Item 15

Governance and Audit Committee

26 November 2019

Report of	**Assistant Director Policy and Corporate**	**Author**	**Paul Cook** ☏ **505861**
Title	**Treasury Management Strategy - Mid Year Review Report 2019/20**		
Wards affected	Not applicable		

1 Executive Summary

1.1 The 2019/20 Treasury Management Strategy Statement (TMSS) was approved by Council on 20 February 2019. This report is a mid-year review of the Council's treasury management.

1.2 Complying with CIPFA's Code of Practice on Treasury Management the update includes:

- an economic update
- whether key elements of the TMSS and annual investment strategy require changes
- performance against prudential indicators
- a review of borrowing strategy
- highlights areas to be taken into consideration in preparing the 2020/21 TMSS

1.3 In addition, this report covers recent changes in the structure of Public Works Loan Board lending rates to local authorities.

2 Recommended Decision

2.1 To approve the mid-year review.

3 Reason for Recommended Decision

3.1 Treasury Management governance arrangements require Governance and Audit to approve a mid-year Treasury Management report.

4 Alternative Options

4.1 Alternative options regarding treasury management activities are considered on an ongoing basis, in consultation with the Council's Treasury Advisors, Link Asset Services.

5 Introduction

5.1 **T**he Council operates a balanced budget in line with statutory requirements. This broadly means that in year income meets the Council's spending requirements.

5.2 Treasury Management operations ensure:

- that cashflow is adequately planned, with surplus monies being invested in line with the Council's Treasury Management Policies and Practices and the Council's risk appetite for investments and borrowing

- that the Council's capital plans are fully funded, treasury management practices supporting the requirement for long term cashflow planning and supporting the Council's need to borrow.

- Local Authorities are required under statute to self-regulate on the affordability, prudence and sustainability of its capital investment plans and borrowing through a process of setting estimates, indicators and the Council's overall risk appetite; and reporting on these on a regular basis.

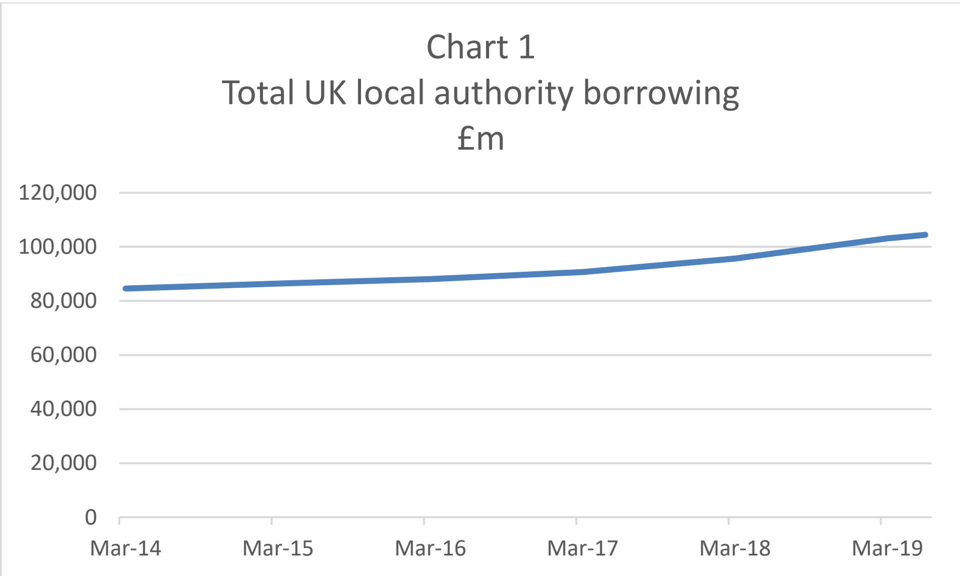
5.3 Treasury Management is defined as 'the management of the Council's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of risks associated with these activities; and the pursuit of optimum performance consistent with those risks.'

5.4 The management of the Council's treasury management processes is supported by Treasury Management Practices and the Council employs Link Asset Services to provide specialist consultancy in respect of treasury management, especially with regards to investments and debt, as well as capital accounting arrangements and asset finance.

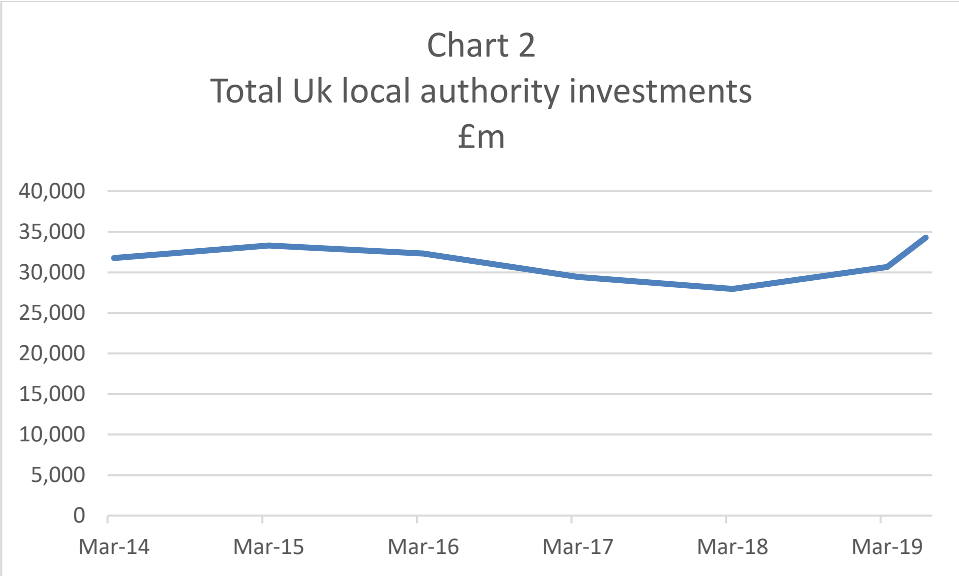
5.6 In line with statutory requirements the Council has adopted the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017). This mid-year position report complies with the Code.

6 Economic Update

6.1 Local authority borrowing has gradually increased over the last few financial years. This reflects the funding of local authority capital programmes.



6.2 Over the same period there has been more variability in total investments.



6.3 There has been a considerable rise in the use of money market funds and other managed funds reflecting the low rates on offer from banks directly to local authorities. The table shows Colchester's comparative position at June 2019. It would appear appropriate for Colchester to examine the potential to invest in other managed funds and proposals will form part of the 2020/21 TMSS proposals brought forward to Cabinet.

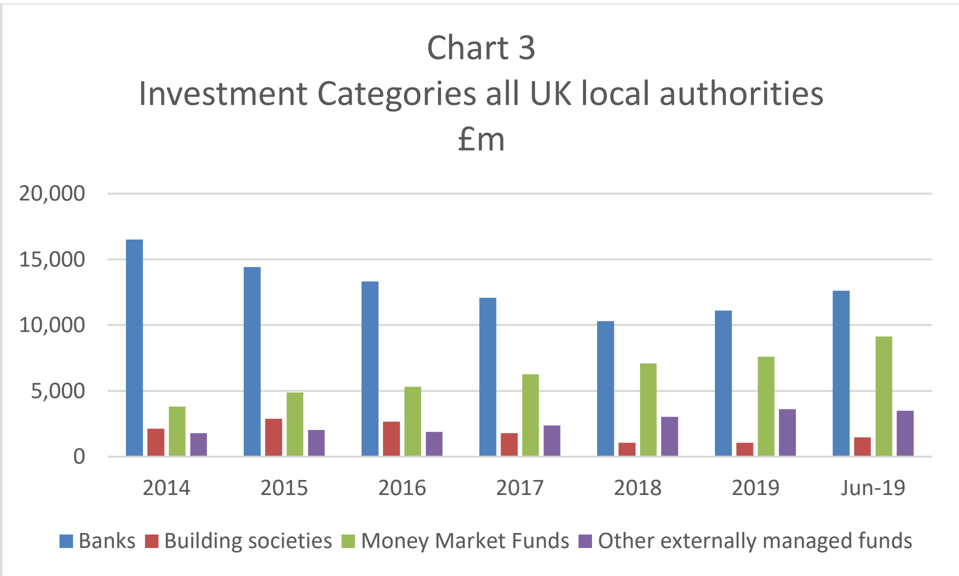


Table 1 – Investment distribution 30 June 2019		UK local authorities	Colchester
1	Bank	29%	52%
2	Building society	3%	6%
3	Money market funds	21%	36%
4	Externally managed funds	8%	Nil
5	Local government	22%	6%
6	Other	17%	Nil
7	Total	100%	100%

6.4 The economic forecast remains difficult with numerous external influences impacting on the UK economy. A recent update provided by the Council's Treasury advisors concludes the following over the next few years based on a level risk analysis:

- moderate levels of growth of 1.4% for 2019, increasing to 1.5% in 2020;

- inflation has decreased to 1.7% in August 2019, but is expected to remain close to the government target of 2%;
- unemployment continues at a 44 year low of 3.8%, with indications that employers are finding it difficult to recruit suitable staff; which could lead to wage inflation and a potential spur in increased household spending.
- the bank rate currently stands at 0.75% and is expected to hold off on changes until there is some clarity on what is going to happen over Brexit.
  - Next month's general election could result in a loosening of monetary policy, expectations of a weak pound and an inflationary pick up; and
  - the world economic outlook continues to dampen growth.

6.5 Full details of the Council's Treasury Advisors economic analysis are included at Appendix A to this report.

7 Treasury Management Strategy 2019/20

7.1 The TMSS includes the following key elements:

- The Council continues to maintain an under-borrowed position. It will borrow internally, reducing the cost of carry as current investment rates are substantially below long term borrowing rates. This also reduces the Council's exposure to credit risk by reducing the level of investment balances.
- The Council's investment policy reflects a low appetite for risk; emphasising the priorities of security and liquidity over yield.
- The budgeted return on investments placed for periods up to 100 days is 0.7%.
- That the Council complies with the CIPFA Prudential and Treasury Management Codes (Revised 2017); in relation to setting of capital plans, setting and reporting on prudential indicators, evaluation of the General Fund MRP and other related governance guidance.

7.2 No immediate mid-year changes are proposed to the TMSS.

8 **The Council's Capital Position and Prudential Indicators**

8.1 This part of the report updates:
- The Council's capital expenditure plans and their financing
- The impact of changes to the Council's capital plans on prudential Indicators and the underlying need to borrow
- Compliance with the limits on borrowing activity.

Capital Expenditure

8.2 The table below identifies the revised 2019/20 capital programme forecast since the original capital budget was approved by Council in February 2019. A review of the capital programme was reported to Scrutiny Panel on 12 November 2019.

Table 3 Capital Expenditure 2019/20 £k	Original Estimate	Spend to Sep 2019	Revised Estimate
General Fund capital expenditure	58,684	14,236	44,457
HRA capital expenditure	26,118	4,072	18,868
Total capital expenditure	**84,802**	**18,308**	**63,325**

Changes to the financing of the capital programme

8.3 Funding of the capital programme is updated for the lower expected level of expenditure. The Medium Term Financial Forecast provides minimum revenue provision and interest for new debt.

	Table 4 - New Borrowing Requirement 2019/20 All £k	Original Estimate	Sep 2019	Revised Estimate
1	General Fund capital expenditure	58,684	14,236	44,457
2	HRA capital expenditure	26,118	4,072	18,868
3	Total capital expenditure	84,802	18,308	63,325
	Resourced by:			
4	Capital receipts	11,053	1,262	4,425
5	Capital grants	14,291	1,798	11,359
6	Capital reserves	12,416	867	9,972
7	Finance leases	0	0	0
8	Revenue	2,449	1,651	2,449
9	New borrowing requirement	44,593	12,730	35,120

Capital Financing Requirement (CFR)

8.4 The following table shows the CFR, the Council's total need to borrow for capital purposes including both past and current financial years.

Table 5 - CFR 2019/20 All £k	Original Estimate	Current Position	Revised Estimate
Opening balance	167,730	154,189	154,189
Unfinanced capital expenditure (as above)	44,593	12,730	35,120
Less MRP/VRP	1,990	1,990	1,990
Closing balance	210,333	164,929	187,319

Limits to borrowing activity

8.5 Councils' have a responsibility to ensure that over the medium-term net borrowing is only be for capital purposes. Gross external debt should not - except in the short term - exceed the CFR in the preceding year plus any additional CFR for the current and the next two financial years. This allows 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.

Table 6 - Limits to Borrowing activity 2019/20 All £k	Original Estimate	Current Position	Revised Estimate
Gross Debt 1 April 2019	158,194	143,598	143,598
Borrowing 2019/20	44,583	12,730	14,011
Other Long Term Liabilities	217	217	217
Gross Debt 31 March	202,994	156,545	157,826
CFR	210,323	164,929	187,319
Under/(Over) Borrowed Position	7,329	8,384	29,493

8.6 The Council is expected to be in an under borrowed position compared to its CFR at the end of 2019/20. This is in line with the Treasury Management Strategy. The Council can demonstrate that its borrowing is for capital investment purposes.

8.7 The Operational Boundary is the limit against which external debt is not normally expected to exceed.

Table 7 – Operational Boundary All £k	Original Estimate	Current Position	Revised Estimate
Operational Boundary	206,415	164,929	206,415

9 Investment Portfolio 2019/20

9.1 In accordance with the Prudential Code, the Council is required to ensure that the security and liquidity of its investments take priority over the level of return. As detailed at paragraph 5, it is a very difficult investment market in terms of returns

9.2 The Council had £62.4m of investments as at 30th September 2019 (£59.2m as at 31 September 2018).

9.3 A full list of investments is listed at Appendix B (confidential section of the Agenda).

9.4 The Head of Finance confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of the year.

10 **Borrowing**

10.1 The Council is forecast to have borrowings of £157,826m at the end of the financial year, with the expectation of utilising £29,493m of cash flow funds in lieu of borrowing to fund the capital programme. This is prudent and cost effective approach in the current economic climate and interest rate structure.

10.2 As detailed above further borrowing of £14m is planned during this financial year. This level of borrowing is dependent on the timing of capital projects. It remains possible that the Council may borrow less than this in this financial year.

10.3 Following previous requests by the Committee and the Scrutiny Panel some comparative information is available on interest rates and borrowing structure. This is set out below.

10.4 The rates paid are largely determined by past decisions. Some authorities have a significant proportion of short term debt enabling them to benefit from current low interest rates. The Colchester debt was substantially acquired in the self-financing housing settlement and therefore this option has not been available. The risk of carrying short term borrowing is the challenge of converting successfully to long term in the event of abrupt major changes in interest rates.

Table 8 – Borrowing actuals 2018/19 for some CIPFA Group members with debt outstanding	Debt 31.3.19	% long	% Short	Avg rate
Basildon	239			4.5
Braintree	6			4.7
Canterbury	216	82	18	2.6
Cherwell	111	39	61	1.5
Colchester	141	100	0	4.5
South Kesteven	99	72	28	2.4

11 PWLB interest rate structure

11.1 On 9 October 2019 HM Treasury raised the PWLB rate by increasing the margin over gilts to 100bps (one percentage point) “to better reflect the availability of capital finance”. Despite this change PWLB rates remain as a low level.

11.2 The reason for this increase is understood to be a general concern over the amount of borrowing local authorities have or will be taken on with the change in rates used to stem the amount of borrowing. For a 50-year loan, the interest rate has now increased to nearly 3%. This change has no impact to existing loans the council currently holds.

11.3 Alternative borrowing sources to PWLB will continue to be assessed.

12. Standard References

11.1 There are no particular references to the Strategic Plan; consultation; or publicity consideration; community safety; health and safety implications.

13. Financial implications

12.1 As set out in the body of this report.

13. Risk Management Implications

13.1 The Council’s Treasury Management Strategy supported by the Treasury Management Practices, reflects the council’s low risk appetite for treasury management investments; in line with the current economic outlook. The mid-year review provides the opportunity to report and review on the practices for the first six months of the financial year against the Council’s strategy and take remedial action as required.

Appendices

Appendix A – Economic Update from Link Asset Services
Appendix B – Confidential paper

Background Papers

Basildon Council Audit and Risk Committee 26.6.19
Braintree DC Corporate Governance Group 25.7.19
Canterbury Council Audit Committee 25.7.19
Cherwell DC Accounts Audit and Risk Committee 31.7.19
South Kesteven Governance and Audit Committee 26.7.19

Appendix A

Economics and interest rates - Link Asset Services Advice

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, in September, his proroguing of Parliament was overturned by the Supreme Court and Parliament carried a bill to delay Brexit until 31 January 2020 if there is no deal by 31 October. MPs also voted down holding a general election before 31 October, though one is likely before the end of 2019. 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 October), the whole Brexit situation is highly fluid and could change radically by the day. Given these circumstances and the likelihood of an imminent general election, any interest rate forecasts are subject to material change as the situation evolves. If the UK does soon achieve a deal on Brexit agreed with the EU, including some additional clarification wording on the Irish border backstop, then it is possible that growth could recover relatively 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 weaken even further than currently 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 e.g. tax cuts, increases in government departments and services annual expenditure budgets and expenditure on infrastructure projects, to boost 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. The MPC meeting of 19 September reemphasised their concern about the downturn in world growth and also expressed concern that the prolonged Brexit uncertainty would contribute to a build-up of spare capacity in the UK economy, especially in the context of a downturn in world growth. This mirrored investor concerns around the world which are now expecting a significant downturn or possibly even a recession in some major 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. However, it is also worth noting that the new Prime Minister is making some significant promises on various spending commitments and a relaxation in the austerity programme. This will provide some support to the economy and, conversely, take some pressure off the MPC to cut Bank Rate to support growth.

As for **inflation** itself, CPI has been hovering around the Bank of England's target of 2% during 2019, but fell to 1.7% in August. It is likely to remain close to 2% over the next two years and so it does not pose any immediate concern to the MPC at the current time. However, if there was a no deal Brexit, inflation could rise towards 4%, primarily as a result of imported inflation on the back of a weakening pound.

With regard to the **labour market,** despite the contraction in quarterly GDP growth of -0.2%q/q, (+1.3% y/y), in quarter 2, employment continued to rise, but at only a muted rate of 31,000 in the three months to July after having risen by no less than 115,000 in quarter 2 itself: the latter figure, in particular, suggests that firms are preparing to expand output and suggests there could be a return to positive growth in quarter 3. Unemployment continued at a 44 year low of 3.8% on the Independent

Labour Organisation measure in July and the participation rate of 76.1% achieved a new all-time high. Job vacancies fell for a seventh consecutive month after having previously hit record levels. However, with unemployment continuing to fall, this month by 11,000, employers will still be having difficulty filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to a high point of 3.9% in June before easing back slightly to 3.8% in July, (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 2.1%. 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. The latest GDP statistics also included a revision of the savings ratio from 4.1% to 6.4% which provides reassurance that consumers' balance sheets are not over stretched and so will be able to support growth going forward. This would then mean that the MPC will need to consider carefully at what point to take action to raise Bank Rate if there is an agreed Brexit deal, as the recent pick-up in wage costs is consistent with a rise in core services inflation to more than 4% in 2020.
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.

USA. President Trump's massive easing of fiscal policy in 2018 fuelled a temporary boost in consumption in that year which generated an upturn in the rate of strong growth to 2.9% y/y. Growth in 2019 has been falling back after a strong start in quarter 1 at 3.1%, (annualised rate), to 2.0% in quarter 2. Quarter 3 is expected to fall further. The strong growth in employment numbers during 2018 has reversed into a falling trend during 2019, indicating that the economy is cooling, while inflationary pressures are also weakening The Fed finished its series of increases in rates to 2.25 – 2.50% in December 2018. In July 2019, it cut rates by 0.25% as a 'midterm adjustment' but flagged up that this was not to be seen as the start of a series of cuts to ward off a downturn in growth. It also ended its programme of quantitative tightening in August, (reducing its holdings of treasuries etc). It then cut rates again in September to 1.75% - 2.00% and is thought likely to cut another 25 bps in December. Investor confidence has been badly rattled by the progressive ramping up of increases in tariffs President Trump has made on Chinese imports and China has responded with increases in tariffs on American imports. This trade war is seen as depressing US, Chinese and world growth. In the EU, it is also particularly impacting Germany as exports of goods and services are equivalent to 46% of total GDP. It will also impact developing countries dependent on exporting commodities to China.

EUROZONE. Growth has been slowing from +1.8 % during 2018 to around half of that in 2019. Growth was +0.4% q/q (+1.2% y/y) in quarter 1 and then fell to +0.2% q/q (+1.0% y/y) in quarter 2; there appears to be little upside potential to the growth rate in the rest of 2019. German GDP growth fell to -0.1% in quarter 2; industrial production was down 4% y/y in June with car production down 10% y/y. Germany would be particularly vulnerable to a no deal Brexit depressing exports further and if President Trump imposes tariffs on EU produced cars.

Interest rate forecasts

The Council's treasury advisor, Link Asset Services, has provided the following forecast:

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	2.20	2.30	2.50	2.60	2.70	2.70	2.80	2.90	3.00	3.00	3.10
10yr PWLB Rate	2.50	2.60	2.80	2.90	3.00	3.00	3.10	3.20	3.30	3.30	3.40
25yr PWLB Rate	3.10	3.30	3.40	3.50	3.60	3.70	3.70	3.80	3.90	4.00	4.00
50yr PWLB Rate	3.00	3.20	3.30	3.40	3.50	3.60	3.60	3.70	3.80	3.90	3.90

The above forecasts have been based on an assumption that there is some sort of muddle through to an agreed deal on Brexit at some point in time. 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.

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 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 September MPC meeting sounded even more concern about world growth and the effect that prolonged Brexit uncertainty is likely to have on growth.

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 broadly similarly to the downside.

One risk that is both an upside and downside risk is that all central banks are now working in very different economic conditions than before the 2008 financial crash. There has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed for eleven years since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could, therefore, over or under-do increases in central interest rates.

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.** In 2018, Italy was a major concern due to having a populist coalition government which made a lot of anti-austerity and anti-EU noise. However, in September 2019 there was a major change in the coalition governing Italy which has brought to power a much more EU friendly government; this has eased the pressure on Italian bonds. Only time will tell whether this new unlikely alliance of two very different parties will endure.
- 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.

- **Other minority EU governments.** Austria, 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.
- 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.
-