Report Number: SWT 113/20

Somerset West and Taunton Council

Audit, Governance and Standards Committee – 7 September 2020

Somerset West and Taunton Council Treasury Management Outturn Report 2019/20

This matter is the responsibility of Cllr Ross Henley, Portfolio Holder for Corporate Resources

Report Author: Steve Plenty, Finance Specialist

1 Executive Summary / Purpose of the Report

1.1 To provide members with an update on the Treasury Management activity of Somerset West and Taunton Council and performance against the Prudential Indicators for 2019/20.

1.2 Treasury management performance during the year has reflected the agreed strategy for the Council, with low risk investment exposure delivering relatively low returns. This is appropriate for the local context.

2 Recommendations

2.1 To note the Treasury Management activity for the 2019/20 financial year and compliance with the Prudential Indicators before recommendation to Full Council for information.

3 Risk Assessment

3.1 The Council has an agreed Treasury Management Strategy Statement (TMSS) and effective management practices to ensure compliance.

4 Background and Full details of the Report

4.1 The Council's treasury management strategy for 2019/20 was approved at Full Council on 21 February 2019. The Council invests 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 Council's treasury management strategy.

4.2 Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the

Council to approve a treasury management strategy before the start of each financial year and, as a minimum, a half-year and annual treasury outturn report. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

4.3 These reports are required to be adequately scrutinised by committee before being recommended to the Council. This role is undertaken by the Audit, Governance and Standards Committee.

4.4 The 2017 Prudential Code includes a requirement for local Councils to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Council's latest Capital Strategy, complying with CIPFA's requirement, was approved by Somerset West and Taunton Full Council on 20 February 2020.

4.5 Treasury management is defined as:

> "The management of the local Council's cash flows, its borrowings and its investments, the management of the associated risks, and the pursuit of the optimum performance or return consistent with those risks".

4.6 Overall responsibility for treasury management remains with the Council with operational responsibility delegated to the S151 Officer. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management objectives.

5 External Context – Analysis by Arlingclose

5.1 Commentary relating to the external context and economic analysis by Arlingclose, the Council's treasury management advisors, can be found in Appendix A to this report.

6 Local Context

6.1 On 31st March 2020, the Council had net investments of £23.826m 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 Actual £m
General Fund CFR	33.955
HRA CFR	107.981
Total CFR	**141.936**
External borrowing	(101.108)
Internal borrowing	**40.828**
Less: Usable reserves	(60.530)
Less: Working capital	(4.124)
Net Investments	**(23.826)**

6.2 The Council pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

6.3 The treasury management position at 31st March 2020 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.19 Balance £m	Movement £m	31.3.20 Balance £m
Long-term borrowing	(79.000)	3.500	(75.500)
Short-term borrowing	(13,500)	(12.000)	(25.500)
Total borrowing	**(92.500)**	**(8.500)**	**(101.000)**
Long-term investments	2.161	(2.158)	0.003
Short-term investments	17.055	(12.02)	5.026
Cash and cash equivalents	22.028	6.663	28.691
Total investments	**41.244**	**(7.524)**	**33.720**
Net Borrowing	**(51.256)**	**(16.024)**	**(67.280)**

Borrowing Update

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

6.5 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 HRA loans to 0.80% above equivalent gilt yields. In respect of the Housing Revenue Account (HRA) the value of this discount is 1% below the rate at which the Council usually borrows from the PWLB), available from 12th March 2020 and £1.15bn of additional "infrastructure rate" funding at gilt yields plus 0.60% to support specific local Council infrastructure projects for England, Scotland and Wales for which there is a bidding process.

6.6 The consultation titled "Future Lending Terms" represents a frank, open and inclusive invitation, allowing key stakeholders to contribute to developing a system whereby PWLB loans can be made available at improved margins to support qualifying projects. It contains proposals on allowing Councils that are not involved in "debt for yield" activity to borrow at lower rates as well as stopping local Councils using PWLB loans to buy commercial assets primarily for yield without impeding their ability to pursue their core policy objectives of service delivery, housing, and regeneration. The consultation also broaches the possibility of slowing, or stopping, individual Councils from borrowing large sums in specific circumstances.

6.7 The consultation closed on 4th June 2020 with implementation of the new lending terms expected in the latter part of this calendar year or financial year beginning 2021/22.

Borrowing strategy

6.8 At 31st March 2020 the Council held £101.000m of loans, (an increase of £8.500m compared to 31st March 2019, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 31st March are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.19 Balance £m	Net Movement £m	31.3.20 Balance £m
Public Works Loan Board	79.500	(3.500)	76.000
Banks (Fixed-term)	3.000	0.000	3.000
Local Councils (Short-term)	10.000	12.000	22.000
Total borrowing	**92.500**	**8.500**	**101.000**

6.9 The Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

6.10 With short-term interest rates remaining much lower than long-term rates, the Council considered it more cost effective in the near term to use internal resources or borrowed rolling temporary / short-term loans instead. The net movement in temporary / short-term loans is shown in Table 3 above.

6.11 The Council has an increasing CFR due to the capital programme and an estimated borrowing requirement as determined by the Liability Benchmark which also takes into account usable reserves and working capital. Having considered the appropriate duration and structure of the borrowing need based on realistic projections, it was decided to take short-term borrowing. The Council currently has £75.500m of longer term borrowings in respect of the Housing Revenue Account, details of which are below. These loans provide some longer-term certainty and stability to the debt portfolio.

Long-dated Loans borrowed	**Amount £m**	**Rate %**	**Maturity Date**
Public Works Loan Board	2.000	0.91	28 Mar 22
Public Works Loan Board	3.000	0.91	28 Mar 22
Public Works Loan Board	5.000	2.40	28 Mar 22
Public Works Loan Board	5.000	2.56	28 Mar 23
Public Works Loan Board	7.000	2.70	28 Mar 24
Public Works Loan Board	6.000	2.82	28 Mar 25
Public Works Loan Board	7.000	2.92	28 Mar 26
Public Works Loan Board	16.000	3.01	28 Mar 27
Public Works Loan Board	7.000	3.08	28 Mar 28
Public Works Loan Board	5.000	3.15	28 Mar 29
Public Works Loan Board	5.500	3.21	28 Mar 30
Public Works Loan Board	1.000	8.38	03 Aug 56
Public Works Loan Board	1.000	7.38	06 May 57
Public Works Loan Board	2.000	6.63	05 Sep 57
Barclays Bank	3.000	4.25	14 Jun 77
Total borrowing	**75.500**		

6.12 The Council's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short- and long-term borrowing was maintained.

6.13 As this year has illustrated, PWLB funding margins have lurched quite substantially and there remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields plus 0.80%, i.e. the PWLB HRA borrowing rate. The Council will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.

Treasury Investment Activity

6.14 The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Council's investment balances ranged between £60.419m and £32.148m due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.19 Balance £m	Net Movement £m	31.3.20 Balance £m
Banks and Building Societies (unsecured)	6.053	(4.060)	1.993
Covered Bonds (secured)	2.138	(0.063)	2.075
Government (inc. local authorities)	12.042	(7.028)	4.834
Money Market Funds	4.310	2.455	6.765
Cash Plus Funds	4.068	(1.045)	3.023
Strategic Bond Funds	1.958	(0.108)	1.850
Equity Income Funds	0.000	2.000	2.000
Property Funds	5.060	(0.183)	4.877
Multi Asset Income Fund	4.945	1.726	6.671
Total Investments	**40.574**	**(6.486)**	**34.088**

6.15 Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

6.16 Given the increasing risk and low returns from short-term unsecured bank investments, the Council has further diversified into more secure and/or higher yielding asset classes as shown in table 4 above. £4.000m that was available for longer-term investment was moved from bank and building society deposits into equity and multi-asset funds.

6.17 The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below. Please not that comparative information as at 31 March 2019 is not available for Somerset West and Taunton Council due to the new council being established on 1 April 2019.

Table 5: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2019 31.03.2020	N/A 3.12	N/A AA	N/A 46%	N/A 39	N/A -1.14%
Similar Las All LAs	3.95 4.03	AA- AA-	59% 56%	53 20	-0.79% -0.34%

6.18 £12.476m of the Council's investments are held in externally managed strategic pooled funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds generated dividends of £461,450 in 2019/20, an income return of 3.31% which is used to support services in year, and an unrealised capital loss of £1,468,067 (-10.59%).

6.19 In a relatively short period since the onset of the COVID-19 pandemic, the global economic fallout was sharp and large. Market reaction was extreme with large falls in equities, corporate bond markets and, to some extent, real estate echoing lockdown-induced paralysis and the uncharted challenges for governments, businesses and individuals. Volatility measured by the VIX index was almost as high as during the global financial crisis of 2008-09 and evidenced in plummeting equity prices and the widening of corporate bond spreads, very close to rivalling those twelve years ago. Gilt yields fell but credit spreads widened markedly reflecting the sharp deterioration in economic and credit conditions associated with a sudden stagnation in economies, so corporate bonds yields (comprised of the gilt yield plus the credit spread) rose and prices therefore fell.

6.20 The Council is using the alternative fair value through profit and loss (FVPL) accounting and must defer the funds' fair value losses to the Pooled Investment Fund Adjustment Account until 2023/24.

6.21 Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives is 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 light of their performance over the medium- / long-term and the Council's latest cash flow forecasts, investment in these funds has been maintained.

Non-Treasury Investments

6.22 The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in the Investment Guidance issued by Ministry of Housing, Communities and Local Government's (MHCLG) and Welsh Government, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

6.23 The Council also holds £6.455m of such investments held as loans to local businesses, charities, partnerships and sports clubs as at 31 March 2020. These investments generated £0.103m of investment income for the Council representing an average rate of return of 3.62%.

Treasury Performance

6.24 The Council measures the financial performance of its treasury management activities in terms of its impact on the revenue budget as shown Table 6 below.

Table 6: Performance

	Budget 2019/20 £m	**Actual 2019/20 £m**	**Variance 2019/20 £m**
Interest Paid	2.788	2.487	(0.301)
Interest Received	(0.712)	(0.855)	0.143

Compliance

6.25 The Section 151 Officer reports that one indicator was not complied with, as at 31.03.2020 the exposure to interest rates falling or rising by 1% was higher than £121k, see 6.30. The treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and all other indicators in the Council's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in Table 7 below.

Table 7: Investment Limits

	2019/20 Maximum	31.3.20 Actual	2019/20 Limit	Complied
Any single organisation, except the UK Government	£9.000m	£nil	£9m	✓
UK Government	£16.545m	£4.834m	Unlimited	✓
Any group of organisations under the same ownership	£9.000m	£nil	£9m per Group	✓
Any group of pooled funds under the same management	£nil	£nil	£21m per Manager	✓
Negotiable instruments held in a broker's nominee account	£2.076m	£2.076m	£21m per Broker	✓
Foreign Countries	£nil	£nil	£9m per Country	✓
Registered providers and registered social landlords	£19.000m	£18.420m	£21m in Total	✓
Unsecured investments with building societies	£2.300m	£1.993m	£9m in Total	✓
Loans to unrated corporates	£nil	£nil	£9m in Total	✓
Money Market Funds	£18.410m	£6.765m	£42m in Total	✓
Real Estate Investment Trusts	£nil	£nil	£21m in Total	✓

6.26 Compliance with the authorised limit and the operational boundary for external debt is demonstrated in Table 8 below.

Table 8: Debt Limits

	2019/20 Maximum	31.3.20 Actual	2019/20 Operational Boundary	2019/20 Authorised Limit	Complied
Borrowing	£104.5m	£101.0m	£212.0m	£244.0m	✓
Total debt	**£104.5m**	**£101.0m**	**£212.0m**	**£244.0m**	✓

Treasury Management Indicators

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

6.28 **Security:** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	31.3.20 Actual	**2019/20 Target**	**Complied**
Portfolio average credit rating	AA	A-	✓

6.29 **Liquidity:** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing.

	31.3.20 Actual	**2019/20 Target**	**Complied**
Total cash available within 3 months	£32.013m	£21m	✓

6.30 **Interest Rate Exposures:** This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interests was:

Interest rate risk indicator	**31.3.20 Actual**	**2019/20 Limit**	**Complied**
Upper limit on one-year revenue impact of a 1% rise in interest rates	(£165,042)	(£121,000)	×
Upper limit on one-year revenue impact of a 1% fall in interest rates	£165,042	£121,000	×

6.31 The impact of a 1% rise or fall in interest rates as at 31.03.20 was slightly higher than the limit within the approved TMSS, this is a low risk breach and will be reviewed in 2020/21.

6.32 The impact of a change in interest rates is calculated on the assumption that maturing loans and investment will be replaced at current rates.

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

	31.3.20 Actual	**Upper Limit**	**Lower Limit**	**Complied**
Under 12 months	25.25%	100%	0%	✓
12 months and within 24 months	9.90%	100%	0%	✓
24 months and within 5 years	17.82%	100%	0%	✓
5 years and within 10 years	40.10%	100%	0%	✓
10 years and above	6.93%	100%	0%	✓

6.34 Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

6.35 Principal **Sums Invested for Periods Longer than a year:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2019/20	**2020/21**	**2021/22**
Actual principal invested beyond year end	£0m	£0m	£0m
Limit on principal invested beyond year end	£40m	£24m	£24m
Complied	✓	✓	✓

<u>Other</u>

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

7 Links to Corporate Aims / Priorities

7.1 The Treasury Management and Investment Strategy supports the delivery of the Corporate Aims.

8 Finance / Resource Implications

8.1 The Treasury Management function has been well-managed during the year in compliance with the Treasury Management Strategy Statement. As interest rates remain low the opportunities to generate significant income through short term investments has been limited.

8.2 This report provides full details of the Treasury Management activity during the year. A summary of the key points follows:

- As at 31 March 2020, Somerset West and Taunton Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £141.936m, while usable reserves and working capital which were the underlying resources available for investment were £60.530m and £4.124m respectively.

- As at 31 March 2020, Somerset West and Taunton Council had external borrowing of £101.000m, with £79.000m attributable to the Housing Revenue Account and £22.000m attributable to the General Fund.

- Somerset West and Taunton Council also had £34.088m of investments as at 31 March 2020.

- The Council's current strategy was to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.

9 Legal Implications

9.1 The S151 Officer has a statutory responsibility to ensure appropriate arrangements are in place to adequately control the Council's resources. The Council is required to have regard to the Prudential Code, Treasury Management Code and relevant statutory guidance.

10 Climate and Sustainability, Safeguarding and/or Community Safety, Equality and Diversity, Social Value, Partnership, Health and Wellbeing, Asset Management, Data Protection and Consultation Implications

10.1 None in respect of this report.

Democratic Path:

- **Audit, Governance and Standards Committee – Yes**
- **Full Council – Yes**

Reporting Frequency: Annually

List of Appendices (delete if not applicable)

Appendix A	External Context – Analysis by Arlingclose
Appendix B	List of Investments as at 31 March 2020

Contact Officers

Name	Steve Plenty
Direct Dial	01984 600173
Email	s.plenty@somersetwestandtaunton.gov.uk

Name	Emily Collacott
Direct Dial	01823 218742
Email	e.collacott@somersetwestandtaunton.gov.uk

Name	Paul Fitzgerald
Direct Dial	01823 217557
Email	p.fitzgerald@somersetwestandtaunton.gov.uk