

Treasury Management Mid-Year Monitoring 2019/20

1. Purpose

- 1.1. The County Council has adopted the key recommendations of 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 County Council to approve a treasury management strategy before the start of the year and a semi-annual and annual treasury outturn report.

2. External Context

- 2.1. The following section outlines the key economic themes currently in the UK against which investment and borrowing decisions have been made in the year to date.

Economic Commentary

- 2.2. 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.
- 2.3. 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.
- 2.4. There was a rise in quarterly Gross Domestic Product (GDP) growth in the first calendar quarter for 2019 from 0.2% in Quarter 4 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 Purchasing Manager's Index (PMI) 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.
- 2.5. 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 (MPC) voted unanimously to maintain the official Bank Rate at 0.75% at the September 2019 meeting.
- 2.6. Globally, the European Central Bank cut its deposit rate by 10 basis points (bps) in September 2019 alongside announcing another round of stimulus, which was closely followed by a 25bps cut by the US Federal Reserve.

Financial markets

- 2.7. 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.
- 2.8. 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.
- 2.9. Recent activity in the bond markets and Public Works Loan Board (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 has not been far behind a yield curve inversion.
- 2.10. 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

- 2.11. 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.
- 2.12. Standard & Poor's (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.
- 2.13. 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.

Outlook for the Remainder of 2019/20

- 2.14. Having increased interest rates by 0.25% in November 2018 to 0.75%, the Bank of England's 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.

- 2.15. 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

- 2.16. 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.

3. Local Context

- 3.1. On 31 March 2019, the County Council had net borrowing of £34.4m arising from financing 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

	31/03/19 Balance £m
CFR	(780.9)
Less: Other debt liabilities*	157.0
Borrowing CFR	(623.9)
Less: resources for investment	589.5
Net Borrowing	(34.4)

* PFI liabilities that form part of the County Council's total debt

- 3.2. The County Council's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing, to reduce risk and keep interest costs low. The treasury management position at 31 August 2019 and the movement since 31 March 2019 is shown in Table 2 below:

Table 2: Treasury Management Summary

	31/03/19 Balance £m	Movement £m	31/08/19 Balance £m	31/08/19 Rate 0%
Long-term borrowing	(271.3)	1.0	(270.3)	4.62
Short-term borrowing	(9.1)	0.5	(8.6)	4.27
Total Borrowing	(280.4)	1.5	(278.9)	4.61
Long-term investments	342.3	(40.1)	302.2	3.19
Short-term investments	184.0	60.6	244.6	1.03
Cash and cash equivalents	56.3	(18.3)	38.0	0.74
Total Investments	582.6	2.2	584.8	2.13
Net Investments	302.2	3.7	305.9	

Note: The figures in the table above are from the balance sheet in the County Council's Statement of Accounts, but adjusted to exclude operational cash, accrued interest and other accounting adjustments

- 3.3. The increase in net investments of £3.7m shown in Table 2 above reflects the combination of repayment of PWLB borrowing of £1.5m and a small increase in investment balances of £2.2m.
- 3.4. The repayment of borrowing is in line with the County Council's policy on internal borrowing. The increase in total investments reflects the fact that the balance at 31 March is typically the lowest of the year, due to many government grants being front loaded.

Borrowing Activity

- 3.5. At 31 August 2019 the County Council held £278.9m of loans (a decrease of £1.5m from 31 March 2019) as part of its strategy for funding previous years' capital programmes. The position at the 31 August and the year-end treasury management borrowing position are summarised in Table 3 below:

Table 3: Borrowing Position

	31/03/19 Balance £m	Net Movement £m	31/08/19 Balance £m	31/08/19 Weighted Average Rate %	31/08/19 Weighted Average Maturity Years
Public Works Loan Board	235.6	(1.5)	234.1	4.71	11.4
Banks (LOBO)	20.0	0	20.0	4.76	13.9
Other (fixed term)	24.8	0	24.8	3.54	17.5
Total Borrowing	280.4	(1.5)	278.9	4.61	12.1

Note: the figures in the table above at 31 March 2019 are from the balance sheet in the County Council's Statement of Accounts but adjusted to exclude borrowing taken out on behalf of others, and accrued interest.

- 3.6. The County Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.
- 3.7. Short-term interest rates have remained much lower than long-term rates and the County Council has therefore considered it to be more cost effective in the near term to use internal resources than to use additional borrowing.
- 3.8. With the assistance of Arlingclose, the benefits of this internal borrowing are regularly monitored against the potential for incurring additional costs by deferring borrowing into future years, when long-term borrowing costs may be higher.
- 3.9. As a result, no new borrowing was undertaken and £1.5m of existing PWLB loans were allowed to mature without replacement. This strategy enabled the County Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.
- 3.10. The County Council continues to hold £20m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the County Council has the option to either accept the new rate or to repay the loan at no additional cost. None of the LOBO loan options were exercised by the lender in the year.

4. Treasury Investment Activity

- 4.1. The County Council holds invested funds representing income received in advance of expenditure plus balances and reserves. The County Council's investment balance was £585m at 31 August 2019, which was £6m lower than at the same point in 2018/19.
- 4.2. During the five-month period to 31 August 2019, the County Council's investment balances ranged between £575m and £677m due to timing differences between income and expenditure. The investment position is shown in Table 4 overleaf:

Table 4: Treasury Investment Position

	31/03/19 Balance	Net Movement	31/08/19 Balance	31/08/19 Income Return	31/8/19 Weighted Average Maturity Years*
	£m	£m	£m	%	
Short term investments:					
- Banks and Building Societies:					
- Unsecured	30.4	10.6	41.0	0.97	0.18
- Secured	15.0	40.1	55.1	1.03	0.68
- Money Market Funds	55.3	(18.3)	37.0	0.74	0.00
- Local Authorities	124.5	15.0	139.5	1.02	0.33
- Corporate Bonds					
- Registered Provider	5.0	(5.0)			
- Cash Plus funds	10.0		10.0	1.64	N/A
Total	240.2	42.4	282.6	1.00	0.33
Long term investments:					
- Banks and Building Societies:					
- Secured	73.3	(40.1)	33.2	1.38	2.94
- Local Authorities	78.0	(10.0)	68.0	1.36	1.99
Total	151.3	(50.1)	101.2	1.37	2.30
Long term investments – high yielding strategy:					
- Local Authorities					
- Fixed deposits	20.0		20.0	3.96	14.55
- Fixed bonds	10.0		10.0	4.20	14.36
- Pooled Funds					
- Pooled property**	67.0	10.0	77.0	3.89	n/a
- Pooled equity**	52.0		52.0	4.90	n/a
- Pooled multi-asset**	42.0		42.0	3.58	n/a
- Registered provider					
Total	191.0	10.0	201.0	4.11	14.49
Total Investments	582.5	2.3	584.8	2.13	1.88

* The weighted average maturity figures exclude pooled fund and cash plus funds, which have no fixed end date.

** The rates provided for pooled fund investments are reflective of annualised income returns over the year to 30 June 2019.

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

4.3. The CIPFA Code and government guidance both require the County Council to invest its funds prudently and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield.

- 4.4. The County Council's objective when investing money is therefore to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults against the risk of receiving unsuitably low investment income.
- 4.5. Security of capital has remained the County Council's main investment objective and has been maintained by following the County Council's counterparty policy as set out in the Treasury Management Strategy Statement.
- 4.6. 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.
- 4.7. The County Council also makes use of secured investment products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.
- 4.8. To ensure sufficient liquidity, the County Council makes use of call accounts and money market funds. With the uncertainty around Brexit, the Council 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.
- 4.9. The progression of risk and return metrics for the County Council's investments that are 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 (excluding pooled funds)

	Credit Rating	Bail-in Exposure	Weighted Average Maturity Days	Rate of Return %
31/03/2019	AA	21%	758	1.35%
30/06/2019	AA-	28%	648	1.25%
Similar Local Authorities	AA-	51%	956	1.01%
All Local Authorities	AA-	62%	28	0.85%

- 4.10. To reduce risk, approximately 72% of the County Council'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 and cash plus funds, which are subject to reduced bail in risk. By comparison, only 49% of the cash held by other similar Local Authorities is not subject to bail-in risk.
- 4.11. 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 Council's ability to generate income on cash

investments, however returns on internally managed investments have been greater than for comparable local authorities.

- 4.12. As the County Council has relatively stable cash balances, the allocation to investments targeting higher yields was increased from £200m to £235m 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.
- 4.13. £201m of this amount has now been invested, £171m of which is in strategic multi-asset, equity and property funds which returned an average income of over 4.1% in dividend payments in the year to the end of June 2019.
- 4.14. These investments have fallen in value in the first half of 2019/20 due to volatility in the markets and are currently worth £660,000 less than the amount originally invested (a fall in percentage terms of 0.39%).
- 4.15. It is, however, the County Council's intention to hold these investments for at least the medium-term and losses would only be crystallised if the investments were sold. Investments 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.
- 4.16. Recent changes to accounting regulations (IFRS9) have introduced a new risk related to the County Council'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 Council's Income and Expenditure account. This does not though present an immediate risk to the County Council, as there is currently a statutory override in place that provides a 4 year grace period before this requirement is implemented.
- 4.17. 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 Council County will be mitigated by reserves accrued through any increases in the value of the County Council's investments over the next 4 years. In addition, a further £3m has already been added to reserves from investment income.
- 4.18. The performance and ongoing suitability of these pooled funds in meeting the County Council's investment objectives is monitored regularly and discussed with Arlingclose.

5. Non-Treasury Investments

- 5.1. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the County Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in the Ministry of Housing, Communities & Local Government (MHCLG) Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.
- 5.2. This could include loans made to Hampshire based businesses or the direct purchase of land or property and such loans and investments will be subject

to the County Council's normal approval process for revenue and capital expenditure and need not comply with the treasury management strategy.

- 5.3. The County Council's existing non-treasury investments are listed in Table 6 below:

Table 6: Non-Treasury Investments

	31/08/19 Asset Value £m	31/08/19 Rate %
Loans to Hampshire based business	9.5	4.00
Joint venture recruitment agency	0.2	5.00
Total	9.7	4.02

6. Compliance Report

- 6.1. The County Council confirms compliance of all treasury management activities undertaken during the period with the CIPFA Code of Practice and the County Council's approved Treasury Management Strategy.
- 6.2. Compliance with the authorised limit and operational boundary for external debt, is demonstrated in Table 7 below:

Table 7: Debt Limits

	2019/20 Maximum £m	31/08/19 Actual £m	2019/20 Operational Boundary £m	2019/20 Authorised Limit £m	Complied
Borrowing	280	279	690	730	✓
PFI and Finance Leases	157	157	160	200	✓
Total Debt	437	436	850	930	✓

7. Treasury Management Indicators

- 7.1. The County Council measures and manages its exposures to treasury management risks using the following indicators.

Interest Rate Exposures

- 7.2. The following indicator shows the sensitivity of the County Council's current investments and borrowing to a change in interest rates.

Table 8 – Interest Rate Exposures

	31/08/19 Actual	Impact of +/-1% Interest Rate Change
Variable interest rate investment exposure	£313m	+/- £3.1m
Variable interest rate borrowing exposure	£23m	+/- £0.2m

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

- 7.3. This indicator is set to control the County Council's exposure to refinancing risk. The upper and lower limits show the maximum and minimum maturity exposure to fixed rate borrowing as agreed in the Treasury Management Strategy Statement.

Table 9 – Maturity Structure of Borrowing

	31/08/19 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	3.6%	50%	0%	✓
12 months and within 24 months	4.2%	50%	0%	✓
24 months and within 5 years	9.4%	50%	0%	✓
5 years and within 10 years	18.3%	75%	0%	✓
10 years and within 20 years	54.5%	75%	0%	✓
20 years and within 30 years	10.0%	75%	0%	✓
30 years and above	0.0%	100%	0%	✓

- 7.4. The County Council holds £20m of LOBO loans where the lender has the option to propose an increase in the interest rate as set dates, following which the County Council has the option to either accept the new rate or to repay the loan at no additional cost. If not repaid before maturity, these loans have an average maturity date of 14 years (minimum 8 years; maximum 26 years).

Principal Sums Invested for Periods Longer than 364 days

- 7.5. The purpose of this indicator is to control the County Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

Table 10 – Principal Sums Invested Beyond Year End

	2019/20	2020/21	2021/22
Actual principal invested beyond year end	£365m	£274m	£246m
Limit on principal invested beyond year end	£410m	£350m	£350m
Complied	✓	✓	✓

- 7.6. The table includes investments in strategic pooled funds of £171m as although these can usually be redeemed at short notice, the County Council intends to hold these investments for at least the medium-term.