AUDIT COMMITTEE 10 JULY 2020

TREASURY MANAGEMENT ANNUAL OUTTURN REPORT 2019/20

1. PURPOSE

1.1. New Forest District 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 Council to approve a treasury management strategy before the start of the year and a semi-annual and annual treasury outturn report.

2. SUMMARY

2.1. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

2.2. The Council's treasury management strategy was most recently updated and approved at a meeting of Full Council in February 2020. The Council has borrowed and invested sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

2.3. 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."

2.4. This annual report sets out the performance of the treasury management function during 2019/20, to include the effects of the decisions taken and the transactions executed in the past year.

2.5. Hampshire County Council's Investments & Borrowing Team has been contracted to manage the Council's treasury management balances since March 2014 but overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

2.6. All treasury activity has complied with the Council's revised Treasury Management Strategy 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 Council's treasury advisers, Arlingclose.

3. EXTERNAL CONTEXT

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

Economic commentary

3.2. The UK's exit from the European Union was one of the main drivers of sentiment on the UK economy for the majority of 2019/20, before focus then shifted to the nation's response to the global coronavirus pandemic in the latter part of the year.

3.3. Prior to the pandemic, labour market data remained positive as the employment rate reached a record high of 76.6% in the three months to March 2020, unemployment was 3.9%, and annual pay growth was positive in real terms.

3.4. As the early effects of the pandemic and the government measures to reduce transmission began to be felt, the headline rate of UK Consumer Price Inflation fell to 0.8% year on year in April 2020 (down from 1.5% year on year in March 2020), below the Bank of England's target of 2%. Gross Domestic Product (GDP) growth in Quarter 1 of 2020 is also estimated to have reduced by 2.0% alongside falls in financial markets not seen since the Global Financial Crisis, triggered by a flight to quality into sovereign debt and other perceived 'safe' assets.

3.5. In response to the spread of the virus, the UK government enforced lockdowns, central banks and governments around the world cut interest rates, and massive stimulus packages were introduced in an attempt to reduce the negative economic impact on domestic and global growth.

3.6. The Bank of England, which had previously held policy rates at 0.75% through 2019/20, moved in March 2020 to cut rates to 0.25% and then swiftly brought them down further to the record low of 0.1%. In conjunction with these cuts, the UK government introduced measures to help businesses and households impacted by a series of social restrictions.

Financial markets

3.7. Financial markets sold off sharply towards the end of the financial year as the impact from the coronavirus worsened. After starting positively in 2020, the FTSE 100 fell over 30% with stock markets in other countries seeing similar falls. In March sterling touched its lowest level against the dollar since 1985.

3.8. The measures implemented by central banks and governments helped restore some confidence and financial markets have rebounded in recent weeks but remain extremely volatile. The flight to quality caused gilts yields to fall substantially. The 5-year benchmark fell from 0.75% in April 2019 to 0.26% on 31 March 2020 and there were similar falls in 10-year and 20-year gilts over the same period, dropping from 1.00% to 0.40% and 1.47% to 0.76% respectively.

Credit review

3.9. Prior to the coronavirus pandemic, both the Fitch and Standard & Poor's rating agencies affirmed the UK's AA sovereign rating and revised the outlook from negative to stable.

3.10. However, Fitch then downgraded the UK sovereign rating to AA- in March 2020 and revised the outlook on the majority of banks on the Arlingclose counterparty list to negative and in some cases also amended the long-term rating (upwards in the case of Canadian and German banks and downwards for Australian banks).

3.11. While the UK and Non-UK banks on the Arlingclose counterparty list remain in a strong and well-capitalised position, the recommended maximum duration for unsecured investments with all these banks was cut to 35 days in mid-March 2020.

3.12. In December 2019, the Bank of England announced its latest stress tests results for the main seven UK banking groups. All seven passed on both a common equity Tier 1 (CET1) ratio and a leverage ratio basis. Under the test scenario the banks' aggregate level of CET1 capital would still remain twice the level before the 2008 financial crisis, suggesting the banks are in a much stronger position than in 2008.

3.13. After remaining flat in January and February, Credit Default Swap (CDS) spreads rose sharply in March as the potential impact of the coronavirus on bank balance sheets gave cause for concern. Spreads declined in late March but remained above their initial 2020 levels.

4. LOCAL CONTEXT

4.1. At 31 March 2020 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £140.1m, while usable reserves and working capital which are the underlying resources available for investment were £56.8m (principal invested plus gains on investments with a variable net asset value). These factors and the year-on-year change are summarised in Table 1:

Table 1: Capital Financing Summary

	31/03/19 Balance £m	Movement £m	31/03/20 Balance £m
General Fund CFR	5.1	2.7	7.8
Housing Revenue Account CFR	1.9	0	1.9
HRA Settlement	134.5	(4.1)	130.4
Total CFR	141.5	(1.4)	140.1
Financed By:			
External Borrowing	135.5	(4.3)	131.2
Internal Borrowing	6.0	2.9	8.9
Total Borrowing	141.5	(1.4)	140.1

4.2. The General Fund CFR (and so internal borrowing) has increased as resources have been required to finance direct property investment during 2019/20, albeit mitigated in part through the application of MRP. The HRA CFR and external borrowing have reduced as a result of the repayment of the maturing HRA Public Works Loan Board (PWLB) debt.

4.3. The Council's strategy was 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 as at 31 March 2020 and the year-on-year change is shown in Table 2 below.

Table 2: Treasury Management Summary

	31/03/19 Balance £m	Movement £m	31/03/20 Balance £m	31/03/20 Rate %
Long-term borrowing	(131.2)	4.3	(126.9)	3.28
Short-term borrowing	(4.3)	-	(4.3)	2.23
Total borrowing	(135.5)	4.3	(131.2)	3.25
Long-term investments	28.8	(10.4)	18.4	3.39
Short-term investments	28.7	(8.7)	20.0	1.18
Cash and cash equivalents	6.8	11.5	18.3	0.45
Total investments	64.3	(7.5)	56.8	1.66
Net borrowing	(71.2)	(3.3)	(74.5)	

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

4.4. Net borrowing in Table 2 has increased during 2019/20 as investment balances have fallen to a greater extent (down £7.5M) than the reduced total external borrowing figure (£4.3M).

5. BORROWING UPDATE

5.1. On 9 October 2019 the PWLB raised the cost of certainty rate borrowing by 1% to 1.8% above UK gilt yields as HM Treasury was concerned about the overall level of local authority debt. PWLB borrowing remains available but the margin of 180bp above gilt yields appears expensive relative to other options. Market alternatives are available and new products will be developed; however, the financial strength of individual authorities will be scrutinised by investors and commercial lenders.

5.2. The Chancellor's March 2020 Budget statement included significant changes to PWLB policy and launched a wide-ranging consultation on the PWLB's future direction. Announcements included a reduction in the margin on new Housing Revenue Account (HRA) loans to 0.80% above equivalent gilt yields (the value of this discount is 1% below the rate at which the Council usually borrows from the PWLB), available from 12 March 2020 and £1.15bn of additional "infrastructure rate" funding at gilt yields plus 0.60% to support specific local authority infrastructure projects for England, Scotland and Wales for which there is a bidding process.

5.3. The consultation closes on 31 July 2020 with implementation of the new lending terms expected in the latter part of this calendar year or financial year beginning 2021/22.

6. BORROWING ACTIVITY

6.1. At 31 March 2020 the Council held £131.2m of loans, a decrease of £4.3m which was a maturity in the year. The vast majority of the loans being in relation to the resettlement of the HRA in 2012/13. The year-end treasury management borrowing position and year-on-year change is shown in Table 3 below.

Table 3: Borrowing Position

	31/03/19 Balance £m	Movement £m	31/03/20 Balance £m	31/03/20 Rate %	31/03/20 WAM* years
Public Works Loan Board	(135.5)	4.3	(131.2)	3.25	16.3
Total borrowing	(135.5)	4.3	(131.2)	3.25	16.3

* Weighted average maturity

Note: the figures in the table above are from the balance sheet in the Council's statement of accounts but adjusted to exclude accrued interest.

6.2. The 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.

6.3. Short-term interest rates have remained much lower than long-term rates and the Council has therefore considered it to be more cost effective in the near term to use internal resources than to use additional borrowing.

6.4. With the assistance of Arlingclose, the benefits of this internal borrowing were monitored regularly against the potential for incurring additional costs by deferring borrowing into future years, when long-term borrowing costs may be higher.

6.5. During 2019/20 the Council repaid £4.3m of maturing PWLB debt and did not replace this borrowing. This will reduce the future cost of interest payments on the Council's external debt.

7. INVESTMENT ACTIVITY

7.1. The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year the Council's investment balances have ranged between £57.5m and £98.1m due to timing differences between income and expenditure. The year-end investment position and the year-on-year change are shown in Table 4 below.

Table 4: Investment Position (Treasury Investments)

Investments	31/03/2019 Balance £m	Movement £m	31/03/2020 Balance £m	31/03/20 Rate %	31/03/20 WAM* years
Short term Investments					
- Banks and Building Societies:					
- Unsecured	8.0	(3.9)	4.1	0.77	0.0
- Secured	5.7	(1.7)	4.0	0.91	0.2
- Money Market Funds	6.8	8.5	15.3	0.40	0.0
- Local Authorities	11.0	(2.0)	9.0	0.94	0.4
- Registered Providers	2.0	2.0	4.0	1.93	1.0
- Cash Plus Funds	2.0	-	2.0	1.37	0.0
	35.5	**2.8**	**38.3**	**0.83**	**0.2**
Long term investments					
- Banks and Building Societies:					
- Secured	7.0	(4.0)	3.0	0.97	2.9
- Local Authorities	4.0	(1.0)	3.0	1.33	1.2
- Registered Providers	4.0	(4.0)	-	-	-
	15.0	**(9.0)**	**6.0**	**1.15**	**2.0**
High yield investments					
- Pooled Property Funds**	7.6	-	7.6	4.25	N/A
- Pooled Equity Funds**	3.0	-	3.0	5.37	N/A
- Pooled Multi-Asset Funds**	3.0	-	3.0	4.38	N/A
	13.6	**-**	**13.6**	**4.53**	**N/A**
TOTAL INVESTMENTS	**64.1**	**(6.2)**	**57.9**	**1.73**	**0.5**

* Weighted average maturity, excluding pooled funds

** The rates provided for pooled fund investments are reflective of annualised income returns over the year to 31 March 2020.

Note: the figures in the table above are from the balance sheet in the Council's statement of accounts but adjusted to exclude operational cash, market value adjustments and accrued interest.

7.2. The CIPFA Code and Government guidance both require the 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. The 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.

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

7.4. Counterparty credit quality was 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.

7.5. The Council also makes use of secured investments products that provide collateral in the event that the counterparty cannot meet its obligations for repayment.

7.6. To reduce risk, 54% of the Council's internally invested cash is invested so that it is not subject to bail-in risk, as it is invested in local authorities, registered providers and secured bank bonds. Of the remaining balance, the majority is invested in overnight money market funds which are subject to reduced bail in risk. By comparison, only 41% of the cash held by other similar Local Authorities is not subject to bail-in risk.

7.7. The UK Bank Rate was cut from 0.75% to 0.25% and then 0.10% in March 2020 due to the effect of the coronavirus pandemic on the economy. Rates had been historically low even prior to these cuts, impacting the Council's ability to generate income on cash investments.

7.8. Against this backdrop, the Council has sought to optimise returns commensurate with the objectives of security and liquidity, achieving an average rate of return of 1.16% on internally managed funds during 2019/20 whilst also maintaining sufficient liquidity through the use of call accounts and money market funds.

7.9. The progression of credit risk and return metrics for the Council's investments managed in-house are shown in extracts from Arlingclose's investment benchmarking in Table 5 below. This compares the data for the quarter ended 31 March 2020 with the same period from the previous year.

Table 5: Investment Benchmarking (excluding pooled funds)

	Credit Rating	Bail-In Exposure	Weighted Average Maturity (days)	Internal Investment Return
31.03.2019	AA-	31%	325	1.11%
31.03.2020	AA	46%	159	0.85%
Similar LAs	AA-	59%	53	0.68%
All LAs	AA-	56%	20	0.64%

7.10. Table 5 shows the average credit rating of the portfolio improved to a level of AA at 31 March 2020. This was alongside increased liquidity in part to fund the prepayment of one year's Pension Fund contributions on

1 April 2020, as well as the late receipt of cash flow support from the Treasury as a result of the Coronavirus pandemic. Expenditure within the Capital programme was also lower than originally anticipated when the Capital Strategy for 2019/20 was drawn up. This increased liquidity meant higher bail-in exposure as a greater proportion of the Council's funds were invested in money market funds, which invest in instruments that are liable to bank bail-in but which are highly diversified therefore reducing this risk.

7.11. Interest rates on shorter duration investments are often lower and, coupled with the impact of the two Bank Rate cuts in March, meant average investment returns at 31 March 2020 were lower than at the same time the previous year. These returns were however greater than other Local Authorities covered by Arlingclose's benchmarking and the Council's internal investment portfolio also compared favourably to the benchmark in terms of the average credit rating, bail-in exposure and weighted average maturity period (the longer the maturity period the less exposed the Council is to reductions in short term interest rates).

7.12. In order to minimise the risk of receiving unsuitably low investment income, the Council has continued to invest a proportion of steady core balances in externally managed pooled funds as part of its high yield strategy.

7.13. The Council's investments in pooled property, equity and multi-asset funds allow diversification into asset classes other than cash without the need to own and manage the underlying investments, with £13.6m now invested. The Council also invests a further £2m into an externally managed cash plus pooled fund, which forms part of its short-term cash portfolio.

7.14. Pooled fund investments are likely to be more volatile than cash in the short-term but generate regular revenue income whilst also providing diversification and the potential for enhanced returns over the longer term.

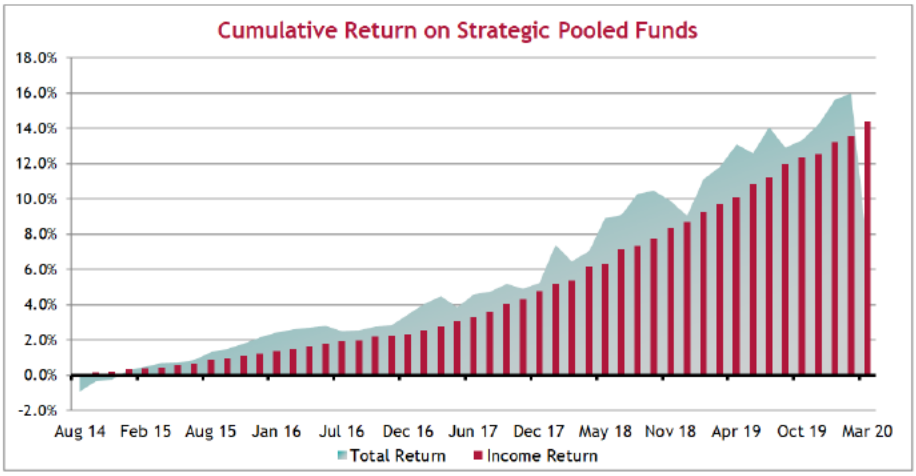
7.15. The impact of the COVID-19 pandemic on financial markets at the end of the financial year meant that the Council's investments in these pooled funds suffered a £1.3m fall in capital value (9.82%) over the year to 31 March 2020, however this loss will only be realised if the assets are sold before they have regained their value. Under the accounting standard IFRS 9 the Council must in the meantime defer these fair value losses to the Financial Instruments Revaluation Reserve until at least 2023/24.

7.16. The fall in the capital value of the Council's pooled funds during 2019/20 reflects the wider market reaction to the coronavirus pandemic, with large falls in equity prices and corporate bond markets, and property markets also affected. Market volatility, as measured by the VIX index, was historically high as investors reacted to the unprecedented situation and attempted to forecast the likely impact on economies, businesses, and individuals. The unrealised capital losses (the 'drawdown' referred to by fund managers) in equity income funds owned by the Council were -19.6% and -33.2% respectively with the peak of the fall coinciding with the Council's financial year end.

7.17. Although capital values fell, the pooled funds delivered strong positive income returns during 2019/20, contributing £0.6m income (a return of 4.53%) to the revenue budget to support the provision of services by the Council, significantly more than could have been achieved through cash investments. Income returns from these funds in 2018/19 were £0.5m (4.10%).

7.18. The total pooled funds return in 2019/20, allowing for the fall in capital value offset in part by the income generated, was a loss of £0.7m (5.29%).

7.19. The cumulative total return from the Council's investments in pooled equity, property and multi-asset funds since purchase is shown in the graph below. This highlights that the Council has benefited from the strong and steady income returns over time. The volatility experienced due to the COVID-19 pandemic has been significant, but this period has not completely eroded the total cumulative positive returns made over the time that these investment have been held by the Council, and although the pooled funds are reporting a negative capital return of 9.82% for the year to 31 March 2020, the cumulative total return from these investments since purchase is positive at 6.39% (made up of an 8.59% capital fall and a 14.98% income return).



7.20. Strategic pooled fund investments are made as long-term investments using core balances that aren't required for current day-to-day liquidity. Investments are made with advice from Arlingclose and in the knowledge that capital values will move both up and down in the short term but with confidence that over longer periods total returns will exceed cash interest returns.

7.21. These investments have no defined maturity date, but are available for withdrawal after a notice period and their performance and continued suitability in meeting the Council's investment objectives is monitored regularly and discussed with Arlingclose

7.22. Given the exceptional impact of the COVID-19 crisis on financial markets, the investments in pooled funds have been reviewed with Arlingclose. Despite the current fall in capital values, Arlingclose's advice remains that these investments continue to be appropriate for the Council and will have a positive impact on the Council's investment income.

8. FINANCIAL IMPLICATIONS

8.1. The outturn for debt interest paid (HRA) in 2019/20 matched the budget set at £4.41m.

8.2. The outturn for investment income received in 2019/20 was £1.29m on an average investment portfolio of £78.64m, therefore giving a yield of 1.64%. In the context of 1.39% being achieved in 2018/19, and an original budgeted target of £0.857m, this is a positive outturn result for the Council.

8.3. The budget for interest payable (HRA) has been reduced within the base budget for 2020/21, in reflection of the principal repayments commencing from 2017/18. The Interest earning target for 2020/21 has been left at a level equivalent to the original budget for 2019/20, on the assumption that cash balances will reduce as a result of the Council implementing its Commercial and Residential Property Strategies. At the time of setting the budget, the fall in markets hadn't occurred, nor had the base rate reduction. The Council may well see a significantly lower return in 2020/21.

9. OTHER NON-TREASURY HOLDINGS AND ACTIVITY

9.1. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

9.2. This could include service investments for operational and/or regeneration reasons as well as commercial investments which are made mainly for financial reasons.

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

Table 6 – Non-Treasury Investments	31/03/20 Asset value £m	31/03/20 Rate of Return
Hythe Marina	2.70	5.6%
Saxon Inn Calmore	0.18	7.0%
Meeting House Lane	0.13	-
New Milton Health Centre	2.33	5.97%
Ampress Car Park	2.10	4.48%
Total	**7.44**	**5.34%**

9.4. Two investment property purchases were made in 2019/20 pursuant to the Council's adoption of the Asset Investment Strategy in February

2017. One is included above (Ampress Car Park) as is immediately income earning (with the Rate of Return reflecting an annualised calculation). The other is not currently income earning as it is a bare land site that the Council intends to develop out into an industrial park.

9.5. The Investment Property note within the Annual Financial Report gives further information on the net gains / losses, and fair value movements.

10. COMPLIANCE REPORT

10.1. The Council confirms compliance of all treasury management activities undertaken during 2019/20 with the CIPFA Code of Practice and the Council's approved revised Treasury Management Strategy.

10.2. 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	31/03/20 Actual £m	2019/20 Operational Boundary £m	2019/20 Authorised Limit £m	Complied
Total debt	135.5	131.3	186.3	201.6	✓

10.3. Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

11. TREASURY MANAGEMENT INDICATORS

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

Interest rate exposures

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

Table 9 – Interest Rate Risk Indicator

	31 March 2020	Impact of +/- 1% interest rate change
Sums subject to variable interest rates		
Investment	£41.4m	+/- £0.4m
Borrowing	£0.0m	+/- £0.0m

11.3. 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

11.4. This indicator is set to control the 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 10: Refinancing rate risk indicator

	31/03/20 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	3%	25%	0%	✓
12 months and within 24 months	3%	25%	0%	✓
24 months and within 5 years	10%	25%	0%	✓
5 years and within 10 years	16%	25%	0%	✓
10 years and above	68%	100%	0%	✓

Principal sums invested for periods longer than a year

11.5. The purpose of this indicator is to control the Council'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 11: Price risk indicator

	2019/20	2020/21	2021/22
Actual principal invested beyond a year	£19.6m	£16.6m	£16.6m
Limit on principal invested beyond a year	£40m	£40m	£40m
Complied	✓	✓	✓

12. OTHER

12.1. IFRS 16 – CIPFA/LASAAC has proposed delaying the implementation of the new IFRS 16 Leases accounting standard for a further year to 2021/22.

13. CRIME AND DISORDER AND ENVIRONMENTAL IMPLICATIONS

13.1. None arising directly from this report.

14. RECOMMENDATIONS

Members are recommended to:

14.1. consider the performance of the treasury function detailed in this report.

Further information	Background papers
Please contact; Rob Sarfas Senior Accountant Investments & Borrowing Hampshire County Council rob.sarfas@hants.gov.uk Alan Bethune Head of Finance (S151) New Forest District Council alan.bethune@nfdc.gov.uk	The Prudential Code, CIPFA Guidance Notes and ODPM Investment Guidance Local Government Act 2003 SI 2003/3146 Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 Treasury Management Strategy Report 2019/20 Audit Committee – 25 January 2019 Council – 25 February 2019 Treasury Management Mid-Year Monitoring Report 2019/20 Audit Committee – 25 October 2019 Treasury Management Strategy Report 2020/21 Audit Committee – 24 January 2020 Council – 24 February 2020