Appendix 1

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Flintshire
COUNTY COUNCIL

# FLINTSHIRE COUNTY COUNCIL

## DRAFT TREASURY MANAGEMENT

## MID YEAR REPORT 2020/21

## 1.00 PURPOSE OF REPORT

1.01 To provide members with a mid-year update on matters relating to the Council's Treasury Management function.

## 2.00 BACKGROUND

2.01 Treasury management comprises the management of the Council's 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.

2.02 The Council's primary objectives for the investment of its surplus funds are to protect the principal sums invested from loss, and to ensure adequate liquidity so that funds are available for expenditure when needed. The generation of investment income to support the provision of local authority services is an important, but secondary, objective.

2.03 The Council's policy is to appoint external consultants to provide advice on its treasury management function. In September 2016 Arlingclose Ltd were reappointed as the Council's advisors for a period of 3 years, following a competitive tendering exercise. This period has been extended a further 2 years as per the contract terms to September 2021.

2.04 The Council has adopted the 2017 edition of the CIPFA Treasury Management in the Public Services: Code of Practice, which requires the Council to approve a treasury management strategy before the start of each financial year, a mid-year report, and an annual report after the end of each financial year.

2.05 In addition, the Welsh Government (WG) issues guidance on local authority investments that requires the Council to approve an investment strategy before the start of each financial year. Welsh Government updated this guidance in November 2019 and it came into force on 1st April 2020.

2.06 This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the WG Guidance.

2.07 The Council approved the 2020/21 Treasury Management Strategy at its meeting on 18th February 2020.

## 3.00 ECONOMIC & INTEREST RATE REVIEW APRIL – OCTOBER 2020.

*Provided by Arlingclose Ltd, the Council's treasury management advisors*.

**Economic background:** The spread of the coronavirus pandemic dominated during the period as countries around the world tried to manage the delicate balancing act of containing transmission of the virus while easing lockdown measures and getting their populations and economies working again. After a relatively quiet few months of Brexit news it was back in the headlines towards the end of the period as agreement between the UK and EU on a trade deal was looking difficult and the government came under fire, both at home and abroad, as it tried to pass the Internal Market Bill which could override the agreed Brexit deal, potentially breaking international law.

The Bank of England (BoE) maintained Bank Rate at 0.1% and its Quantitative Easing programme at £745 billion. The potential use of negative interest rates was not ruled in or out by BoE policymakers, but then a comment in the September Monetary Policy Committee meeting minutes that the central bank was having a harder look at its potential impact than was previously suggested took financial markets by surprise.

Government initiatives continued to support the economy, with the furlough (Coronavirus Job Retention) scheme keeping almost 10 million workers in jobs, grants and loans to businesses and 100 million discounted meals being claimed during the ‘Eat Out to Help Out’ (EOHO) offer.

GDP growth contracted by a massive 19.8% (revised from first estimate -20.4%) in Q2 2020 (Apr-Jun) according to the Office for National Statistics, pushing the annual growth rate down to -21.5% (first estimate -21.7%). Construction output fell by 35% over the quarter, services output by almost 20% and production by 16%. Recent monthly estimates of GDP have shown growth recovering, with the latest rise of almost 7% in July, but even with the two previous monthly gains this still only makes up half of the lost output.

The headline rate of UK Consumer Price Inflation (CPI) fell to 0.2% year/year in August, further below the Bank of England’s 2% target, with the largest downward contribution coming from restaurants and hotels influenced by the EOHO scheme. The Office for National Statistics’ preferred measure of CPIH which includes owner-occupied housing was 0.5% y/y.

In the three months to July, labour market data showed the unemployment rate increased from 3.9% to 4.1% while wages fell 1% for total pay in nominal terms (0.2% regular pay) and was down 1.8% in real terms (-0.7% regular pay). Despite only a modest rise in unemployment over the period, the rate is expected to pick up sharply in the coming months as the furlough scheme ends in October. On the back of this, the BoE has forecast unemployment could hit a peak of between 8% and 9%.

The US economy contracted at an annualised rate of 31.7% in Q2 2020 (Apr-Jun). The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25% but announced a change to its inflation targeting regime. The move is to a more flexible form of average targeting which will allow the central bank to maintain interest rates at low levels for an extended period to support the economy even when inflation is 'moderately' above the 2% average target, particularly given it has been below target for most of the last decade.

The European Central Bank maintained its base rate at 0% and deposit rate at -0.5%.

**Financial markets:** Equity markets continued their recovery, with the Dow Jones climbing to not far off its pre-crisis peak, albeit that performance being driven by a handful of technology stocks including Apple and Microsoft, with the former up 75% in 2020. The FTSE 100 and 250 have made up around half of their losses at the height of the pandemic in March. Central bank and government stimulus packages continue to support asset prices, but volatility remains.

Ultra-low interest rates and the flight to quality continued, keeping gilts yields low but volatile over the period with the yield on some short-dated UK government bonds remaining negative. The 5-year UK benchmark gilt yield started and ended the June–September period at -0.06% (with much volatility in between). The 10-year gilt yield also bounced around, starting at 0.21% and ending at 0.23% over the same period, while the 20-year rose from 0.56% to 0.74%. 1-month, 3-month and 12-month bid rates averaged 0.02%, 0.06% and 0.23% respectively over the period.

At the end of September, the yield on 2-year US treasuries was around 0.13% while that on 10-year treasuries was 0.69%. German bund yields remain negative across most maturities.

**Credit review:** Credit default swap spreads eased over most of the period but then started to tick up again through September. In the UK, the spreads between ringfenced and non-ringfenced entities remains, except for retail bank Santander

UK whose CDS spread remained elevated and the highest of those we monitor at 85bps, while Standard Chartered was the lowest at 41bps. The ring-fenced banks are currently trading between 45 and 50bps.

After a busy second quarter of the calendar year, the subsequent period has been relatively quiet for credit changes for the names on our counterparty list. Fitch assigned a AA- deposit rating to Netherlands lender Rabobank with a negative outlook and prior to that, while not related to our counterparty list but quite significant, revised the outlook on the US economy to Negative from Stable while also affirming its AAA rating.

There continues to remain much uncertainty around the extent of the losses banks and building societies will suffer due to the impact from the coronavirus pandemic and for the UK institutions on our list there is the added complication of the end of the Brexit transition period on 31st December and what a trade deal may or may not look like. The institutions on Arlingclose's counterparty list and recommended duration remain under constant review, but at the end of the period no changes had been made to the names on the list or the recommended maximum duration of 35 days.

**Outlook for the remainder of 2020/21**

The medium-term global economic outlook is weak. While the strict initial lockdown restrictions have eased, coronavirus has not been supressed and second waves have prompted more restrictive measures on a regional and national basis. This ebb and flow of restrictions on normal activity will continue for the foreseeable future, at least until an effective vaccine is produced and importantly, distributed.

The global central bank and government responses have been significant and are in many cases on-going, maintaining more stable financial, economic and social conditions than otherwise. This has supported a sizeable economic recovery in Q3.

However, the scale of the economic shock to demand, on-going social distancing measures, regional lock downs and reduced fiscal support will mean that the subsequent pace of recovery is limited. Early signs of this are already evident in UK monthly GDP and PMI data, even before the latest restrictions.

This situation will result in central banks maintaining low interest rates for the medium term. In the UK, Brexit is a further complication. Bank Rate is therefore likely to remain at low levels for a very long time, with a distinct possibility of being cut to zero. Money markets have priced in a chance of negative Bank Rate.

Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid inflation expectations. There is a chance yields may follow a slightly different path in the medium term, depending on investor perceptions of growth and inflation, or if the UK leaves the EU without a deal.

Arlingclose expects Bank Rate to remain at the current 0.10% level and additional monetary loosening in the future most likely through further financial asset purchases (QE). While Arlingclose's central case for Bank Rate is no change from the current level of 0.1%, further cuts to Bank Rate to zero or even into negative territory cannot be completely ruled out.

Gilt yields are expected to remain very low in the medium term. Shorter-term gilt yields are currently negative and will remain around zero or below until either the Bank of England expressly rules out negative Bank Rate or growth/inflation prospects improve.

Downside risks remain in the near term, as the government dials down its fiscal support measures, reacts to the risk of a further escalation in infection rates and the Brexit transition period comes to an end.

| | Dec 20 | Mar 21 | Jun 21 | Sept 21 | Dec 21 | Mar 22 | Jun 22 | Sept 22 | Dec 22 | Mar 23 | Jun 23 | Sept 23 | Dec 23 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Upside Risk (%) | 0.00 | 0.00 | 0.00 | 0.15 | 0.15 | 0.15 | 0.15 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 |
| Interest Rate (%) | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 |
| Downside Risk (%) | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |

## 4.00 <u>BORROWING REQUIREMENTS AND DEBT MANAGEMENT</u>

4.01 PWLB (Public Works Loans Board) Certainty Rate Update.

The Authority submitted its application to WG along with the 2020-21 Capital Estimates Return to access this reduced rate for a further 12 months from 1st November 2020.

4.02 The total long term borrowing outstanding totals £280.9 million.

4.03 Loans with the Public Works Loans Board are in the form of fixed rate (£256.57m). £18.95m is variable in the form of Lobo's (Lender's Option, Borrower's Option) and

£5.38m are interest free loans from government. The Council's average long term borrowing rate is currently 4.70%.

| | Balance 01/04/2020 £m | Debt Maturing £m | New Debt £m | Balance 30/09/2020 £m |
|---|---|---|---|---|
| Long Term Borrowing | 286.11 | (10.59) | 0.00 | 275.52 |
| Government Loans | 5.17 | (0.25) | 0.46 | 5.38 |
| TOTAL BORROWING | 291.28 | (10.84) | 0.46 | 280.9 |
| Other Long Term Liabilities * | 4.48 | 0.00 | 0.00 | 4.48 |
| TOTAL EXTERNAL DEBT | 295.76 | (10.84) | 0.46 | 285.38 |
| Increase/ (Decrease) in Borrowing £m | | | | (10.38) |

** relates to finance leases in respect of Deeside Leisure Centre and Jade Jones Pavilion*

4.04 No new long term borrowing has been undertaken so far during 2020/21.

Affordability (interest costs charged on new loans) and the "cost of carry" (costs associated with new long term loans) remain important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of long term borrowing.

4.05 Internal Borrowing and Short Term Borrowing

Given the significant cuts to local government funding putting pressure on Council finances, the borrowing strategy is to minimise debt interest payments without compromising the longer-term stability of the portfolio. With short-term interest rates currently lower than long-term rates, it has been more cost effective in the short-term to use internal resources, and to borrow short-term instead.

The differential between the cost of new longer-term debt and the return generated on the Council's temporary investment returns was significant at around 1.35%.

The use of internal resources in lieu of borrowing has therefore continued to be used over the period as the most cost effective means of funding capital expenditure. This has lowered overall treasury risk by reducing both external debt and temporary investments.

Short term borrowing was undertaken as necessary. The total short term borrowing as at 30th September 2020 was £30m with an average rate of 0.47%.

The Council's capital expenditure plans will continue to be monitored throughout 2020/21 to inform and assess the Council's long term borrowing need. This is to ensure that the Council does not commit to long term borrowing too early and refinance unnecessarily which will be costly and have significant revenue implications. The continued use of short-term borrowing will assist with such. This will be balanced against securing low long term interest rates currently being forecast and assessing the affordability of long-term borrowing in the short term against the savings made over the life of the loan.

4.06 Lender's Option Borrower's Option Loans (LOBOs)

The Authority holds £18.95m 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 Authority has the option to either accept the new rate or to repay the loan at no additional cost. The option to change the terms on £18.95m of the Council's LOBOs was not exercised by the lender. The Authority acknowledges there is an element of refinancing risk even though in the current interest rate environment lenders are unlikely to exercise their options.

4.07 Debt Rescheduling

The premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Authority's portfolio and therefore unattractive for debt rescheduling activity. No rescheduling activity was undertaken as a consequence.

The Corporate Finance Manager, in conjunction with the Council's treasury advisors will continue to review any potential opportunities for restructuring the Council's debt in order to take advantage of potential savings as interest rates change and to enhance the balance of the long term portfolio (amend the maturity profile and/or the balance of volatility).

**4.08 Borrowing Update**

On 9th October 2019 the PWLB raised the cost of certainty rate borrowing to 1.8% above UK gilt yields making it relatively expensive. Market alternatives are available, however the financial strength of individual authorities will be scrutinised by investors and commercial lenders.

The Chancellor's March 2020 Budget statement included significant changes to Public Works Loan Board (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 authority usually borrows from the PWLB). £1.15bn of additional “infrastructure rate” funding at gilt yields plus 0.60% has been made available to support specific local authority infrastructure projects for England, Scotland and Wales for which there is a bidding process.

The consultation titled “Future Lending Terms” allows stakeholders to contribute to developing a system whereby PWLB loans can be made available at improved margins to support qualifying projects. It contains proposals to allow authorities that are not involved in “debt for yield” activity to borrow at lower rates as well as stopping local authorities using PWLB loans to buy commercial assets primarily for yield. The consultation also broaches the possibility of slowing, or stopping, individual authorities from borrowing large sums in specific circumstances.

The Council responded to the consultation which closed on 31st July 2020. The announcement and implementation of the revised lending terms is expected in the latter part of this calendar year or early next year.

## 5.0 INTERIM INVESTMENT AND PERFORMANCE REPORT

5.01 The Welsh Government’s Investment Guidance gives priority to security and liquidity and the Authority’s aim is to achieve a yield commensurate with these principles.

On 25th September the overnight, 1- and 2-week deposit rates on Debt Management Account Deposit Facility (DMADF) deposits dropped below zero percent to -0.03%, the rate was 0% for 3-week deposits and 0.01% for longer maturities.

In order to avoid the cost of negative interest rates the Council withdrew £10m from Money Market Funds (MMFs) to invest with the DMADF for 1 month. Shorter-term investments can now be made in MMFs where they still attract positive rates of interest.

The return on MMFs net of fees also fell over the six months and for many funds net returns range between 0% and 0.1%. In many instances, the fund management companies have temporarily lowered or waived fees to maintain a positive net return.

5.02 The maximum investments the Authority had on deposit at any one time totalled £80.5m. The average investment balance for the period was £43.5m and the average rate of return was 0.05%, generating investment income of £11k.

5.03 Up to 30th September, investments were made in the Debt Management Office

Deposit Account and Money Market Funds

5.04 The average of long and short-term borrowing was £319.7m generating interest payable of £6.786m, in line with budget forecasts to date.

| | Investments | | Borrowing | |
|---|---|---|---|---|
| | Interest received £'000 | Interest rate % | Interest paid £'000 | Interest rate % |
| 2020/21 Apr-Sept | 10.9 | 0.05 | 6,786 | 4.29 |
| 2019/20 Apr-Sept | 88.9 | 0.67 | 6,496 | 4.34 |
| Difference | (78.0) | | 290 | |

Year-end projections are as follows:

| | Investments | | Borrowing | |
|---|---|---|---|---|
| | Interest received £'000 | Interest rate % | Interest paid £'000 | Interest rate % |
| 2020/21 estimate | 19.9 | 0.05 | 13,559 | 4.17 |
| 2019/20 actual | 159.2 | 0.63 | 13,387 | 4.03 |
| Difference | (139.3) | | 171 | |

5.05 Credit Risk (security)

Counterparty credit quality was assessed and monitored with reference to credit ratings (the Authority's minimum long-term counterparty rating for institutions defined as having "high credit quality" is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

5.06 Liquidity

In keeping with the WG's Guidance on Investments, the Council maintained a sufficient level of liquidity through the use of Money Market Funds.

5.07 Yield

The Council sought to optimise returns commensurate with its objectives of security and liquidity. The Council's investment yield is outlined in 5.02.

## 6.00 REGULATORY UPDATES

6.01 **IFRS 16:** The implementation of the new IFRS 16 Leases accounting standard has been delayed until 2021/22.

## 7.00 COMPLIANCE

7.01 The Council can confirm that it has complied with its Prudential Indicators for the period April to September 2020. These were approved on 18th February 2020 as part of the Council's 2020/21 Treasury Management Strategy.

7.02 In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during the period April – September 2020. None of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

## 8.00 OTHER ITEMS

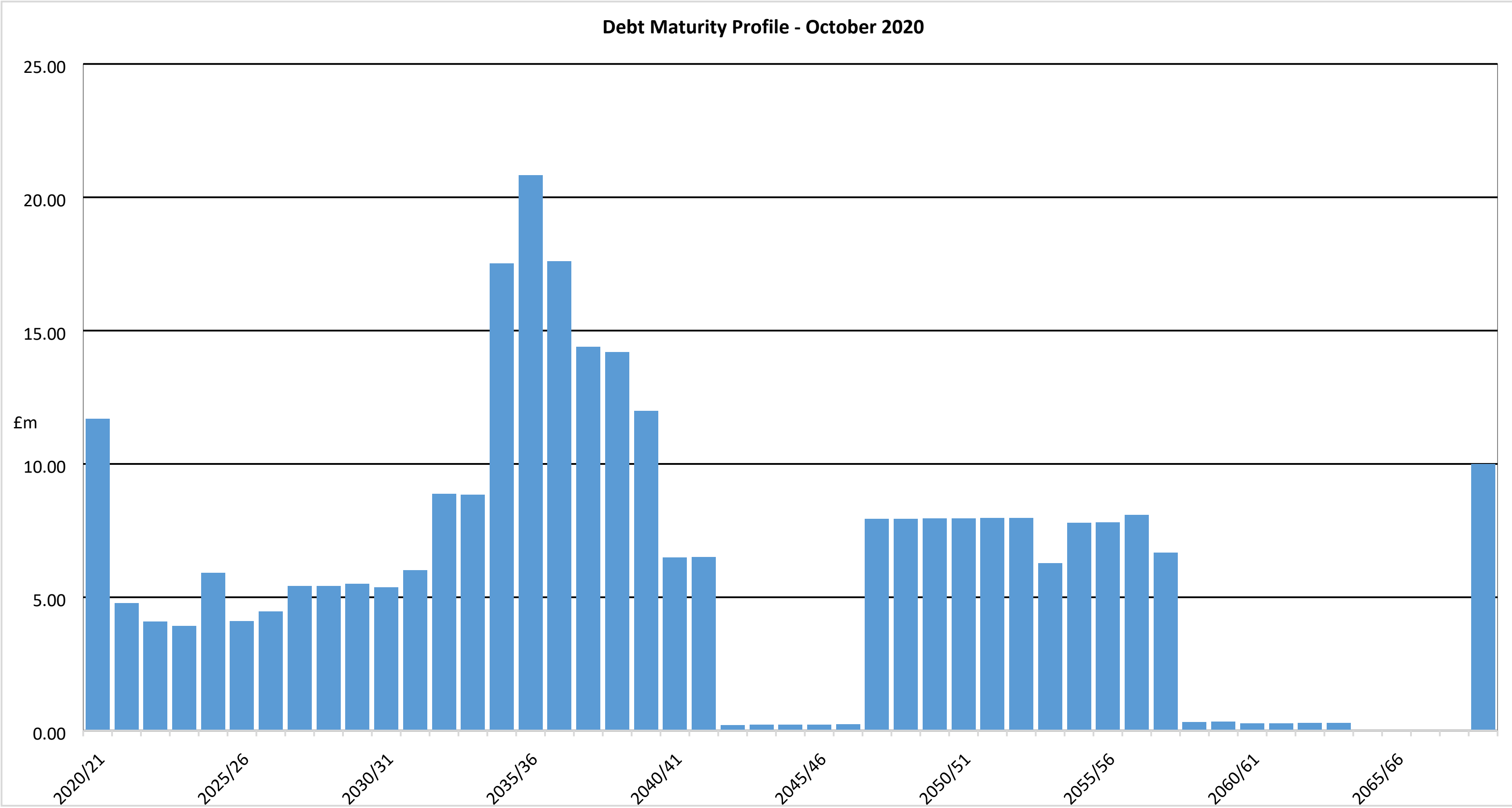
8.01 Other treasury management related activity that took place during April – September 2020 includes:

- The Treasury Management Annual Report 2019/20 was reported to Audit Committee on 23rd July 2020, Cabinet on 8h September 2020 and to Council on 20th October 2020.
- The Quarter 1 Treasury Management update was reported to the Audit Committee.

## 9.00 CONCLUSION

9.01 In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during the first half of 2020/21.

9.02 As indicated in this report none of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.


Debt Maturity Profile - October 2020
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