Appendix E

Treasury Management Half Yearly Report

Introduction

The Authority has adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports.

The Authority's treasury management strategy for 2020/21 was approved by full Council in February 2020. The Authority has borrowed substantial 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 remains central to the Authority's treasury management strategy.

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 Authority's Capital Strategy, complying with CIPFA's requirement, was also approved by full Council in February 2020.

External Context

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.

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 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). 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. 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).

Credit review:

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 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.

Local Context

On 31st March 2020, the Authority had net borrowing of £436m arising from its revenue and capital income and expenditure. 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

	31.3.20 Balance £'000
General Fund CFR	494,333
Total Borrowing	484,748
Internal Borrowing	**9,585**

Lower official interest rates have lowered the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The Authority pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk.

The treasury management position on 30th September 2020 and the change over the six months is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.20 Balance £'000	Movement £m	30.9.20 Balance £m	30.9.20 Rate %
Long-term borrowing Short-term borrowing	350,000 134,748	0 -17,248	350,000 117,500	1.92% 0.07%
Total borrowing	**484,748**	**-17,248**	**467,500**	**1.46%**
Long-term investments Short-term investments Cash and cash equivalents	9,219 32,500 4,254	0 -12,500 -2122	9,219 20,000 2,132	3.00% 0.08% 0.01%
Total investments	**45,973**	**-14,622**	**31,351**	**0.93%**
Net borrowing	**438,775**	**-2,626**	**436,149**	**1.43%**

Net borrowing has decreased since the 31st March, predominantly due to income received from the Government for COVID payments and fluctuations in the authorities working capital requirements over the period. This has been used to offset borrowing until such time it is needed. This is a prudent way to manage funds, reducing refinancing risk, and reducing interest costs to the Council.

Borrowing Update

On 9th October 2019 the PWLB raised the cost of certainty rate borrowing to 1.8% above UK gilt yields making it more expensive.

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. £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 consultation closed on 31st July 2020 with the announcement and implementation of the revised lending terms expected in the latter part of this calendar year or early next year.

Municipal Bonds Agency (MBA): The MBA revised its standard loan terms and framework agreement. Guarantees for the debt of other borrowers are now proportional and limited and a requirement to make contribution loans in the event of a default by a borrower has been introduced. The agency has issued 5-year floating rate and 40-year fixed rate bonds in 2020, in both instances Lancashire County Council is the sole borrower and guarantor.

Borrowing Strategy during the period

At 30th September 2020 the Authority held £467.5m of loans, a decrease of £17.2m compared to 31st March 2020, as part of its strategy for funding previous and current years' capital programmes. This reduction is predominantly due to the reduction in investments over the period, therefore reducing the need to borrow. Outstanding loans on 30th September are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.20 Balance £'000	Net Movement £'000	30.9.20 Balance £'000	30.9.20 Average Rate %
Public Works Loan Board	351,000	-500	350,500	1.92%
Local authorities	133,748	-16,748	117,000	0.07%
Total Borrowing	**484,748**	**-17,248**	**467,500**	**1.46%**

The 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, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective.

Treasury Investment Activity

The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances ranged between £83m and £28m due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

Investment Limits	31.3.20 Balance £'000	Net Movement £'000	30.9.20 Balance £'000	30.9.20 Income Return %
Banks	4,254	-2122	2,132	0.01%
Money Market Funds	32,500	-12,500	20,000	0.08%
CCLA Property Fund	9,219	0	9,219	3.00%
Total Investments	**45,973**	**-14,622**	**31,351**	**0.93%**

In the light of the pandemic crisis and the likelihood of unexpected calls on cash flow, the Authority kept more cash available at very short notice than is normal. Liquid cash was diversified over several counterparties and Money Market Funds to manage both credit and liquidity risks.

Externally Managed Pooled Funds:

The Authority is invested in the CCLA Local Authorities Property Fund. The falls in the capital values of the underlying assets due to COVID 19, were reflected in the 31st March 2020 fund valuations with the fund registering negative capital returns over a 12-month period.

Like many other property funds, dealing (i.e. buying or selling units) in the CCLA Local Authorities Property Fund was suspended by the fund in March 2020. The relative infrequency of property transactions in March as the pandemic intensified meant that it was not possible for valuers to be confident that their valuations correctly reflected prevailing conditions. To avoid material risk of disadvantage to buyers, sellers and holders of units in the property fund, the management company was obliged to suspend transactions until the required level of certainty is re-established. The dealing suspension was lifted in September 2020. There has also been a change to redemption terms for the CCLA Local Authorities Property Fund; from September 2020 investors are required to give at least 90 calendar days' notice for redemptions.

Because the Authority's externally managed funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives are regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three- to five-year period total returns will exceed cash interest rates.

In 2020/21 the Authority expects to receive significantly lower income from its cash and short-dated money market investments and from its externally managed funds than it did in 2019/20 and earlier years. Dividends and income paid will ultimately depend on many factors including but not limited to the duration of COVID-19 and the extent of its economic impact and the funds sectoral investments.

Compliance

The Chief Financial Officer must report that treasury management activities undertaken during the first half of 2020/21 did not fully comply with the Authority's approved Treasury Management Strategy.

The limit on specified investments being a maximum of £10m with any single organisation was breached during April and into early May to ensure liquidity of funds during the initial COVID 19 lockdown. Please see table 5 below for more information

Table 5: Investment Limits

	Q2 Maximum £'000	30.9.20 Actual £'000	2020/21 Limit £'000	Complied?
Any single organisation, except the UK Government	25,046	2,132	10,000	No
Money Market Funds	10,000	10,000	10,000	Yes
CCLA Property Fund	9,219	9,219	14,500	Yes

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 6 below. Neither the Operational Boundary, not Authorised Limit were breached during the first half of 2020/21

Table 6: Debt Limits

	2020.21 Maximum £'000	30.9.20 Actual £'000	2020/21 Operational Boundary £'000	2020/21 Authorised Limit	Complied?

Borrowing	497,000	467,000	578,350	599,350	Yes

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.

Treasury Management Indicators

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

Security: The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio.

	30.9.20 Actual	2020.21 Target	Complied ?
Portfolio average credit score	A	A	✓

Liquidity: The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount it can borrow each quarter without giving prior notice.

	30.9.20 Actual	2020.21 Target	Complied
Total sum borrowed in past 3 months without prior notice	£0m	£0m	✓

Interest Rate Exposures: This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed was:

	30.9.20 Actual	2020.21 Limit	Complied ?
Upper limit on fixed interest rate exposure	75%	100%	✓
Upper limit on variable interest rate exposure	25%	100%	✓

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

Maturity Structure of Borrowing: This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	30.9.20 Actual	Upper Limit	Lower Limit	Complied ?
Under 12 months	25%	100%	0%	✓
12 months and within 24 months	0%	100%	0%	✓
24 months and within 5 years	0%	100%	0%	✓
5 years and within 10 years	29%	100%	0%	✓
10 years and above	46%	100%	0%	✓

Principal Sums Invested for Periods Longer than 365 days: The purpose of this indicator is to control the 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:

	2018.19 £'000	2019.20 £'000	2020.21 £'000
Actual principal invested beyond year end	0	0	0
Limit on principal invested beyond year end	£14.5m	£14.5m	£14.5m

Arlingclose's Outlook for the remainder of 2020/21

	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Official Bank Rate													
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
Arlingclose Central Case	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

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 0.10%, 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.