REPORT to :	Audit & Governance Committee
LEAD OFFICER:	Director of Finance and Customer Services
DATE:	29th July 2020

WARD/S AFFECTED: All

Treasury Management Annual Report 2019/20

1. PURPOSE

1.1 To formally report the Treasury outturn for 2019/20, as also reflected in the 2019/20 Outturn Corporate Monitoring Report (9th July Executive Board).

2. RECOMMENDATIONS

2.1 Audit and Governance Committee is recommended to note the Outturn position for 2019/20.

3. BACKGROUND

3.1 In February/March 2019 the Council agreed a Treasury Management Strategy and Minimum Revenue Provision (MRP) Policy for 2019/20.

3.2 The CIPFA Treasury Management Code required the Council to approve a Treasury Management Strategy (including various Treasury Management indicators) before the start of each financial year, and to consider the outturn after each year end. This report is to update Audit and Governance Committee on the overall outturn position for 2019/20.

4. KEY ISSUES AND RISKS

4.1 Treasury Priorities

The Council has operated within CIPFA and statutory guidance and requirements in respect of Treasury Management practice. The approved Treasury Management Policy Statement, together with the more detailed Treasury Management Practices and each year's Annual Strategy have all emphasised the importance of security and liquidity over yield.

5. 2019/20 OUTTURN

5.1 Original Strategy for 2019/20

5.1.1 The Strategy for 2019/20 was approved by Executive Board on 14th March 2019. The main aspects of the strategy are outlined below :

- With short-term interest rates expected to continue to be lower than long-term rates it was acknowledged, for another year, that it may continue to be more cost effective not to borrow and instead reduce the level of investments.

- Long-term borrowing would be taken if it became apparent that there was a risk of significantly increased interest rates.

- Any balances over and above those required to maintain basic liquidity could be invested either in the medium term (out to a year) or the longer term (over a year), though it was recognised that long term investment was unlikely. Priority was given to security of funds and liquidity (accessibility) over yield (or return).

- The limits to investment by reference to amount, duration and credit rating were largely unchanged from those applying in previous years

5.2 Economic Review 2019/20

5.2.1 The UK's exit from the European Union and future trading arrangements, had remained one of the major influences on the UK economy and sentiment during 2019/20. Politics played a major role in financial markets over the period as the UK's tenuous progress negotiating its exit from the European Union together with its future trading arrangements drove volatility, particularly in foreign exchange markets. The outcome of December's General Election removed a lot of the uncertainty and looked set to provide a 'bounce' to confidence and activity.

5.2.2 The headline rate of UK Consumer Price Inflation fell to 1.7% year on year in February, below the Bank of England's target of 2%. Labour market data remained positive. The unemployment rate was 3.9% in the three months to January 2020 while the employment rate hit a record high of 76.5%. The average annual growth rate for pay, both including and excluding bonuses, was 3.1% in January 2020.

5.2.3 Growth Domestic Product (GDP) growth in Q4 2019 was reported as flat by the Office for National Statistics and service sector growth slowed and production and construction activity contracted on the back of what at the time were concerns over the impact of global trade tensions on economic activity. The annual rate of GDP growth remained below-trend at 1.1%.

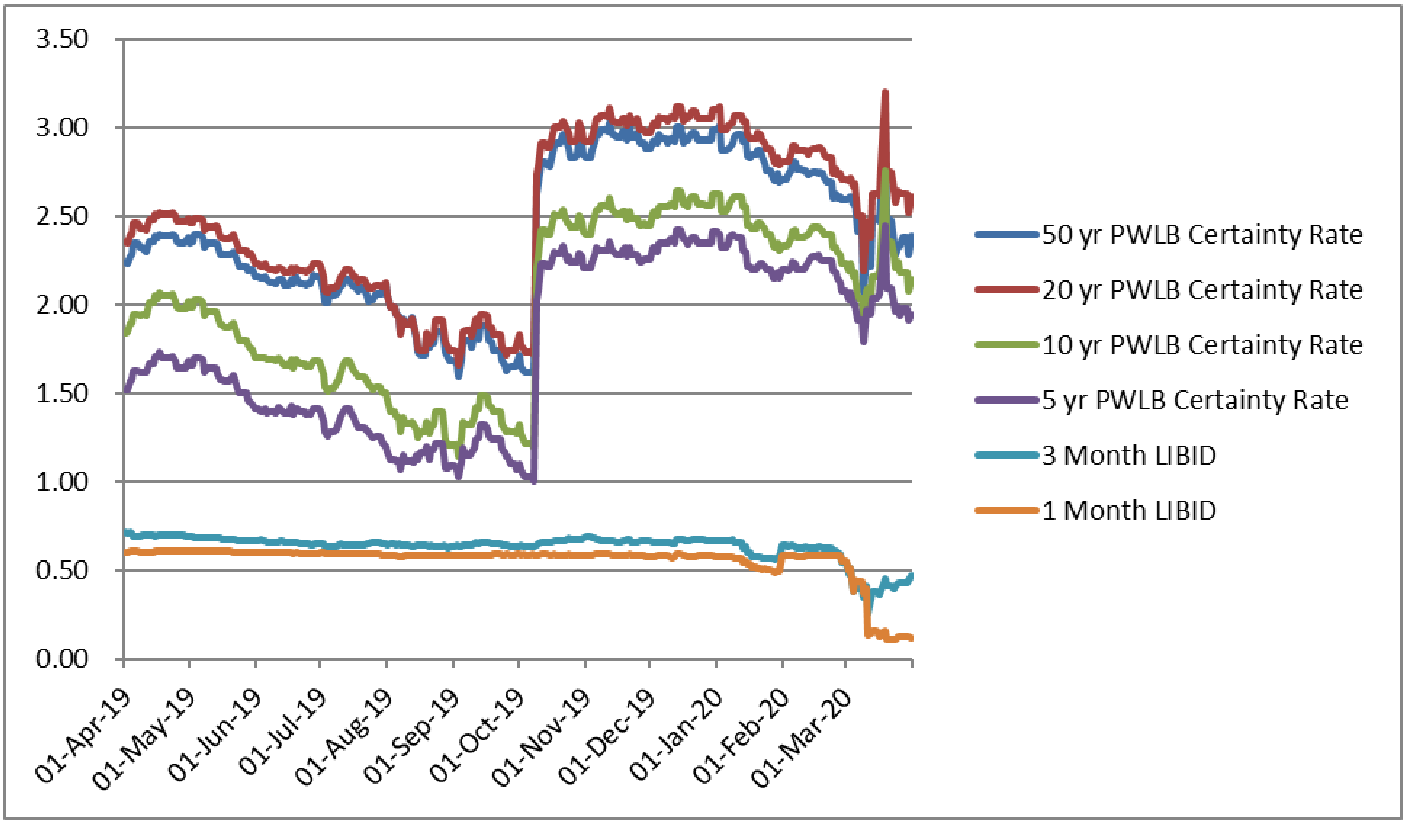
5.2.4 Then coronavirus swiftly changed everything. COVID-19, which had first appeared in China in December 2019, started spreading across the globe causing plummeting sentiment and falls in financial markets not seen since the Global Financial Crisis as part of a flight to quality into sovereign debt and other perceived 'safe' assets.

5.2.5 In response to the spread of the virus and sharp increase in those infected, the government enforced lockdowns, central banks and governments around the world cut interest rates and introduced massive stimulus packages in an attempt to reduce some of the negative economic impact to domestic and global growth.

5.2.6 The Bank of England, which had held policy rates steady at 0.75% through most of 2019/20, moved in March to cut rates to 0.25% from 0.75% and then swiftly thereafter brought them down further to the record low of 0.1%. In conjunction with these cuts, the UK government introduced a number of measures to help businesses and households impacted by a series of ever-tightening social restrictions, culminating in pretty much the entire lockdown of the UK.

5.2.7 The pattern of interest rates over the year is summarised in the chart below. Local government long-term borrowing costs are set by the Public Works Loans Board (PWLB) - these directly mirror gilt yields. As reflected in the chart below, on 9 October 2019 the PWLB increased the margin it charges over gilt yields by 1%, now making it a relatively expensive borrowing option. Nominal investment rates, measured through the London Inter-Bank Bid Rate (LIBID), are also shown.

Interest Rate Movements in 2019/20 –



5.3 Treasury Management Performance 2019/20

5.3.1 By 31st March 2020, the Council had net borrowing of around £176M, arising from its revenue and capital income and expenditure, an increase of £3M from the previous year.

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 the table below.

Balance Sheet Summary	31 March 2019 £M	2019/20 Movement £M	31 March 2020 £M
General Fund CFR Less CFR re Debt -	297.6	3.1	300.7

managed by Lancashire County Council (LCC)	-15.6	0.3	-15.3
re Private Finance Initiative (PFI) arrangements	-69.7	0.2	-69.5
Loans/Borrowing CFR	**212.3**	**3.6**	**215.9**
Less Usable Reserves	-40.1	-1.5	-41.6
Less Working Capital	0.6	1.4	2.0
Net Borrowing	**172.8**	**3.5**	**176.3**

The overall increase in **net borrowing** occurred primarily because of additional borrowings taken for the 3 year pension pre-payment made in April 2020 (which will lead to net budget savings).

5.3.2 Under the Council's Minimum Revenue Provision (MRP) Policy,

(a) the MRP charge to the accounts in respect of both PFI debt and debt managed by LCC has been less than the actual debt repaid, and
(b) the MRP charge to the accounts in respect of the Council's own capital spend financed from borrowing has increased.

The Council's CFR has increased as a result of capital spend in 2019/20 in excess of the MRP charge and capital receipts applied this year.

5.3.3 The following table summarises debt and investments at the start and end of the year:

	31 Mar 2019 Principal (£ M)	Rate / Return	Avg Life (Yrs)	31 Mar 2020 Principal (£ M)	Rate / Return	Avg Life (Yrs)
Fixed rate funding:						
Public Works Loans Board	138.0	3.61%	18.5	131.7	3.68%	18.3
Market Debt (Long Term)	5.3	4.50%	36.0	10.3	4.47%	34.7
Market Debt (Short Term)	41.0	0.95%		84.0	0.95%	
	184.3			**226.0**		
Variable rate funding:						
Public Works Loans Board	0.0			0.0		
Market	13.0	4.48%	27.1	8.0	4.50%	21.0
	13.0			**8.0**		
Loans taken by Blackburn with Darwen Borough Council	**197.3**			**234.0**		
Debt from PFI arrangements	65.1			63.4		
Debt managed by LCC	14.7	2.0%		14.1	2.15%	
Total debt	**277.1**			**311.5**		
Total investments	**24.5**	**0.73%**		**57.5**	**0.67%**	

In summary, the key changes to the Council's overall debt position across the year were:

(a) An increase in the level of short term borrowing, from £41M to £84M,
(b) Principal repayments of £6.4M on PWLB EIP (Equal Instalment of Principal) loans

(c) Repayments of part of the outstanding PFI debt recognised on the balance sheet for Building Schools for the Future (BSF), and of debt managed by LCC.

No debt rescheduling was undertaken, because the premiums payable on early repayment of PWLB debt made it uneconomic to do so.

5.3.4 Short term loans were taken for a range of durations at various points across the year. Investments continued to be maintained to ensure sufficient resources to cover day to day cash flow needs, and would be higher when the timing of short term loans taken was not aligned to the immediate cash flow requirements of the Council.

Across the year, 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 long-term plans change.

Overall, investment balances are still much lower than they would have been if long-term borrowing had been taken to cover the Council's CFR position. The degree to which long-term debt was less than CFR increased, by £10M, to around £66M, as a result of the current years capital spend being financed by short-term borrowings.

The deliberate strategy of taking short-term loans continued to deliver large savings on borrowing costs.

5.3.5 In summary, the outturn position in respect of interest costs and income, and MRP charges, was as follows:

Outturn 2018/19 £'000		**Original Budget 2019/20** £'000	**Outturn 2019/20** £'000
5,378	Interest paid on borrowing – long term debt	5,869	5,770
539	Interest paid on borrowing – short term debt	540	378
333	Interest paid on debt managed by LCC	351	305
6,230	PFI interest paid	6,168	6,057
(256)	Interest – treasury/other minor elements	(100)	(188)
(1,170)	Interest & dividends from BSF investments	-	(1,060)
5,670	MRP on Council borrowing	6,226	6,021
153	MRP – PFI debt	165	165
340	MRP – debt managed by LCC	340	340

5.3.6 Interest paid on borrowing in 2019/20 was around £0.26M down on the original estimate, reflecting both lower short-term interest rates and the decision not to take on new long-term debt in year. Interest on long-term borrowing increased from around £5.378M last year to £5.770M this year, as a result of the full year impact of new long-term borrowing taken in December 2018.

5.3.7 The average investment balance over the year was down at £27M (£37M in 2018/19). In the final quarters of both 2018/19 and 2019/20 higher investment balances were held. 2018/19 this was following the PWLB loans taken in December 2018, and in 2019/20 this was as a result of additional short-term borrowing taken for the 3 years pension prepayment made in April 2020. (see Weekly Balances **Appendix 1**).

Overall, interest and dividends received fell slightly to £1.2M in 2019/20 (£1.4M in 2018/19). The most significant variation was due to lower average investment balances held over the year.

The income from interest and dividends in relation to the BSF investments were £1M higher than the original budget. **A one off windfall of around £1M** was generated for the council by the restructuring of the second of the BSF PFI debt frameworks. Last year a similar dividend was received by the council as a result of the restructuring of first of the BSF PFI debt frameworks. "Routine" PFI investment receipts fell to £0.08M (£0.15M in 2018/19) due to the dividends usually received for the 6 months October – March being surrendered as part of the agreement for the sale of the investments.

Investment interest rates increased a little but remained low across 2019/20, and fell significantly in March 2020. Funds have continued to be invested for short periods, and sometimes with the government's Debt Management Office, to manage risk – this also contributed to the relatively low returns. Interest earned on treasury cash investments decreased, from £0.24M to £0.19M, and the average rate of return rose to 0.69% (against 0.63% in 2018/19).

5.3.8 The impact of the revised MRP Policy introduced in 2016/17, can be seen in the continuing lower MRP costs in 2019/20, which, at £6.5M, were still significantly lower than they would have been under the previous policy. The final MRP costs at outturn were in line with expectations.

5.3.9 The position with regard to performance against Treasury/Prudential Indicators in 2019/20 is summarised in **Appendix 2**. There was no breach of the Authorised Borrowing Limit or the Operational Boundary (set for management purposes).

Outturn capital spend was £26M, which is below the £35M anticipated at the start of the year.

5.4 Treasury Management Consultancy

5.4.1 The Council is now contracted up to 31st March 2021 to receive treasury management support from Arlingclose Limited. This is following a one year extension of the existing contract we had with them. They provide advice and information on the Council's investment and borrowing activities, although responsibility for final decision-making remains with the Council and its officers.

5.4.2 Over the period, in providing support to the Council, Arlingclose have reviewed the Council's Treasury management procedures and activities. They have provided member training; ongoing officer training; support for and review of treasury decisions, reports and strategies; feedback on accounting for treasury activities; benchmarking with other authorities; guidance on borrowing and investment opportunities; forecasts of interest rates; and regular updates on credit ratings and other information on credit quality. The quality of the support provided has been of a high standard.

5.5 Counterparty Update

5.5.1 In Q4 2019 credit rating agencies affirmed the UK's AA sovereign rating, removed it from Rating Watch Negative (RWN) and assigned a negative outlook. They then affirmed UK banks' long-term ratings, removed the RWN and assigned a stable outlook. The Bank of England announced its latest stress tests results for the main seven UK banking groups. All of the banking groups passed.

5.5.2 After remaining flat in January and February, Credit Default Swap (CDS), an indicator of market confidence in banks, 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 and through to mid-April but remain above their initial 2020 levels.

5.5.3 Credit rating agencies downgraded the UK sovereign rating to AA- in March which was followed by a number of actions on UK and Non-UK banks.

5.6 <u>Risk Management</u>

5.6.1 The Council's key priorities for managing its investments are the security and liquidity of its funds, before seeking the best rate of return. Most surplus cash is therefore held as short-term investments with the UK Government, highly rated banks and pooled funds.

5.6.2 The Council's primary objective for the management of its debt is to ensure its long-term affordability. The largest part of its loans is from the Public Works Loan Board at long-term fixed rates of interest.

5.6.3 A combination of short duration investments and long duration debt exposes the Council to the risk of falling investment income during periods of low interest rates. However, the risk of low investment returns is viewed as of lower priority compared to the benefits of optimising the security and liquidity of investments, and the savings made on borrowing costs. Also, though the Council has no long term investments, it is hedged against the investment return risk by its short term debt.

5.6.4 The Council is holding a significant element (£84M) in short-term loans from other local authorities. If the medium to long-term cost of debt were to move upwards, it may be necessary to restructure the Council's debt quickly, and cope with an increased cost of borrowing. This issue remains under review, with regular updates from Arlingclose.

6. FINANCIAL IMPLICATIONS

The financial implications arising from the 2019/20 Treasury Outturn have been incorporated into Corporate Budget Monitoring Reports.

7. LEGAL IMPLICATIONS

7.1 Under the Local Government Act 2003, local authorities determine locally their levels of capital investment and associated borrowing. The Prudential Code has been developed to support local authorities in taking these decisions, and the Council is required by Regulation to have regard to the Code when carrying out its duties under Part 1 of the Local Government Act 2003.

7.2 The Department for Communities and Local Government issued Guidance on Local Government Investments, under the Local Government Act 2003, effective from 1st April 2010. Authorities must manage their investments within an approved strategy, setting out what categories of investment they will use and how they will assess and manage the risk of loss of investments.

8. POLICY IMPLICATIONS, RESOURCE IMPLICATIONS, CONSULTATIONS

None

9. STATEMENT OF COMPLIANCE

The recommendations are made further to advice from the Monitoring Officer and the Section 151 Officer has confirmed that they do not incur unlawful expenditure. They are also compliant with equality legislation and an equality analysis and impact assessment has been considered. The recommendations reflect the core principles of good governance set out in the Council's Code of Corporate Governance.

VERSION:	**0.01**

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BACKGROUND PAPER:	Treasury Management strategy for 2019/20 approved at Executive Board 14th March 2019.