Agenda Item No:6

TREASURY MANAGEMENT REPORT – QUARTER ONE UPDATE 2019-20

To:	**General Purpose Committee**
Meeting Date:	**26th September 2019**
From:	**Chief Finance Officer**
Electoral division(s):	**All**
Forward Plan ref:	**Not applicable** *Key decision:* **No**
Purpose:	**To provide the first quarterly update on the Treasury Management Strategy 2019/20, approved by Council in February 2019.**
Recommendation:	**The General Purposes Committee is recommended to note the Treasury Management Report.**

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1. BACKGROUND

1.1 The Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice for Treasury Management recommends that members be updated on treasury management activities regularly (annual, mid-year or quarterly reports). This report, therefore, ensures this Council is implementing best practice in accordance with the Code.

2. ECONOMIC CLIMATE

2.1 A detailed commentary from the Council's treasury advisors of the Q1 economic climate is provided at **Appendix A** to this report. In brief summary, Q1 saw:

- Brexit was delayed until 31st October 2019;
- Gross Domestic Product (GDP) rose by a solid 0.5% q/q in Q1, but contracted at the start of Q2;
- The fundamentals that determine consumer spending remained healthy;
- Inflation bobbed around the Bank of England's 2% target;
- There was a widespread fall in investors' global interest rate expectations;
- The Monetary Policy Committee kept Bank Rate on hold at 0.75%, but struck a more dovish tone;

3. INTEREST RATE FORECAST

3.1 The latest (August 2019) forecast for UK Bank Rate along with Public Works Loan Board (PWLB) borrowing rates (certainty rate) from the Council's treasury advisors is set out below:

Table 1: Interest Rate Forecast

Link Asset Services Interest Rate View											
	Sep-19	**Dec-19**	**Mar-20**	**Jun-20**	**Sep-20**	**Dec-20**	**Mar-21**	**Jun-21**	**Sep-21**	**Dec-21**	**Mar-22**
Bank Rate View	0.75%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.00%	1.00%	1.25%
5yr PWLB Rate	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%	1.80%	1.90%	2.00%	2.00%	2.10%
10yr PWLB Rate	1.50%	1.60%	1.80%	1.90%	2.00%	2.00%	2.10%	2.20%	2.30%	2.30%	2.40%
25yr PWLB Rate	2.10%	2.30%	2.40%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%	3.00%	3.00%
50yr PWLB Rate	2.00%	2.20%	2.30%	2.40%	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%

3.2 There are many risks to the forecast set out above, principally around the timing and pace of further rate rises, and a listing of underlying assumptions is attached at **Appendix B**. Budget estimates prudently include sensitivity analysis of the impact that a slower than forecast economic recovery would have upon the Council, and any impact of changes to interest rates is reported through the Budget Monitoring process.

4. INVESTMENTS

4.1 The Treasury Management Strategy Statement (TMSS) for 2019-20, which includes the

Annual Investment Strategy, was approved by the Council in February 2019. It sets out the Council's investment priorities as being (in order):

1. Security of Capital;
2. Liquidity of Cash; and then
3. Yield

4.2 The Council will aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity.

4.3 The table below summarises the maturity profile of the Council's investment portfolio at the end of Q1 2019/20 (excluding third party loans):

Table 2 – Investment maturity profile at end of Q1 2019-20

			Maturity Period				
		0d	**0-3m**	**3-6m**	**5yrs ***	**Total**	
Product	**Access Type**	**£m**	**£m**	**£m**	**£m**	**£m**	**%**
Money Market Funds	Same-Day	27.4				**27.4**	***37.7***
Bank Call Account	Instant Access	5.0				**5.0**	***6.9***
Certificate of Deposits	Fixed Term / Tradeable		20.0	10.0		**30.0**	***41.3***
Pooled Property Fund	Redemption Period				10.3	**10.3**	***14.1***
	Total	**32.4**	**20.0**	**10.0**	**10.3**	**72.7**	***100.0***
	%	***44.6***	***27.5***	***13.8***	***14.1***	***100.0***	

* CCLA Property Fund holding expected to be held for up to 5 years.

4.4 Set out below are details of the amounts outstanding on loans and share equity investments advanced to third party organisations, classed as capital expenditure, at the end of Q1:

Table 3 – Third Party Loans - This Land Ltd

Loan Summary	**Amount Outstanding**	**Repayment Year**
Bridging Loan	£7.600m	2020
Loans for land acquired from third party	£2.040m	2021
Loans for land acquired from CCC	£78.872m	20282029
Total Loans	**£88.512m**	
Equity Holdings	**£3.951m**	N/a
Grand Total	**£92.463m**	

Table 4 - Third Party Loans - Other

Borrower	Start Date	Original Amount	Amount Outstanding	Rate	Maturity Date	Remarks
Arthur Ranks Hospice Charity	16/06/16	£4.000m	£3.680m	3.34%	16/06/42	In repayment. Minor rescheduling agreed 2018.
Estover Playing Field 2015 CIC	08/11/18	£0.350m	£0.305m	3.15%	02/12/24	Relating to assets at Wisbech Castle. Interest only and repayment on principal maturity.
Wisbech Town Council	10/05/18	£0.150m	£0.150m	2.88%	09/04/43	In repayment. Relating to infrastructure at Estover Playing Field. Guaranteed by March Town Council.

Table 5 – Third Party Loans - Cashflow Loans (variable rate)

Borrower	Start Date	Amount Outstanding	Remarks
LGSS Law	21/08/18	£0.325m	Call account – no defined repayment date. State Aid reference rate plus 0.75% margin, interest repaid and rate reset quarterly.

Table 6 – Third Party Loans – Other Share/Equity Investments

Investment Summary	Start Date	Amount Outstanding	Remarks
UK Municipal Bond Agency	25/09/14	£0.400m	Seed capital shares. No defined repayment date.

4.5 Financial markets trade on confidence and certainty, and with this in short supply investment rates are volatile and are expected to remain relatively low in short to medium-term durations. Alternative asset classes such as Property and Multi Asset Funds may be considered for longer durations for added return, but with caution given susceptible to principal fluctuation.

4.6 At 31st March 2019 investment balances totalled £29.6m, held in Money Market Funds, Call/Notice accounts and the CCLA Property Fund. This figure excludes third party loans and share capital which are set out above. Due to the nature of various government funding streams and timing of capital expenditure, the average level of funds available for investment purposes during Q1 was £72.7m.

4.7 Investment balances are forecast to reduce by the financial year end as internal resources from temporary positive cashflow surpluses are applied to fund expenditure demands in lieu of fully funding the borrowing requirement (internal borrowing) on a net basis. This process effectively reduces the cost of carrying additional borrowing at a higher cost than the income that could be generated through short term investment of those balances, as well as reducing investment counterparty credit risk.

4.8 The Council's investments outperformed against the most comparable weighted duration benchmark by 66 basis points (equivalent to £105k more than benchmark return).

Table 7: Benchmark Performance – Q1 2019/20

Benchmark	Benchmark Return	Council Performance
3m London Interbank Bid Rate (LIBID)	0.65%	1.31%

4.9 Debt financing budget projections for the financial year are reported through the Budget Monitoring process.

4.10 Leaving market conditions aside, the Council's return on investments is influenced by a number of factors, the largest contributors being the duration of investments and the credit quality of the institution or instrument:

- Credit risk is the consideration of the likelihood of default and is controlled through the creditworthiness policy approved by Council.
- The duration of an investment introduces liquidity risk; the risk that funds cannot be accessed when required.
- Interest rate risk; the risk that arises from fluctuating market interest rates.

4.11 These factors and associated risks are actively managed by the LGSS Integrated Finance Treasury team.

5. BORROWING

5.1 The Council can raise cash through borrowing in order to fund expenditure on its capital programme for the benefit of Cambridgeshire. The amount of new borrowing needed each year is determined by capital expenditure plans and projections of the Capital Financing Requirement, underlying borrowing requirement, forecast cash-backed reserves and both current and forecast economic conditions.

5.2 Overall borrowing outstanding reduced during Q1 when compared to Q4 2018/19 by £15.1m. At Q4 2018/19, the Council held £598.3m of borrowing, of which £156.0m matured in less than 1 year. At the end of Q1, the Council held £583.2m of borrowing, of which £156.2m matures in less than 1 year. The net reduction borrowing was the result of the temporary uplift in cash balances from the timing of various government funding streams mentioned in paragraph 4.6.

5.3 Table 8 below sets out the maturity profile of the Council's borrowing portfolio at the end of Q1. The majority of loans are PWLB loans and have a fixed interest rate and are long term in nature which limits the Council's exposure to interest rate fluctuations.

Table 8: Borrowing Maturity Profile – Q1 2019/20

Term Remaining	Borrowing	
	£m	%
Under 12 months	156.160	26.8
1-2 years	92.899	15.9
2-5 years	60.547	10.4
5-10 years	62.566	10.7
10-20 years	58.990	10.1
20-30 years	46.515	8.0
30-40 years	20.000	3.4
40-50 years	35.000	6.0
Over 50 years	50.500	8.7
TOTAL	**583.177**	**100.0**

5.4 Market Lender option borrower option (LOBO) loans are included at their final maturity rather than their next potential call date. In the current low interest rate environment the likelihood of lenders exercising their option to increase the interest rates on these loans - and so triggering the Council's option to repayment at par - is considered to be low.

5.5 The Council is in an internally borrowed cash position and balances will need to be replenished at some point in the future (subject to expenditure demands). Officers continue to assess cashflow forecasts against projected movements in borrowing rates. Sharp or sustained movements in borrowing rates will increase the likelihood of additional longer term borrowing.

5.6 The Council has entered into a Framework Agreement with the UK Municipal Bonds Agency (MBA). This included the advance of seed capital shares of £0.4m as reported in Table 6 above. It is hoped this will allow for the Council to potentially raise loan finance through MBA as an alternative to PWLB and market loans. Feedback from the MBA suggests a bond issue is not currently imminent alongside current economic and market uncertainty. There is strong support to the MBA from the Local Government Association.

6. BORROWING RESTRUCTURING

6.1 No borrowing rescheduling was undertaken during the Q1. Rescheduling opportunities are limited in the current economic climate. For PWLB loans, due to the spread between the carrying rate of existing borrowing and early redemption rates, substantial exit (premium) costs would be incurred. For market borrowing, the lender uses the certainty of the loans cashflow profile to hedge against forecast interest rate movements and so would pass the cost of unwinding these instruments onto the Council as an exit (premium) cost.

6.2 Officers continue to monitor the position regularly, and are in regular dialogue with the market loan lenders who may be open to negotiating on exit costs in return for early repayment of principal. Further updates on this position will be reported should they materialise.

7. TREASURY AND PRUDENTIAL INDICATORS

7.1 The Council's approved Treasury and Prudential Indicators (affordability limits) were approved alongside the Treasury Management Strategy Statement (TMSS). It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits.

7.2 During Q1 the Council has operated within the Treasury and Prudential Indicators set out in the Council's TMSS, shown in **Appendix C**.

8. ALIGNMENT WITH CORPORATE PRIORITIES

8.1 A good quality of life for everyone

There are no significant implications for this priority.

8.2 Thriving places for people to live

There are no significant implications for this priority.

8.3 The best start for Cambridgeshire's children

There are no significant implications for this priority.

9. SIGNIFICANT IMPLICATIONS

9.1 Resource Implications

This report provides information on performance against the Treasury Management Strategy. Decisions on treasury management, which are driven by the capital programme and the Council's overall financial position, will impact the Debt Charges Budget and are reported through the Budget Monitoring process.

9.2 Procurement/Contractual/Council Contract Procedure Rules Implications

There are no significant implications for this category.

9.3 Statutory, Legal and Risk Implications

The Council continues to operate within the statutory requirements for borrowing and investments. Further details can be found within the Prudential Indicators in **Appendix C**.

9.4 Equality and Diversity Implications

There are no significant implications for this category.

9.5 **Engagement and Communications Implications**

There are no significant implications for this category.

9.6 **Localism and Local Member Involvement**

There are no significant implications for this category.

9.7 **Public Health Implications**

There are no significant implications for this category.

Implications	**Officer Clearance**
Have the resource implications been cleared by Finance?	Yes Name of Financial Officer: Tom Kelly
Have the procurement/contractual/ Council Contract Procedure Rules implications been cleared by the LGSS Head of Procurement?	Not applicable
Has the impact on statutory, legal and risk implications been cleared by LGSS Law?	Not applicable
Have the equality and diversity implications been cleared by your Service Contact?	Not applicable
Have any engagement and communication implications been cleared by Communications?	Not applicable
Have any localism and Local Member involvement issues been cleared by your Service Contact?	Not applicable
Have any Public Health implications been cleared by Public Health	Not applicable

Source Documents	**Location**
None	N/A

Appendix A
Economic Commentary; Extract from Treasury Advisors (Link Asset Services)

The UK economy posted a stronger-than-expected expansion in Q1 of 0.5% q/q, but that was probably a temporary high as activity was brought forward ahead of the original 29th March Brexit deadline. As a result, we doubt Q2 will be as good. Indeed, stock building added to the quarterly rate of GDP growth in Q1 as firms built up their stocks ahead of a possible no deal Brexit. Admittedly, a large chunk of these stocks were imported, so the net boost was smaller. Nonetheless, stock building will exert a similar drag on GDP growth in Q2.

In fact, the chances of the economy escaping a quarterly contraction in Q2 seem to be receding in light of the latest survey and official data. GDP fell in April by the largest monthly fall in three years. This partly reflected the decision by car manufacturers to bring forward their annual car plant shutdowns from August to April in case of a no deal. As a result, vehicle production dropped in April. Granted, the Society of Motor Manufacturers & Traders (SMMT) car production data suggest that these losses were recouped in May. After all, production rose again in May to boost GDP.

Even so, GDP may still struggle to expand in Q2 as a whole – we have pencilled in a minor contraction. Indeed, June's manufacturing PMI suggests the sector is still suffering from a Brexit-related hangover and a weak global economy and probably shrank in Q2.

What's more, household spending will probably fall short of the impressive rise in Q1. Retail sales volumes were flat in April and fell in May. But a major slump in consumer spending in Q2 or further ahead seems unlikely.

Indeed, looking through the Brexit volatility, while consumer confidence has been relatively weak, the fundamentals that determine consumer spending have remained healthy. Admittedly, employment only rose by 32,000 in the three months to April, well below the 98,000 average monthly rise in 2018. But with the unemployment rate still at its 45-year low of 3.8%, the tightness in the labour market has pushed up wage growth. Indeed, the headline measure excluding bonuses nudged up from 3.3% in March to 3.4% in April – just below the decade high of 3.5%. And with inflation bobbing around the Bank of England's 2% target, real wage growth has reached its highest rate since late 2016.

CPI inflation dropped from 2.1% in April to 2.0% in May as the previous upward pressure on airfares due to the later timing of Easter unwound. Underlying price pressures look subdued too. Core services inflation fell from 3.1% to 2.9% in May and input price inflation dropped from 4.5% to just 1.3%, its lowest rate since June 2016. At the same time, output price inflation nudged down from 2.1% in May to 1.8%.

Nonetheless, there are still some reasons to think that CPI inflation will edge up at the end of the year as rising agricultural prices push up food inflation and core inflation starts to pick up now that the lagged effects of a fall in import price inflation have come to an end. What's more, the recent pick-up in wage costs is consistent with a rise in core services inflation to just shy of 4% in early-2020.

Appendix A Continued.

Bank Rate: Meanwhile, investors have reassessed the outlook for UK monetary policy and have gone from expecting rate hikes in early May to now expecting cuts. This is partly because of the weakening global outlook and rising expectations of rate cuts in the US and euro-zone. But growing concerns over a no deal Brexit have also weighed on expectations. Indeed, at the Treasury Committee in June, the Governor of the Bank of England gave the strongest hint yet that in a no deal Brexit, the Monetary Policy Committee (MPC) would cut rates. In that scenario, we think that rates would be cut fairly quickly from 0.75% to 0.25%.

Meanwhile, it wasn't surprising that the MPC kept Bank Rate on hold at 0.75% at June's meeting given the drop in GDP in April and inflation falling back to target in May. What was perhaps more surprising after its hawkish comments in May, was the Committee's new-found dovish tone. The MPC noted that "the near term data have been broadly in line with the May Inflation Report, but that downside risks to growth have increased." It also sounded more concerned about the possibility of a no deal Brexit. Instead of chastising the market for underestimating how much interest rates might rise as it did in May, the MPC pointed out that "the ongoing tension between the MPC's forecast…of a smooth Brexit and the assumptions about alternative Brexit scenarios that were priced into financial market variables".

Turning to fiscal policy, regardless of the Brexit situation, all roads appear to lead to looser fiscal policy. Public sector net borrowing (PSNB ex.) came in only just above the OBR's February forecast of £23.4bn in 2018/19 – down from the £37.1bn the OBR predicted in March 2018. Admittedly, PSNB ex. will probably rise slightly this year due to a number of promises made in the 2018 Budget, including spending on the NHS. But the OBR's projections still suggest that there is around £27bn headroom against the current fiscal rule.

Of course, how much borrowing rises depends on the outcome of Brexit.

- If a deal is reached, faster GDP growth would reduce public spending, raise tax revenues and cut the deficit, perhaps allowing fiscal policy to be loosened without borrowing rising at all.
- However, in a no deal, the weaker economy would push up the deficit. As a result, the Government would have to choose between keeping the fiscal rules intact or loosening fiscal policy to give the economy a boost. We think that they would opt for the latter, arguing that exceptional circumstances allowed for fiscal rules to be suspended.

Turning to the financial markets, concerns over global growth and subsequent falls in interest rate expectations have caused developed market bond yields to slump – the 10-year gilt yield fell from 1.05% at the start of the quarter to 0.81%. However, lower interest rate expectations have supported increases in equities. The FTSE 100 finished the quarter around 2.5% higher although it underperformed compared to the S&P 500 perhaps since the FTSE 100 has a high concentration of energy firms, so the fall in oil prices over the quarter has probably weighed on its overall performance.

Appendix B
Interest Rate Forecast Commentary; Extract from Treasury Advisors (Link Asset Services)

As there are so many variables at this time, caution must be exercised in respect of all interest rate forecasts. The general expectation for an eventual trend of gently rising gilt yields and PWLB rates is unchanged. Negative, (or positive), developments could significantly impact safe-haven flows of investor money into UK, US and German bonds and produce shorter term movements away from our central forecasts.

Our interest rate forecast for Bank Rate is in steps of 25 bps whereas PWLB forecasts have been rounded to the nearest 10 bps and are central forecasts within bands of + / - 25 bps.

Naturally, we continue to monitor events and will update our forecasts as and when appropriate.

The balance of risk to the UK is:

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit, as well as a softening global economic picture.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.

One risk that is both an upside and downside risk is that all central banks are now working in very different economic conditions than before the 2008 financial crash. There has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed for eleven years since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could, therefore, over or under-do increases in central interest rates.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Brexit – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- Bank of England monetary policy takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of Eurozone sovereign debt crisis.
- Weak capitalisation of some European banks.
- Minority governments, in particular in Germany, but also in Spain, Portugal, Netherlands and Belgium.
- The increases in interest rates in the US during 2018, combined with an on-off potential trade war between the USA and China, sparked major volatility in equity markets during the final quarter of 2018 and into 2019. Some emerging market countries which have borrowed heavily in dollar denominated debt could be particularly exposed to investor flight from equities to safe havens, typically US treasuries, German bunds and UK gilts.

Appendix B continued.

- There are concerns around the level of US corporate debt which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates are:

- Brexit – if agreement was reached all round that removed all threats of economic and political disruption between the EU and the UK.
- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- UK inflation, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

Appendix C
Treasury and Prudential Indicators

Prudential Indicator	2019/20 Indicator	2019/20 Q1
Authorised limit for external debt (Inc' loans raised to on-lend to Housing & Investment Company)	----- £1,088.0m	-----
Operational boundary for external debt (Inc' loans raised to on-lend to Housing & Investment Company)	----- £1,058.0m	-----
Capital Financing Requirement (CFR) *[Including PFI and Finance Lease Liabilities]*	£1,008.0m	£966.5m
Ratio of financing costs to net revenue streams	9.2%	8.9%
Upper limit of fixed interest rates based on net debt	150%	105%
Upper limit of variable interest rates based on net debt	65%	-5%
Principal sums invested > 364 days (exc' third party loans)	£50.0m	£10.3m
Maturity structure of borrowing limits:-		
Under 12 months	Max. 80% Min. 0%	29.4%
12 months to 2 years	Max. 50% Min. 0%	15.9%
2 years to 5 years	Max. 50% Min. 0%	10.4%
5 years to 10 years	Max. 50% Min. 0%	10.7%
10 years and above	Max. 100% Min. 0%	33.6%

- The Treasury Management Code of Practice guidance notes requires that maturity is determined by the earliest date on which the lender can trigger repayment, which in the case of LOBO loans is the next break/call point. This approach differs to Table 8 at paragraph 5.3 above, which shows the Council's LOBO loan at maturity date as the likelihood of the option being exercised is low.