Annual Treasury Outturn Report 2019/20

1. Purpose

1.1. Hampshire Fire and Rescue Authority 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 Fire and Rescue Authority 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 Fire and Rescue Authority's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

2.2. The Fire and Rescue Authority's treasury management strategy for 2019/20 was approved at a meeting of Hampshire Fire and Rescue Authority in February 2019. The Fire and Rescue Authority 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 Fire and Rescue Authority'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. 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 therefore integral to the Fire and Rescue Authority's treasury management objectives.

2.6. All treasury activity has complied with the Fire and Rescue Authority's 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 Fire and Rescue Authority's treasury advisers, Arlingclose.

2.7. The 2017 Prudential Code includes the requirement to produce a Capital Strategy, a summary document approved 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 19 February 2020.

3. External Context

3.1. The following sections outline the key economic themes 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 1.5% year on year in March 2020 (and further still to 0.8% in April 2020), below the Bank of England’s target of 2%. Gross Domestic Product 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 0.10%. 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 of the coronavirus worsened. After starting positively in 2020, the FTSE 100 fell over 30%, with stock markets in other countries seeing similar drops. 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 test 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 remain twice the level it was 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 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 Fire and Rescue Authority's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £10.8m, while usable reserves and working capital are the underlying resources available for investment and amounted to £28.0m. These factors and the year-on-year change are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31/03/19 Balance £m	Movement £m	31/03/20 Balance £m
CFR	11.2	(0.4)	10.8
Less: External borrowing			
- Public Works Loan Board	(8.4)	0.1	(8.3)
Internal borrowing	**2.8**	**(0.3)**	**2.5**
Less: Working capital liability	3.3	1.1	4.4
Less: Usable reserves	(30.4)	(0.9)	(31.3)
Net investments	**(24.3)**	**(0.1)**	**(24.4)**

4.2. CFR has reduced due to MRP as all 2019/20 capital expenditure was funded without new borrowing. Borrowing has reduced by £100,000 as loans have been allowed to mature and therefore repaid, and no new borrowing has been undertaken. The Fire and Rescue Authority'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. Usable reserves rose as contributions were made to the capital programme, Transformation Reserve and Equipment Reserve, which were expected to be offset by payments out, but due to delays in vehicle purchases the overall reserves level increased rather than fell in the year. Reduced internal borrowing and an increase in usable reserves has been netted off by an increase in the working capital liability, resulting in a very small rise in net investments reported at 31 March 2020.

4.3. 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	(8.3)	1.2	(7.1)	4.88
Short-term borrowing	(0.1)	(1.1)	(1.2)	3.64
Total borrowing	(8.4)	0.1	(8.3)	4.70
Long-term investments	6.5	2.5	9.0	3.85
Short-term investments	10.0	(6.0)	4.0	0.93
Cash and cash equivalents	7.9	4.6	12.5	0.43
Total investments	24.4	1.1	25.5	1.71
Net investments	16.0	1.2	17.2	

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.

4.4. The Fire & Rescue Authority's internal borrowing policy has translated into a reduction in investment balances in Table 2, in comparison to Table 1.

5. Borrowing Update

5.1. On 9 October 2019 the Public Works Loan Board (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. This was in part as a response to what HM Treasury describes as a minority of councils using cheap PWLB finance to buy significant amounts of commercial property for rental income, reducing the availability of PWLB finance for core local authority activities. Announcements included a reduction in the margin on new Housing Revenue Account (HRA) loans to 0.80% above equivalent gilt yields (which would not directly affect the Fire & Rescue Authority as it is not a Housing Authority), 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, and the Fire & Rescue Authority intends to respond to the consultation.

6. Borrowing Activity

6.1. At 31 March 2020 the Fire and Rescue Authority held £8.3m of loans as part of its strategy for funding previous years' capital programmes. The year-end treasury management borrowing position and year-on-year change is shown in Table 3 below. A further £1.2m of PWLB borrowing will mature during 2020/21.

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	(8.4)	0.1	(8.3)	4.70	9.8
Total borrowing	(8.4)	0.1	(8.3)	4.70	9.8

* Weighted average maturity

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 accrued interest.

6.2. 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.

6.3. Short-term interest rates have remained much lower than long-term rates and the Fire and Rescue Authority 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. As a result, no new borrowing was undertaken and £0.1m of existing PWLB loans were allowed to mature without replacement. This strategy enabled the Fire and Rescue Authority to reduce net borrowing costs (despite forgone investment income) and reduce overall treasury risk.

7. Investment Activity

7.1. The Fire and Rescue Authority holds invested funds representing income received in advance of expenditure plus balances and reserves held. During the year, the Fire and Rescue Authority's investment balances have ranged between £19.9m and £36.8m 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. During the year the high yield investment balance increased from £3.5m to £7.0m as the agreed strategy was implemented, and investments were made in pooled property, equity and multi-asset funds to allow dividend yield to further contribute to interest income.

Table 4: Investment Position (Treasury Investments)

Investments	31/03/19 Balance £m	Movement £m	31/03/20 Balance £m	31/03/20 Rate %	31/03/20 WAM* years
Short term investments					
- Banks and Building Societies					
- Unsecured	3.1	(0.1)	3.0	0.49%	0.0
- Secured	4.0	(3.0)	1.0	0.84%	0.3
- Money Market Funds	6.8	2.7	9.5	0.41%	0.0
- Local Authorities	4.0	(1.0)	3.0	0.96%	0.1
	17.9	(1.4)	16.5	0.55%	0.0
Long term investments					
- Banks and Building Societies					
- Secured	2.0	(1.0)	1.0	1.01%	3.0
- Local Authorities	1.0	-	1.0	1.30%	1.2
	3.0	(1.0)	2.0	1.16%	2.1
High yield investments					
- Pooled Property Funds**	2.0	1.3	3.3	3.96%	N/A
- Pooled Equity Funds**	1.5	0.5	2.0	5.50%	N/A
- Pooled Multi-Asset Funds**	-	1.7	1.7	4.86%	N/A
	3.5	3.5	7.0	4.63%	N/A
TOTAL INVESTMENTS	24.4	1.1	25.5	1.71%	0.3

* Weighted average maturity

** The rates provided for pooled fund investments are reflective of the average dividend return over the last 12 months.

Note: the figures in the table on the previous page 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.

7.2. 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 investments before seeking the highest rate of return, or yield. The Fire and Rescue Authority'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 Fire and Rescue Authority's main investment objective and has been maintained by following the Fire and Rescue Authority's counterparty policy as set out in its Treasury Management Strategy Statement.

7.4. Counterparty credit quality has been assessed and monitored with reference to credit ratings, the analysis of funding structure 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 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.

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

7.7. The progression of credit risk and return metrics for the Fire and Rescue Authority's investments that are managed in-house (excluding external pooled funds) are shown in extracts from Arlingclose's quarterly 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 (investments managed in-house)

	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return**
31.03.2019	AA	43%	178	0.93%
31.03.2020	AA-	68%	99	0.61%
Police & Fire Authorities	AA-	58%	46	0.51%
All LAs	AA-	56%	20	0.64%

* Weighted average maturity
** based on investments held at end of quarter

7.8. Table 5 shows the average credit rating of the portfolio was AA- at 31 March 2020; this has reduced from AA in part due to the lack of availability of AAA rated covered bonds when previously held investments matured. AA- is a very good average credit rating and is in line with other Police & Fire Authorities and all Local Authorities covered by Arlingclose's benchmarking. This was alongside increased liquidity in part to fund the prepayment of three year's Pension Fund contributions on 1 April 2020. This increased liquidity meant higher bail-in exposure as a greater proportion of the Fire and Rescue Authority'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.

7.9. 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 Police and Fire Authorities. Bail-in exposure was higher than for other Police and Fire Authorities and the weighted average maturity period was shorter than last year (but still compared favourably to other Police and Fire Authorities), both of which were as a result of holding cash to make the large advance pension contributions payment of £3.9m on 1 April 2020.

7.10. As the Fire and Rescue Authority has relatively stable cash balances, the Fire and Rescue Authority has continued to invest in externally managed pooled funds as part of its high yielding strategy, (as shown in Table 4) with the aim of increasing the level of income contributed to the revenue budget without impacting liquidity.

7.11. The high yielding strategy generated an average income return of 4.6%, contributing to an average return for the investment portfolio in aggregate of 1.7% at 31 March 2020. By comparison, the average income return at 31 March 2020 for all other investments was 0.6%. This would equate to £0.3m of income from the high yield strategy and £0.1m from all other investments based on the snapshot of investments at 31 March 2020.

7.12. The Fire and Rescue Authority has £7m of core balances invested in externally managed pooled property, equity and multi-asset funds, which allow diversification into asset classes other than cash without the need to own and manage the underlying investments.

7.13. Pooled fund investments in property, equity and bonds 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.

7.14. The impact of the COVID-19 pandemic on financial markets at the end of the financial year meant that the Fire and Rescue Authority's investments in these pooled funds suffered a £1.1m fall in capital value (15.2%) over the year to 31 March 2020, meaning these investments are now worth £0.7m less than the Fire and Rescue Authority originally invested. This will only result in the Fire and Rescue Authority losing money if the assets are sold before they have regained their value and the Fire and Rescue Authority has always planned to hold these investments for at least the medium term, accepting that capital values would move both up and down in the short term. Under the accounting standard IFRS 9 the Fire and Rescue Authority must in the meantime defer these fair value losses to the Pooled Fund Adjustment Account, which is available until at least 2023/24.

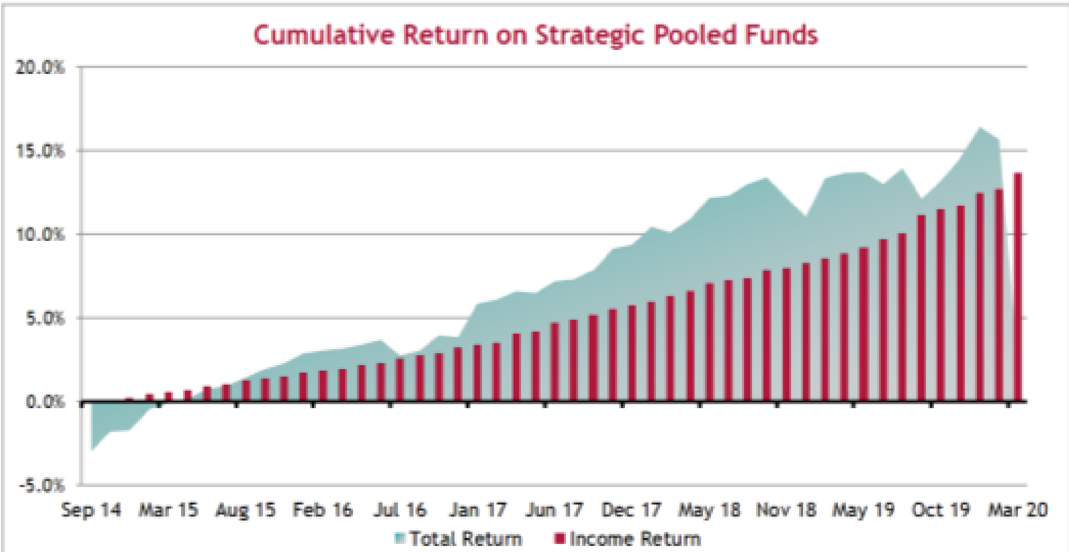
7.15. The fall in the capital value of the Fire and Rescue Authority's pooled funds during 2019/20 reflects the wider market reaction to the coronavirus pandemic, with large falls in equity prices and corporate bond markets, and property markets also affected. Market volatility, as measured by the VIX 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 funds owned by the Fire and Rescue Authority were especially large at -19.6% and -33.2% respectively.

7.16. Although capital values fell, the pooled funds delivered strong positive income returns during 2019/20, contributing £0.3m income (a return of 4.6% pa) to the revenue budget to support the provision of services by the Fire and Rescue Authority, significantly more than could have been achieved through cash investments.

7.17. The total return in 2019/20, allowing for the fall in capital value but offset in part by the income generated, was a loss of £0.8m (10.4% pa).

7.18. The cumulative total return from the Fire and Rescue Authority's investments in pooled equity, property and multi-asset funds since purchase is shown in the graph below. This highlights that the Fire and Rescue Authority has benefited from the strong and steady income returns over time.

7.19. 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 investments have been held by the Fire and Rescue Authority, and although the pooled funds are reporting a negative capital return of 15.2% pa for the year to 31 March 2020, the cumulative total return from these investments since purchase is positive at 2.1% (made up of 11.6% capital loss and a 13.7% income return).



7.20. Strategic pooled fund investments are made as long-term investments using core balances that are not required for current day-to-day liquidity.

Investments are made based on 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. The investments have no defined maturity date but are available for withdrawal after a notice period and their performance and continued suitability in meeting the Fire and Rescue Authority's investment objectives in 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 Fire and Rescue Authority and will have a positive impact on the Fire and Rescue Authority's investment income.

8. Financial Implications

8.1. The outturn for debt interest paid in 2019/20 was £391,000 on an average debt portfolio of £8.3m, against a budgeted £393,000 on an average debt portfolio of £8.3m.

8.2. The outturn for investment income received in 2019/20 was £510,000 on an average investment portfolio of £28.2m, therefore giving a yield of 1.81%, against a budgeted £210,000. The Fire and Rescue Authority doubled its investments in externally managed pooled funds early in 2019/20 and £320,000 of the income relates to the pooled funds holdings. By comparison investment income received in 2018/19 was £379,000 (£179,000 relating to pooled fund investments) on an average investment portfolio of £27.5m with a yield of 1.37%.

9. Non-Treasury Investments

9.1. 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 the treasury management strategy. The Fire & Rescue Authority does not have any existing non-treasury investments.

10. Compliance Report

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

10.2. Compliance with the authorised limit and operational boundary for external debt, is demonstrated in Table 6 overleaf.

Table 6: Debt Limits

	2019/20 Maximum £m	31/03/20 Actual £m	2019/20 Operational Boundary £m	2019/20 Authorised Limit £m	Complied
Borrowing	8.4	8.4	18.6	21.4	✓
Total debt	8.4	8.4	18.6	21.4	✓

11. Treasury Management Indicators

11.1. The Fire and Rescue Authority 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 Fire and Rescue Authority's current investments and borrowing to a change in interest rates:

Table 7 – Interest Rate Risk Indicator

	31/03/20 Actual	Impact of +/- 1% interest rate change
Sums subject to variable interest rates:		
Investment	£15.8m	£0.2m
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 Fire and Rescue Authority'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 8 – Maturity Structure of Borrowing

	31/03/20 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	14%	50%	0%	✓
12 months and within 24 months	5%	50%	0%	✓
24 months and within 5 years	18%	50%	0%	✓
5 years and within 10 years	1%	75%	0%	✓
10 years and within 20 years	62%	75%	0%	✓
20 years and above	0%	100%	0%	✓

Principal Sums Invested for Periods Longer than a year

11.5. 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 long-term principal sum invested to final maturities beyond the period end were:

Table 9 – Principal Sums Invested for Periods Longer than a year

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

11.6. 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.

12. Other

IFRS 16

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