BOROUGH COUNCIL OF WELLINGBOROUGH **AGENDA ITEM 6**

Resources Committee **18 November 2020**

Report of the Section 151 Officer

2020-21 MID YEAR REPORT ON TREASURY MANAGEMENT

1 Purpose of Report

This report aims to keep members informed of treasury management activity, in line with the Treasury Management Strategy Statement (TMSS) which was approved by this committee on 11 March 2020.

2 Executive Summary

2.1 This report combines the actual performance and investments held as at 30 September 2020 with an overall outline of expected performance for the remainder of the financial year.

2.2 It also includes as an appendix an update on the current UK economy and the forecast for interest rates going forwards. The market and economy are key factors in the level of returns that can be expected from investments and this information should help members understand the wider economic picture and its influences over the rate of return achieved.

3 Appendices

Appendix 1 - Summary of Investment transactions at 30 September 2020

Appendix 2 – Summary of economic background and interest forecast at 30 September 2020

4. **Proposed action: The resources committee is invited to RESOLVE to:**

4.1 **Note the Mid-Year Report on Treasury Management**

5. Background

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management and the council's treasury management policy requires periodic reports on the routine activity of the treasury management function and operations to be reported to committee, which includes a mid-year update report. This report fulfils that requirement.

6 Discussion

Annual Investment Strategy:

6.1 The Treasury Management Strategy Statement (TMSS) for 2020-21 was approved by council on 11 March 2020. The council's annual investment strategy, which is incorporated in the TMSS, outlines the council's investment

priorities as follows:

- security of capital
- liquidity of investments
- yield from its investments

6.2 The council has historically invested mainly in building societies, which do not necessarily have high credit ratings as defined by the recognised credit rating agencies e.g. Fitch and Moody's. However, at the present time building societies are continuing to provide better rates of return, with a good history of credit and as such the credit risk of investing with them is considered acceptable within the parameters outlined in the TMSS. All potential investees are monitored carefully and on a regular basis.

6.3 The treasury management strategy allows for up to 25% of available funds (if we exclude our current banking provider) to be invested in individually specified domestic banks and a total of £25m in the larger domestic building societies. Wellingborough's portfolio of investments currently totals £32m, comprised of £11m with four domestic banks, £16m with eleven domestic building societies and £4m with other UK local authorities.

6.4 The effects of the Covid 19 pandemic, Brexit and other international political uncertainties have affected the rates of return that the council receives from investments. As illustrated in the economic background in appendix 2, investment rates are expected to continue at very low levels in the medium-term, having remained at 0.1% since March 2020. This has meant that current investments are being entered into at somewhat lower rates than those previously available in 2019/20.

6.5 The level of funds available for investment purposes in the first half of 2020-21, as reported above, was £32m. Many of these funds were non-reserve backed working capital balances and as such were temporary in nature. The level of funds were dependent on the timing of precept and NNDR payments, as well as the receipt and payment of various grants. Progress on the capital programme also influences the level of funds available for investment purposes.

2020-21 Performance to date

6.6 Appendix 1 shows a detailed list of the investments held at 30 September 2020. These totalled £32m which includes £5m in call accounts, with interest receivable for the first 6 months amounting to £118k.

6.7 The profiling and the maturity of these investments are summarised in the following charts:

Chart 1:

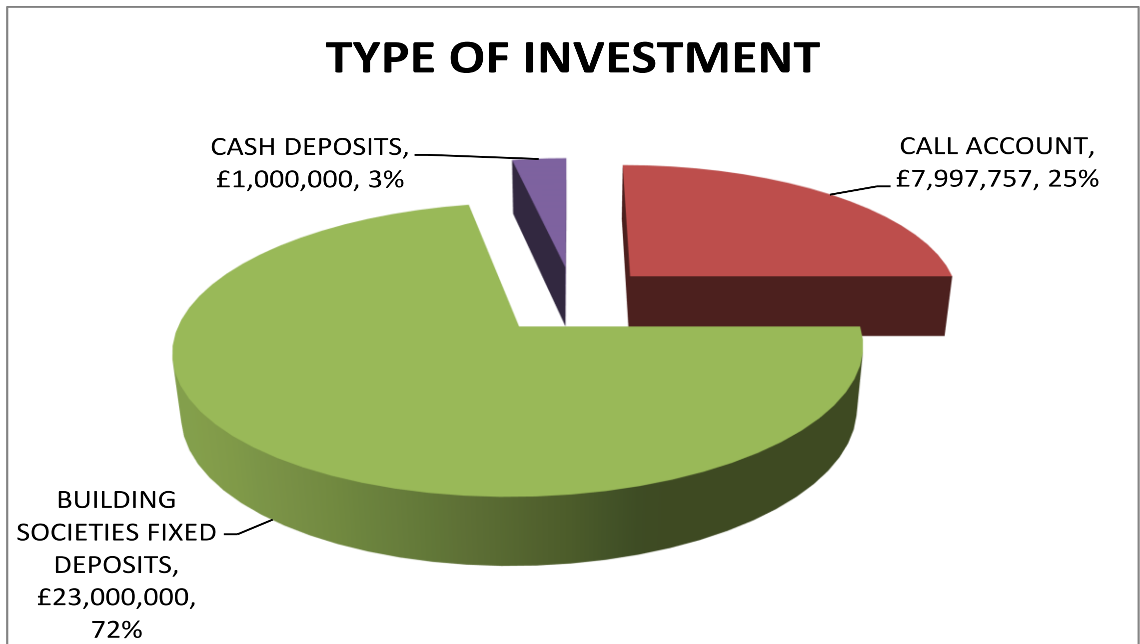
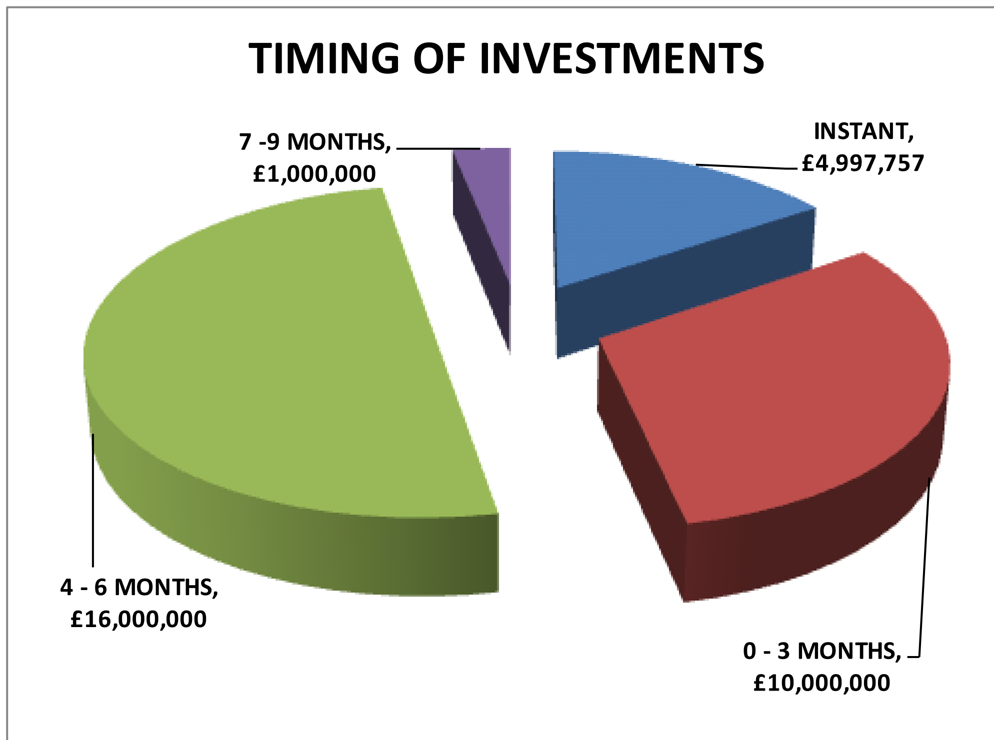


Chart 2:



6.8 The average rate of return that the council has achieved for the first six month period is 0.61%, compared to the average three months LIBID (London Interbank Bid Rate) interest rate for the same period of 0.25%.

6.9 The estimated interest receivable for the year is £220k, based on an average annual interest rate of 0.40%. The 2020-21 budget was set at £352k

assuming an average rate of return of 1%, therefore anticipated performance for the year is approximately £132k below budget and the deficit on the budget for Investment Income will be reported as part of the revenue monitoring process for the year.

6.10 Link Asset Services, the council's treasury management advisers, have provided an overview of the current economic climate and this is set out at appendix 2, as it helps to set the scene within which the council's treasury management function operates.

6.11 The table in appendix 2 predicts that the Bank of England base rates are likely to remain at 0.1% for the next two financial years. This is due to the impact of the Covid 19 pandemic and will have a significant effect on future investment interest returns. The projected impact of this will be incorporated into the 2020-21 budget and medium-term forecasts for the following years.

6.12 The S151officer confirms that the approved limits within the annual investment strategy were only breached during April of 2020-21 when the council received an unexpected Covid 19 grant for £17.8m. This was quickly paid out to the necessary parties, with the remainder being moved into the authority's other accounts as per the treasury management strategy.

6.13 The council has complied fully with the requirements of its approved treasury management strategy during the period including use of approved counterparties and investment limits.

7 Legal Powers

Local Government Act 2003.

8 Financial and Value For Money Implications

As stated in the report.

9 Risk Analysis

Nature of risk	Consequences if realised	Likelihood of occurrence	Control measures
Fall in interest rates	Reduced income	Medium	Maintaining as high an average interest rate as possible through a mix of short and longer term fixed and variable rate investments.
Less funds available for investment	Reduced income	Medium	Regular budget monitoring, allowing for remedial action to be taken.
Loss of capital	Reduced funds available for both capital and revenue purposes	Low	Financial ratings of counterparties and limits on amounts invested. Review of council's lending policies.

10 Implications for Resources

No direct implications for staffing or property.

11 Implications for Stronger and Safer Communities

No direct implications.

12 Implications for Equalities

No direct implications.

13 Author and Contact Officer

Tracey Cave, Service Accountant

14 Consultees

Shaun Darcy, Executive Director, S151 Officer

Eric Symons, Assistant Director, Deputy S151 Officer

Julie O’Connell, Finance Manager

15 Background Papers

Treasury Management Strategy Statement 2020-21

Appendix 1

Summary of Investment transactions at 30 September 2020

Borrower	Interest Rate %	Period of Loan	Value of Investment £	Maturity Date
Newcastle Building Society	1.20	366	1,000,000	01/10/2020
Monmouthshire Building Society	1.05	367	2,000,000	05/10/2020
Newcastle Building Society	1.20	365	1,000,000	06/10/2020
Newbury Building Society	1.15	364	2,000,000	02/10/2020
Thurrock Council	1.05	365	2,000,000	04/11/2020
West Bromwich Building Society	1.00	364	1,000,000	04/12/2020
National Counties Building Society	1.17	365	1,000,000	06/01/2021
Thurrock Council	1.03	365	2,000,000	14/01/2021
Lloyds Bank	1.10	333	1,000,000	18/12/2020
Lloyds Bank	1.10	366	1,000,000	20/01/2021
Progressive Building Society	1.00	365	1,000,000	29/01/2021
Monmouthshire Building Society	1.00	366	1,000,000	17/02/2021
Furness Building Society	1.20	365	1,000,000	04/03/2021
Santander Bank	0.60	365	1,000,000	29/05/2021
Progressive Building Society	0.50	273	1,000,000	03/03/2021
Saffron Building Society	0.47	274	1,000,000	31/03/2021
National Counties Building Society	0.48	248	2,000,000	22/03/2021
Thurrock Council	0.33	224	1,000,000	31/03/2021
Newcastle Building Society	0.33	194	1,000,000	23/03/2021
Santander Notice Account	0.70	180	3,000,000	
Lloyds Call Account	0.05	CALL	4,996,236	
Bank Of Scotland Call Account	0.00	CALL	813	
HSBC Call Account	0.00	CALL	707	
Total			31,997,757	

Appendix 2

Summary of Economic Background and Outlook at 30 September 2020

1. Economics update

- As expected, the Bank of England's Monetary Policy Committee kept Bank Rate unchanged on 6th August (and subsequently 16th September). It also kept unchanged the level of quantitative easing at £745bn. Its forecasts were optimistic in terms of three areas:
  - The fall in **GDP** in the first half of 2020 was revised from 28% to 23% (subsequently revised to -21.8%). This is still one of the largest falls in output of any developed nation. However, it is only to be expected as the UK economy is heavily skewed towards consumer-facing services – an area which was particularly vulnerable to being damaged by lockdown.
  - The peak in the **unemployment rate** was revised down from 9% in Q2 to 7½% by Q4 2020.
  - It forecast that there would be excess demand in the economy by Q3 2022 causing CPI **inflation** to rise above the 2% target in Q3 2022, (based on market interest rate expectations for a further loosening in policy). Nevertheless, even if the Bank were to leave policy unchanged, inflation was still projected to be above 2% in 2023.
- It also squashed any idea of using **negative interest rates**, at least in the next six months or so. It suggested that while negative rates can work in some circumstances, it would be "less effective as a tool to stimulate the economy" at this time when banks are worried about future loan losses. It also has "other instruments available", including QE and the use of forward guidance.
- The MPC expected the £300bn of **quantitative easing** purchases announced between its March and June meetings to continue until the "turn of the year". This implies that the pace of purchases will slow further to about £4bn a week, down from £14bn a week at the height of the crisis and £7bn more recently.
- In conclusion, this would indicate that the Bank could now just sit on its hands as the economy was recovering better than expected. However, the MPC acknowledged that the "medium-term projections were a less informative guide than usual" and the minutes had multiple references to **downside risks,** which were judged to persist both in the short and medium term. One has only to look at the way in which second waves of the virus are now impacting many countries including Britain, to see the dangers. However, rather than a national lockdown, as in March, any spikes in virus infections are now likely to be dealt with by localised measures and this should limit the amount of economic damage caused. In addition, Brexit uncertainties ahead of the year-end deadline are likely to be a drag on recovery. The wind down of the initial generous furlough scheme through to the end of October is another development that could cause the Bank to review the need for more support for the economy later in the year. Admittedly, the Chancellor announced in late September a second six month package from 1 November of government support for jobs whereby it will pay up to 22% of the costs of retaining an employee working a minimum of one third of their normal hours. There was further help for the self-employed, freelancers and the hospitality industry. However, this is a much less generous scheme than the furlough package and will inevitably mean there will be further job losses from the 11% of the workforce still on furlough in mid September.
- Overall, **the pace of recovery** is not expected to be in the form of a rapid V shape, but a more elongated and prolonged one after a sharp recovery in June through to August which left the economy 11.7% smaller than in February. The last three months of 2020 are now likely to show no growth as consumers will probably remain cautious in spending and uncertainty over the outcome of the UK/EU trade negotiations concluding at the end of the year will also be a headwind. If the Bank felt it did need to provide further support to recovery, then it is likely that the tool of choice would be more QE.
- There will be some **painful longer term adjustments** as e.g. office space and travel by planes, trains and buses may not recover to their previous level of use for several years, or possibly ever. There is also likely to be a reversal of globalisation as this crisis has shown up how vulnerable

long-distance supply chains are. On the other hand, digital services are one area that has already seen huge growth.

- One key addition to **the Bank's forward guidance** was a new phrase in the policy statement, namely that "it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably". That seems designed to say, in effect, that even if inflation rises to 2% in a couple of years' time, do not expect any action from the MPC to raise Bank Rate – until they can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate
- The **Financial Policy Committee** (FPC) report on 6th August revised down their expected credit losses for the banking sector to "somewhat less than £80bn". It stated that in its assessment "banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC's central projection". The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC's projection, with unemployment rising to above 15%.
- **US.** The incoming sets of data during the first week of August were almost universally stronger than expected. With the number of new daily coronavirus infections beginning to abate, recovery from its contraction this year of 10.2% should continue over the coming months and employment growth should also pick up again. However, growth will be dampened by continuing outbreaks of the virus in some states leading to fresh localised restrictions. At its end of August meeting, the Fed tweaked **its inflation target** from 2% to maintaining an average of 2% over an unspecified time period i.e.following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time. This change is aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary "trap" like Japan. It is to be noted that inflation has actually been under-shooting the 2% target significantly for most of the last decade so financial markets took note that higher levels of inflation are likely to be in the pipeline; long-term bond yields duly rose after the meeting. The Fed also called on Congress to end its political disagreement over providing more support for the unemployed as there is a limit to what monetary policy can do compared to more directed central government fiscal policy. The FOMC's updated economic and rate projections in mid-September showed that officials expect to leave the fed funds rate at near-zero until at least end-2023 and probably for another year or two beyond that. There is now some expectation that where the Fed has led in changing its inflation target, other major central banks will follow. The increase in tension over the last year between the US and China is likely to lead to a lack of momentum in progressing the initial positive moves to agree a phase one trade deal.
- **EU.** The economy was recovering well towards the end of Q2 after a sharp drop in GDP, (e.g. France 18.9%, Italy 17.6%). However, the second wave of the virus affecting some countries could cause a significant slowdown in the pace of recovery, especially in countries more dependent on tourism. The fiscal support package, eventually agreed by the EU after prolonged disagreement between various countries, is unlikely to provide significant support and quickly enough to make an appreciable difference in weaker countries. The ECB has been struggling to get inflation up to its 2% target and it is therefore expected that it will have to provide more monetary policy support through more quantitative easing purchases of bonds in the absence of sufficient fiscal support.
- **China.** After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and has enabled it to recover all of the contraction in Q1. However, this was achieved by major central government funding of yet more infrastructure spending. After years of growth having been focused on this same area, any further spending in this area is likely to lead to increasingly weaker economic returns. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.
- **Japan.** There are some concerns that a second wave of the virus is gaining momentum and could dampen economic recovery from its contraction of 8.5% in GDP. It has been struggling to get out of a deflation trap for many years and to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. The resignation of Prime Minister Abe is not expected to result in any significant change in economic policy.

- **World growth.** Latin America and India are currently hotspots for virus infections. World growth will be in recession this year. Inflation is unlikely to be a problem for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

2. Interest rate forecasts

The Council's treasury advisor, Link Group, provided the following forecasts on 11 August 2020 (PWLB rates are non-HRA certainty rates, gilt yields plus 180bps):

Link Group Interest Rate View 11.8.20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Bank Rate View	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month average earnings	0.05	0.05	0.05	0.05	0.05	0.05	-	-	-	-	-
6 month average earnings	0.10	0.10	0.10	0.10	0.10	0.10	-	-	-	-	-
12 month average earnings	0.15	0.15	0.15	0.15	0.15	0.15	-	-	-	-	-
5yr PWLB Rate	1.90	1.90	2.00	2.00	2.00	2.00	2.00	2.10	2.10	2.10	2.10
10yr PWLB Rate	2.10	2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30
25yr PWLB Rate	2.50	2.50	2.50	2.50	2.60	2.60	2.60	2.70	2.70	2.70	2.70
50yr PWLB Rate	2.30	2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50	2.50	2.50

The coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March to cut Bank Rate to first 0.25%, and then to 0.10%, it left Bank Rate unchanged at its last meeting on 6th August, although some forecasters had suggested that a cut into negative territory could happen. However, the Governor of the Bank of England has made it clear that he currently thinks that such a move would do more damage than good and that more quantitative easing is the favoured tool if further action becomes necessary. As shown in the forecast table above, no increase in Bank Rate is expected within the forecast horizon ending on 31st March 2023 as economic recovery is expected to be only gradual and, therefore, prolonged.

GILT YIELDS / PWLB RATES. There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was heightened expectations that the US could have been heading for a recession in 2020. In addition, there were growing expectations of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued. Combined, these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers. This means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. The consequence of this has been the gradual lowering of the overall level of interest rates and bond yields in financial markets. Over the year prior to the coronavirus crisis, this has seen many bond yields up to 10 years turn negative in the Eurozone. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities.

Gilt yields had, therefore, already been on a generally falling trend up until the coronavirus crisis hit western economies during March. After gilt yields initially spiked upwards in March, we have seen yields fall sharply in response to major western central banks taking rapid policy action to deal with excessive stress in financial markets during March, and starting massive quantitative easing driven purchases of government bonds: these actions also acted to put downward pressure on government bond yields at a time when there has been a huge and quick expansion of government expenditure financed by issuing government bonds. Such unprecedented levels of issuance in "normal" times would have caused bond yields to rise sharply. At the close on 30th September, all gilt yields from 1 to 6 years were in negative territory, while even 25-year yields were only at 0.76% and the 50 year at 0.60%.

From the local authority borrowing perspective, HM Treasury imposed **two changes of margins over gilt yields for PWLB rates** in 2019-20 without any prior warning. The first took place on 9th October 2019, adding an additional 1% margin over gilts to all PWLB period rates. That increase was then, at least partially, reversed for some forms of borrowing on 11th March 2020, but not for mainstream non-HRA capital schemes. At the same time the Government announced in the Budget a programme of increased infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins; the HM Treasury consultation was initially due to end on 4th June, but that date was subsequently put back to 31st July. To date, the outcomes of the consultation have yet to be announced but it is clear that HM Treasury will most likely no longer allow local authorities to borrow money from the PWLB to purchase commercial property if the primary aim is to generate an income stream (assets for yield).

Following the changes on 11th March 2020 in margins over gilt yields, the current situation is as follows: -

- **PWLB Standard Rate** is gilt plus 200 basis points (G+200bps)
- **PWLB Certainty Rate** is gilt plus 180 basis points (G+180bps)
- **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
- **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
- **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

It is possible that the non-HRA Certainty Rate will be subject to revision downwards after the conclusion of the HM Treasury consultation; however, the timing of such a change is currently an unknown, although it would be likely to be within the current financial year.

As the interest forecast table for PWLB certainty rates, (gilts plus 180bps), above shows, there is likely to be little upward movement in PWLB rates over the next two years as it will take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down period. Inflation is also likely to be very low during this period and could even turn negative in some major western economies during 2020/21.