries that form an informal bloc of industrialised democracies--the United States, Canada, France, Germany, Italy, Japan, and the United Kingdom--that meets annually to discuss issues such as global economic governance, international security, and energy

policy.

Gilts: gilts are bonds issued by the UK Government to borrow money on the financial markets. Interest paid by the Government on gilts is called a coupon and is at a rate that is fixed for the duration until maturity of the gilt, (unless a gilt is index linked to inflation); while the coupon rate is fixed, the yields will change inversely to the price of gilts i.e. a rise in the price of a gilt will mean that its yield will fall.

HRA: housing revenue account.

13

IMF: International Monetary Fund - the lender of last resort for national governments which get into financial difficulties.

LIBID: the London Interbank Bid Rate is the rate bid by banks on deposits i.e., the rate at which a bank is willing to borrow from other banks. It is the "other end" of the LIBOR (an offered, hence "ask" rate, the rate at which a bank will lend).

MHCLG: the Ministry of Housing, Communities and Local Government -the Government department that directs local authorities in England.

MPC: the Monetary Policy Committee is a committee of the Bank of England, which meets for one and a half days, eight times a year, to determine monetary policy by setting the official interest rate in the United Kingdom, (the Bank of England Base Rate, commonly called Bank Rate), and by making decisions on quantitative easing.

MRP: minimum revenue provision -a statutory annual minimum revenue charge to reduce the total outstanding CFR, (the total indebtedness of a local authority).

PFI: Private Finance Initiative – capital expenditure financed by the private sector i.e. not by direct borrowing by a local authority.

PWLB: Public Works Loan Board – this is the part of H.M. Treasury which provides loans to local authorities to finance capital expenditure.

QE: quantitative easing – is an unconventional form of monetary policy where a central bank creates new money electronically to buy financial assets, such as government bonds, (but may also include corporate bonds). This process aims to stimulate economic growth through increased private sector spending in the economy and also aims to return inflation to target. These

purchases increase the supply of liquidity to the economy; this policy is employed when lowering interest rates has failed to stimulate economic growth to an acceptable level and to lift inflation to target. Once QE has achieved its objectives of stimulating growth and inflation, QE will be reversed by selling the bonds the central bank had previously purchased, or by not replacing debt that it held which matures. The aim of this reversal is to ensure that inflation does not exceed its target once the economy recovers from a sustained period of depressed growth and inflation. Economic growth, and increases in inflation, may threaten to gather too much momentum if action is not taken to 'cool' the economy.

RPI: the Retail Price Index is a measure of inflation that measures the change in the cost of a representative sample of retail goods and services. It was the UK standard for measurement of inflation until the UK changed to using the EU standard measure of inflation – CPI. The main differences between RPI and CPI is in the way that housing costs are treated and that the former is an arithmetical mean whereas the latter is a geometric mean. RPI is often higher than CPI for these reasons.

TMSS: the annual treasury management strategy statement reports that all local authorities are required to submit for approval by the full council before the start of each financial year.

VRP: a voluntary revenue provision to repay debt, in the annual budget, which is additional to the annual MRP charge, (see above definition).