Treasury Management Mid-Year Monitoring Report 19/20

1. Executive Summary

1.1. The Fire and Rescue Authority adopts the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code), last updated in 2017. The CIPFA Code requires the Fire and Rescue Authority to approve a treasury management strategy before the start of the year and semi-annual and annual treasury management reports.

1.2. This report fulfils the Fire and Rescue Authority's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code and provides an update on the performance of the treasury management function during 2019/20.

1.3. Treasury management in the context of this report is defined as:

"The management of the organisation's 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."

1.4. Overall responsibility for treasury management remains with the Fire and Rescue Authority. No treasury management activity is without risk and the effective identification and management of risk are integral to the Fire and Rescue Authority's treasury management objectives.

1.5. All treasury activity has complied with the Fire and Rescue Authority's TMS and Investment Strategy for 2019/20, and all relevant statute, guidance and accounting standards. In addition, support in undertaking treasury management activities has been provided by the Fire and Rescue Authority's treasury advisers, Arlingclose. The Fire and Rescue Authority has also complied with all of the prudential indicators set in its TMS.

1.6. The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, which is a summary document approved by full council covering capital expenditure and financing, treasury management and non-treasury investments. Hampshire Fire and Rescue Authority's Capital and Investment Strategy, complying with CIPFA's requirement, was approved by the Fire and Rescue Authority on 20 February 2019.

2. Recommendation

2.1. That the mid-year review of treasury management activities be noted.

3. External Context

3.1. The following sections outline the key economic themes currently in the UK against which investment and borrowing decisions have been made to date in 2019/20.

Economic Commentary

3.2. UK Consumer Price Inflation (CPI) for June 2019 was 2.0% year on year, coming in at consensus and meeting the Bank of England's inflation target.

3.3. Labour market data for the three months to May 2019 showed the unemployment rate remained at a low of 3.8% while the employment rate of 76.0% dipped by 0.1%, the first quarterly decrease since June to August 2018. Once adjusted for inflation, real wages were up 1.7% on an annual basis as wages continue to rise steadily and provide some upward pressure on general inflation.

3.4. There was a rise in quarterly GDP growth in the first calendar quarter for 2019 from 0.2% in Q4 2018 to 0.5%, with stockpiling ahead of the expected March 2019 Brexit date distorting data. Production and construction registered positive output and growth in the period, however at the end of June 2019, seasonally adjusted Markit UK Construction PMI (Purchasing Manager's Index) logged a record-low figure of 43.1, suggesting that construction has suffered the largest contraction in output since April 2009. GDP growth was 1.8% year/year, however with the service sector slowing and a weaker global backdrop the outlook was for subdued growth.

3.5. In early July, the Bank of England Governor Mark Carney signalled a major shift to the Bank's rhetoric and increased the possibility of interest rate cuts, however the Monetary Policy Committee voted unanimously to maintain the official Bank Rate at 0.75% at the September 2019 meeting.

3.6. Globally, the European Central Bank cut its deposit rate by 10 basis points in September 2019 alongside announcing another round of stimulus, which was closely followed by a 25 basis points cut by the US Federal Reserve.

Financial Markets

3.7. Markets have rallied since the beginning of 2019, and the FTSE 100 was up over 10% in pure price terms for the first 6 months of the calendar year, with most of the gains achieved in the first quarter of the calendar year.

3.8. Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. Gilt yields fell, with the 5-year benchmark gilt yield falling from 0.75% at the start of April to 0.63% at the end of June. There were falls in the 10-year and 20-year gilts over the same period dropping from 1.00% to 0.83% and from 1.47% to 1.35% respectively. Money markets rates stabilised with 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaging 0.60%, 0.68% and 0.92% respectively over the period.

3.9. Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth is not just a UK phenomenon but a global risk. The US yield curve inverted (10-year Treasury yields were lower than US 3-month money market rates) in March 2019 and this relationship remained and broadened throughout the period. History has shown that a recession hasn't been far behind a yield curve inversion.

3.10. Germany sold 10-year Bunds at -0.24% in June, the lowest yield on record. Bund yields had been trading at record lows in the secondary market for some time, however the negative yield in the primary market suggests that if investors were to hold until maturity, they are guaranteed to sustain a loss - highlighting the uncertain outlook for Europe's economy.

Credit Background

3.11. Credit Default Swap (CDS) spreads fell slightly across the board during the quarter, continuing to remain low in historical terms. After hitting around 97bps at the start of the period, the spread on non-ringfenced bank NatWest Markets plc fell back to around 82bps at the end of June, while for the ringfenced entity, National Westminster Bank plc, the spread fell from 67bps to 58bps. The other main UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 28 and 59bps at the end of the period.

3.12. S&P upgraded RBS Group and its subsidiaries, raising the long-term issuer ratings by one notch due to RBS Group's strengthened credit fundamentals following a long period of restructuring. S&P believes the group and its subsidiaries have enhanced their capacity to manage the current UK political and economic uncertainties.

3.13. There were minimal other credit rating changes during the period to the end of June 2019. Moody's revised the outlook on Barclays Bank PLC to positive from stable and also revised the outlook to stable from negative for Goldman Sachs International Bank.

4. Local Context

4.1. On 31 March 2019, the Fire and Rescue Authority had net investments of £13.5m a greater cash balance in comparison to the financing of its historical capital programme. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below:

Table 1: Balance Sheet Summary

	31/03/2019 Balance £m
CFR	(11.2)
Less: Resources for investment	24.7
Net investments	13.5

4.2. The Fire and Rescue Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, to reduce risk and keep interest costs low. The treasury management position as at 31 August 2019 and the movement since 31 March 2019 is shown in Table 2 overleaf:

Table 2: Treasury Management Summary

	31/03/2019 Balance £m	Movement £m	30/08/2019 Balance £m	30/08/2019 Rate %
Long-term borrowing	(8.30)	-	(8.30)	(4.70)
Short-term borrowing	(0.10)	-	(0.10)	(4.88)
Total borrowing	(8.40)	-	(8.40)	(4.71)
Long-term investments	6.50	2.50	9.00	2.55
Short-term investments	10.00	7.50	17.50	0.91
Cash and cash equivalents	7.88	(1.00)	6.88	0.73
Total investments	24.38	9.00	33.38	1.32
Net external investments	15.98	9.00	24.98	

Note: the figures as at 31 March 2019 in the table above are from the balance sheet in the Fire and Rescue Authority's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments.

4.3. The increase in net investments of £9.0m shown in Table 2 above reflects the combination of no increase in borrowing, and an increase in investment balances of £9.0m. The increase in total investments since 31 March 2019 reflects the fact that the balance at 31 March is typically the lowest of the year, due to many government grants being front-loaded. The largest grant is the annual pensions grant, which is received every July and used to pay pensions throughout the year.

5. Borrowing Activity

5.1. As shown in Table 2, at 31 August 2019 the Fire and Rescue Authority held £8.4m of loans, as part of its strategy for funding previous years' capital programmes. Further details are shown in Table 3 below.

Table 3: Borrowing Position

	31/03/19 Balance £m	Movement £m	30/08/19 Balance £m	30/08/19 Rate %	30/08/19 WAM* years
Public Works Loan Board	(8.40)	-	(8.40)	(4.71)	10.23
Total borrowing	(8.40)	-	(8.40)	(4.71)	10.23

* Weighted average maturity

Note: the figures in the table above at 31 March 2019 are from the balance sheet in the Fire and Rescue Authority's statement of accounts but adjusted to exclude borrowing taken out on behalf of others and accrued interest.

5.2. The Fire and Rescue Authority'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. The flexibility to renegotiate loans should the Fire and Rescue Authority's long-term plans change is a secondary objective.

5.3. In keeping with these objectives, no new borrowing was undertaken in the period. This strategy enabled the Fire and Rescue Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

5.4. The benefits of internal borrowing are monitored regularly against the potential for incurring additional costs by deferring borrowing into future years, when long-term borrowing rates are forecast to rise. Arlingclose assists the Fire and Rescue Authority with the monitoring of internal and external borrowing.

6. Investment Activity

6.1. The Fire and Rescue Authority holds invested funds representing income received in advance of expenditure plus balances and reserves. The Fire and Rescue Authority's investment holding was £33.38m at 31 August 2019, which was £2.28m (7%) higher than the same time last year.

6.2. During the five month period from 1 April to 31 August 2019, the Fire and Rescue Authority's investment balance ranged between £20m and £37m due to timing differences between income and expenditure.

6.3. Table 4 overleaf shows investment activity for the Fire and Rescue Authority as at 31 August 2019 in comparison to the reported activity as at 31 March 2019.

6.4. The increase in total investments since 31 March 2019 reflects the fact that the balance at 31 March is typically the lowest of the year, due to many government grants being front-loaded. The largest grant is the annual pensions grant, which is received every July and used to pay pensions throughout the year.

Table 4: Investment Position (Treasury Investments)

Investments	31/03/2019 Balance £m	Movement £m	30/08/2019 Balance £m	30/08/2019 Rate %	30/08/2019 WAM* years
Short term investments					
- Banks and Building Societies					
- Unsecured	3.07	3.43	6.50	0.82	0.25
- Secured	4.00	2.00	6.00	1.06	0.59
- UK Treasury Bills	-	3.00	3.00	0.70	0.16
- Money Market Funds	6.81	(0.93)	5.88	0.73	0.00
- Local Authorities	4.00	(1.00)	3.00	0.96	0.72
	17.88	6.50	24.38	0.86	0.32
Long term investments					
- Banks and Building Societies					
- Secured	2.00	(1.00)	1.00	1.03	3.62
- Local Authorities	1.00	-	1.00	1.30	1.82
	3.00	(1.00)	2.00	1.16	2.72
High yield investments					
- Pooled Property Funds**	2.00	1.25	3.25	2.86	n/a
- Pooled Equity Funds**	1.50	0.50	2.00	5.06	n/a
- Multi-Asset Fund**	-	1.75	1.75	0.69	n/a
	3.50	3.50	7.00	2.95	n/a
TOTAL INVESTMENTS	24.38	9.00	33.38	1.32	0.50

* Weighted average maturity

** The rates provided for pooled fund investments are reflective of annualised income returns over the year to 30 June 2019. The lower rate for the Multi-Asset Fund is largely due to the effect of a purchase part way through the year.

Note: the figures in the table above are from the balance sheet in the Fire and Rescue Authority's statement of accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments.

6.5. The CIPFA Code and government guidance both require the Fire and Rescue Authority 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.

6.6. The Fire and Rescue Authority'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.

6.7. Security of capital has remained the Fire and Rescue Authority's main investment objective. This has been maintained by following the Fire and Rescue's counterparty policy as set out in its Treasury Management Strategy Statement for 2019/20.

6.8. Counterparty credit quality has been assessed and monitored with reference to credit ratings, the analysis of funding structures and susceptibility to bail-in, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

6.9. The Fire and Rescue Authority also makes use of secured investments products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.

6.10. To ensure sufficient liquidity, The Fire and Rescue Authority makes use of call accounts and money market funds. With the uncertainty around Brexit, the Fire & Rescue Authority will ensure there are enough accounts open at UK domiciled banks and Money Market Funds to hold sufficient liquidity and that its account with the Debt Management Account Deposit Facility (DMADF) remains available for use in an emergency.

6.11. The progression of credit risk and return metrics for the Fire and Rescue Authority's investments managed in-house (excluding external pooled funds) are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below:

Table 5: Investment Benchmarking (investments managed in-house)

	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return
HFRA performance:				
- 31/03/2019	AA	43%	178	0.93%
- 30/06/2019	AA-	55%	172	0.89%
Police & Fire Authorities	AA-	66%	69	0.71%
All LAs	AA-	62%	28	0.85%

* Weighted average maturity

6.12. To reduce risk, approximately 45% of the Fire and Rescue Authority's surplus cash is invested so that it is not subject to bail-in risk, with the remaining balance largely held in overnight money market funds, which are subject to reduced bail in risk. By comparison, only 34% of the cash held by other similar Police and Fire Authorities is not subject to bail-in risk.

6.13. The UK Bank Rate has remained at 0.75% since August 2018 and short-term money market rates have also continued to be relatively low. This has had an ongoing impact on the Fire and Rescue Authority's ability to generate income on cash investments and average returns on internally managed investments have reduced slightly since 31 March 2019, however these remain greater than for comparable Police and Fire Authorities.

6.14. As the Fire & Rescue Authority has relatively stable cash balances, the allocation to investments targeting higher yields was increased from £3.5m to £7.0m as part of the Treasury Management Strategy for 2019/20, with the aim of increasing the level of income contributed to the revenue budget without impacting liquidity.

6.15. This amount has now been fully invested in externally managed pooled equity, property and multi-asset funds which generated an average annual total return of 2.84% during the period to 31 August 2019. This return comprised a 6.26% income return which contributes to the revenue budget and is used to support services in year, offset by 3.42% of negative capital growth (around £0.25m).

6.16. These investments have fallen in value in the first five months of 2019/20 due to volatility in the markets, however the Fire & Rescue Authority's intention is to hold these investments for at least the medium-term and losses would only be crystallised if the investments were sold.

6.17. The investments in pooled funds are made in the knowledge that capital values will move both up and down in the short term, but with the confidence that over a three- to five- year period total returns should exceed cash interest rates, whilst also providing regular income, diversification and the potential for capital growth and it is the Fire and Rescue Authority's intention to hold these investments for at least the medium term.

6.18. Recent changes to accounting regulations (IFRS9) have introduced a new risk related to the Fire & Rescue Authority's investments in pooled funds whereby any fall in the capital value of the funds would now have to be taken as an expenditure charge to the Fire & Rescue Authority's Income and Expenditure account. This does not though present an immediate risk to the Fire and Rescue Authority, as there is currently a statutory override in place that provides a 4 year grace period before this requirement is implemented.

6.19. If no further changes are made at the end of the 4 year period, the risk of a fall in value resulting in an expenditure charge for the Fire and Rescue Authority will be mitigated by reserves accrued through any increases in the value of the Fire and Rescue Authority's investments over the next 4 years.

6.20. The performance and ongoing suitability of these pooled funds in meeting the County Council's investment objectives is monitored regularly and discussed with Arlingclose.

7. Non-Treasury Investments

7.1. Although not classed as treasury management activities the Fire & Rescue Authority may also make loans and investments for service purposes, for example the direct purchase of land or property. Such loans and investments will be subject to the Fire & Rescue Authority's normal approval processes for revenue and capital expenditure and need not comply with this treasury management strategy. The Fire & Rescue Authority does not have any existing non-treasury investments.

8. Compliance Report

8.1. The Fire and Rescue Authority confirms compliance of all treasury management activities undertaken during the period with the CIPFA Code of Practice and the Fire and Rescue Authority's approved TMS. Compliance with the authorised limit and operational boundary for external debt, is demonstrated in Tables 6 overleaf.

Table 6: Debt Limits

	2019/20 Maximum £m	30/08/2019 Actual £m	2019/20 Operational Boundary £m	2019/20 Authorised Limit £m	Complied
Borrowing	8.4	8.4	14.5	18.2	✓
Other long term liabilities	-	-	5.0	5.0	✓
Total debt	8.4	8.4	19.5	23.2	✓

9. Treasury Management Indicators

9.1. The Fire and Rescue Authority measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

9.2. The following indicator shows the sensitivity of the Fire & Rescue Authority's current investments and borrowing to a change in interest rates:

Table 7: Interest Rate Exposures

	31/08/19 Actual	**Impact of +/-1% interest rate change**
Variable interest rate investment exposure	£25m	+/- £0.3m
Variable interest rate borrowing exposure	£0m	n/a

9.3. Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

Maturity Structure of Borrowing

9.4. This indicator is set to control the Fire and Rescue Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be as shown in table 8 overleaf:

Table 8 – Maturity Structure of Borrowing

	30/08/2019 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	1%	50%	0%	✓
12 months and within 24 months	14%	50%	0%	✓
24 months and within 5 years	19%	50%	0%	✓
5 years and within 10 years	5%	75%	0%	✓
10 years and within 20 years	61%	75%	0%	✓
20 years and above	0%	100%	0%	✓

Principal Sums Invested for Periods Longer than 365 days

9.5. The purpose of this indicator is to control the Fire and Rescue Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

Table 9 – Principal Sums Invested for Periods Longer than 365 days

	2019/20	2020/21	2021/22
Actual principal invested beyond year end	£9.0m	£9.0m	£8.0m
Limit on principal invested beyond year end	£10m	£10m	£10m
Complied	✓	✓	✓

9.6. The table includes investments in strategic pooled funds of £7m as although these can usually be redeemed at short notice, the Fire and Rescue Authority intends to hold these investments for at least the medium-term.

10. Outlook for the remainder of 2019/20

10.1. Having increased interest rates by 0.25% in November 2018 to 0.75%, the Bank of England's Monetary Policy Committee (MPC) is now expected to maintain Bank Rate at this level for the foreseeable future. There are, however, upside and downside risks to this forecast, dependant on Brexit outcomes and the evolution of the global economy.

10.2. With the downside risks to the UK economy growing and little likelihood of current global trade tensions being resolved imminently and global growth recovering soon thereafter, our treasury advisor Arlingclose's central forecast is for that the Bank of England's MPC will maintain Bank Rate at 0.75% but will stand ready to cut rates should the Brexit process engender more uncertainty for business and consumer confidence and for economic activity.

	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Case	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Downside risk	0.00	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75

10.3. Gilt yields have fallen to recent lows. Resolution of global political uncertainty would see yields rise but volatility arising from both economic and political events continue to offer longer-term borrowing opportunities for those clients looking to lock in some interest rate certainty.