HAMPSHIRE COUNTY COUNCIL

Decision Report

Decision Maker:	Audit Committee
Date:	19 December 2019
Title:	Treasury Management Mid-year Monitoring Report 2019/20
Report From:	Deputy Chief Executive and Director of Corporate Resources

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Purpose of the report

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.

Recommendation

2. The Audit Committee are asked to note the following recommendations being reported to Cabinet and Full Council:

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

Executive Summary

4. The report fulfils the County Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code and provides an update on the performance of the treasury management function during 2019/20.

5. The County Council's treasury management strategy was most recently updated and approved at a meeting of Full Council in February 2019. The County 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 County Council's treasury management strategy.

6. 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."

7. Overall responsibility for treasury management remains with the County Council. No treasury management activity is without risk and the effective identification and management of risk are integral to the County Council's treasury management objectives.

8. All treasury activity has complied with the County Council'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 County Council's treasury advisers, Arlingclose. The County Council has also complied with all the prudential indicators set in its Treasury Management Strategy.

9. The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The County Council's Capital and Investment Strategy, complying with CIPFA's requirement, was approved by full Council on 14 February 2019.

External Context

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

Economic commentary

11. 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.

12. 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

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

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

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

Financial markets

16. 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.

17. 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.

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

19. 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

20. 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.

21. 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.

22. 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.

Local Context

23. 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	**31/03/2019 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

24. 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	31/3/19 Balance £m	Movement £m	31/8/19 Balance £m	31/8/19 Rate %
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

25. The increase in net investments of £3.7m shown in Table 2 above reflects the combination of repayment of Public Works Loan Board (PWLB) borrowing of £1.5m and a small increase in investment balances of £2.2m.

26. 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

27. 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. Further details are summarised in Table 3 below.

Table 3: Borrowing Position	31/3/19 Balance £m	Net Movement £m	31/8/19 Balance £m	31/8/19 Weighted Average Rate %	31/8/19 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.

28. 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.

29. 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.

30. 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.

31. 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.

32. The County Council continues to hold £20.0m 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.

Treasury Investment Activity

33. The County Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. The County Council's investment balance was £585m at 31 August 2019, which was £6m lower than at the same point in 2018/19.

34. During the five-month period to 31 August 2019, the County Council's investment balances ranged between £575m and £677m million due to timing differences between income and expenditure. The investment position is shown in Table 4 below.

Table 4: Treasury Investment Position	**31/03/2019 Balance £m**	**Net Movement £m**	**31/08/2019 Balance £m**	**31/8/19 Income Return %**	**31/8/19 Weighted Average Maturity years***
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	-	0.0	-	-	-
- Registered Provider	5.0	(5.0)	-	-	-
- Cash Plus funds	10.0	0.0	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	0.0	20.0	3.96	14.55
- Fixed bonds	10.0	0.0	10.0	4.20	14.36
- Pooled Funds					
- Pooled property**	67.0	10.0	77.0	3.89	n/a
- Pooled equity**	52.0	0.0	52.0	4.90	n/a
- Pooled multi-asset**	42.0	0.0	42.0	3.58	n/a
- Registered provider	-	0.0	-	-	-
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.

35. 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.

36. 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.

37. 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.

38. 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.

39. 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.

40. 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.

41. 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 LAs	AA-	51%	956	1.01%
All LAs	AA-	62%	28	0.85%

42. 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.

43. 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.

44. 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.

45. £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.

46. 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%).

47. 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.

48. 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.

49. 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.

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

Non-Treasury Investments

51. 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 MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

52. 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.

53. 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

Compliance Report

54. 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.

55. Compliance with the authorised limit and operational boundary for external debt, is demonstrated in Table 7 below.

Table 7 – Debt Limits	**2019/20 Maximum**	**31/08/19 Actual**	**2019/20 Operational Boundary**	**2019/20 Authorised Limit**	**Complied?**
Borrowing	280	279	690	730	✓
PFI and Finance Leases	157	157	160	200	✓
Total debt	**437**	**436**	**850**	**930**	✓

Treasury Management Indicators

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

Interest Rate Exposures

57. 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

58. 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%	✓

59. The County Council holds £20m of LOBO (Lender's Option Borrower's Option) 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

60. 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	2020/21
Actual principal invested beyond year end	£365m	£274m	£246m
Limit on principal invested beyond year end	£410m	£350m	£350m
Complied?	✓	✓	✓

61. 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.

Outlook for the remainder of 2019/20

62. Having increased interest rates by 0.25% in November 2018 to 0.75%, the Bank of England's Monetary Policy Committee (MPC) is now expected to

maintain Bank Rate at this level for the foreseeable future. There are, however, upside and downside risks to this forecast, dependant on Brexit outcomes and the evolution of the global economy.

63. 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

64. 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.

REQUIRED CORPORATE AND LEGAL INFORMATION:

Links to the Strategic Plan

This proposal does not link to the Strategic Plan but, nevertheless, requires a decision because it relates to the effective management of the County Council's cash balances.

NB: If the 'Other significant links' section below is not applicable, please delete it.

Other Significant Links

Links to previous Member decisions:	
Title	Date
Direct links to specific legislation or Government Directives	
Title	Date

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

Document	Location
None	

EQUALITIES IMPACT ASSESSMENT:

1. Equality Duty

   The County Council has a duty under Section 149 of the Equality Act 2010 (‘the Act’) to have due regard in the exercise of its functions to the need to:

   - Eliminate discrimination, harassment and victimisation and any other conduct prohibited by or under the Act with regard to the protected characteristics as set out in section 4 of the Act (age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation);
   - Advance equality of opportunity between persons who share a relevant protected characteristic within section 149(7) of the Act (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, sex and sexual orientation) and those who do not share it;
   - Foster good relations between persons who share a relevant protected characteristic within section 149(7) of the Act (see above) and persons who do not share it.

   Due regard in this context involves having due regard in particular to:

   - The need to remove or minimise disadvantages suffered by persons sharing a relevant protected characteristic that are connected to that characteristic;
   - Take steps to meet the needs of persons sharing a relevant protected characteristic that are different from the needs of persons who do not share it;
   - Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity in which participation by such persons is disproportionally low.

2. Equalities Impact Assessment:

Equalities objectives are not expected to be adversely impacted by the proposals in this report.