AGENDA: 12

2020/21 TREASURY MANAGEMENT MID-YEAR REPORT

REPORT BY NICOLA ALLEN

PURPOSE OF THE REPORT

The purpose of this report is to present the 2020/21 treasury management mid-year report for Devon and Cornwall, for comment.

1.0 Introduction

1.1 The Treasury Management Strategy for 2020/21 is underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

1.2 The Code also recommends a report on Treasury Management activities at least twice a year; a mid-year, and a year-end (outturn) report, and both of these are reported to the Independent Audit Committee. This report sets out the performance of the treasury management function for the period from 1 April to 30 September 2020.

1.3 Treasury management is defined as:

"The management of the PCC's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks".

1.4 Operational treasury management activity is undertaken by the Alliance finance function, supported by the treasury advisors Arlingclose Limited, under the direction of the Chief Finance Officer (Treasurer), and in accordance with the strategy and practices approved by the PCC.

2.0 External Context

2.1 GDP growth contracted by a massive 19.8% (revised from first estimate -20.4%) in Apr-Jun according to the Office for National Statistics, pushing the annual growth rate down to -21.5% (first estimate -21.7%). 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. A fuller explanation of the external context, as provided by the Treasury Management Advisors, Arlingclose Limited, is provided in Appendix 4.

3.0 Investment Activity

3.1 At 30 September 2020 the PCC had short term investments and cash equivalents of £35.2m. Year to date balances ranged between £68k and £41.6m.

3.2 The period-end investment position and the year-to-date change is shown at Appendix 1 Table 2.

3.3 Both the CIPFA Code and government guidance require funds to be invested prudently, regarding the security and liquidity of investments before seeking the highest rate of return, or yield. The 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.

3.4 Investments are reviewed quarterly and benchmarked against other similar organisations by Arlingclose Limited. The benchmarking for quarter 2 is provided at Appendix 1 - Table 3. The total return on Devon and Cornwall balances was significantly higher (0.39%) compared with the average of Police and Fire Authorities (-0.04%) and 128 Local Authorities (-0.46%). Market volatility caused by COVID-19 meant that interest rates reduced. This did have an impact on the investments held by Devon and Cornwall but to a lesser extent than the comparators due to the type of instruments they hold.

You will also see a reasonable diversification of funds with the smallest proportion held with banks. This is in line with Arlingclose's advice.

3.5 In terms of investments for the remaining year, we have received guidance from Arlingclose advising us to use MMF's and banks (no longer than 35 days) as per their Counterparty Lists; and Local Authorities. Brokers are contacted regularly throughout each week to establish if there are Local Authorities looking for funds. What we are currently seeing is Local Authorities looking for funds for several months which happen to overlap with forecasted dips in our cashflow. Advice from Arlingclose is to lend short term and not to put ourselves in a position where funds invested for a longer period are substituted by borrowing when cash is needed as the costs of borrowing outweighs the interest earnt. On this basis, we will continue to diversify the investments with MMF's and banks and continue to engage with our brokers and seek advice from Arlingclose.

4.0 Borrowing Activity

4.1 **Borrowing Update**: On 9th October 2019 the PWLB raised the cost of certainty rate borrowing to 1.8% above UK gilt yields making it relatively expensive. Market alternatives are available, however the financial strength of individual authorities will be scrutinised by investors and commercial lenders.

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.

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.

4.2 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.

4.3 The forecast CFR position is £71m which is £7m less than the forecast reported at quarter 1 but remains higher than the amount budgeted (£66m). This increase against budget is mainly due to the completion of the sale of Heavitree Road moving to 2021/22. The rescheduling of this capital receipt reduces the available funding in 2020/21. To negate this, borrowing has increased. This increase has then been reduced by a few projects moving from the 2020/21 programme into 2021/22 resulting in a forecast position of £71m.

4.4 **Short Term Borrowing:** In quarter 2, a borrowing requirement of £2m was required overnight on the 2 July 2020 to cover fluctuations in cash until the receipt of the Pension Top up grant on the 3 July 2020. The overnight borrowing of £2m was arranged with Blaenau Gwent County Borough Council at an interest rate of 0.06%. The brokerage fee totalled £5.47 with £3.29 interest paid.

4.5 **Long Term Borrowing:** No new long-term external borrowing has been arranged. Existing borrowing has been arranged with PWLB and the next loan to mature will be in 2025.

5.0 Performance Report

5.1 The financial performance of treasury management activities is measured both in terms of its impact on the revenue budget and its relationship to benchmark interest rates. The Arlingclose benchmarking is provided at Appendix 1 Table 3.

5.2 Interest receivable forecast for the year is £152k compared to a budgeted amount of £242k. The budget was set at 0.75% and so far, this quarter we have seen MMF rates averaging 0.06%, however, as advised by Arlingclose and our Brokers, there is a high possibility that rates will fall to base rate or below. We have already seen negative rates with the Debt Management Office within quarter 2. This interest rate forecast, together with the advice of more diversification has impacted on our predicted income return.

5.3 Funds are diversified where possible and we continue to explore placing investments with Local Authorities. However due to Local Authorities receiving additional funding for COVID, this option is limited.

5.4 As at 30 September 2020, all treasury activity complied with the PCC's Treasury Management Strategy and Investment Strategy as well as all relevant statute, guidance and accounting standards.

5.5 During the period 1 July to 30 September there were no breaches to the operational limits.

6.0 Other matters

6.1 The implementation of the new IFRS 16 Leases accounting standard has been delayed until 2021/22. A significant amount of work has already been completed. The impact of this standard will be covered within the 2021/22 Treasury Management Strategy and will be referred to in the 2020/21 Statement of Accounts with full disclosures being made in the 2021/22 Accounts.

7.0 Outlook for the remainder of 2020/21

7.1 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 0.1%, further cuts to Bank Rate to zero or even into negative territory cannot be completely ruled out. A fuller explanation of the outlook for the remainder of 2020/21, as provided by the Treasury Management Advisors, Arlingclose Limited, is provided in Appendix 5.

7.2 As a result of the recent DMO decision to charge negative interest rates for some of the short term investment (primarily overnight up to two weeks) an amendment to the current Treasury Management Strategy (TMS) is proposed. The current TMS sets an upper limit of a £1.25m balance for our bank account. The bank account is currently set at a 0% interest rate so it would appear sensible to leave excess funds in the bank account rather than invest these sums at a negative interest rate with DMO. The criteria around this proposal is set out below:-

- Where the only investment option available incurs a negative interest rate then these excess funds will be left in the bank account except where:

- The total amount remaining in the bank exceeds £6m in line with the cash limit for investment to a single organisation,
- Or the bank account interest rate falls below 0% or the investment rate pertaining to the investment.

8.0 Recommendation

8.1 That the Independent Audit Committee review the proposal to amend the Treasury Management Strategy and recommend to the Devon and Cornwall Joint Leadership Board approval of this change.

Deborah Broome
Management Accountant

Lucinda Hines
Head of Technical Accounting

Nicola Allen
Treasurer to the OPCC

Appendices
Appendix 1 – Investments
Appendix 2 – Treasury Management Indicators
Appendix 3 – Prudential Indicators
Appendix 4 – Economic Update provided by Arlingclose Ltd
Appendix 5 – Outlook for the remainder of 2020/21 provided by Arlingclose Ltd

INVESTMENTS Appendix 1

Table 1: Investment Limits

	2020/21 Cash Limit	30/09/2020 Actual	Complied?
Any single organisation, except the UK Government	£12m each (£6m unsecured funds)	£6m unsecured	Yes
Any group of organisations under the same ownership	£12m per Group (£6m unsecured funds)	£6m unsecured	Yes
Any group of pooled funds under the same management	£6m per Manager	£6m per Manager	Yes
Negotiable instruments held in a broker's nominee account	£24m per Broker	£0 per Broker	Yes
Limit per non-UK country	£12m per Country	£0 per Country	Yes
Registered providers	£20m in Total	£0 in Total	Yes
Unsecured investments with building societies	£12m in Total	£0 in Total	Yes
Money Market Funds	£32m in Total	£16.19m in Total	Yes
Bank Account	£1.25m	£1.11m	Yes

Table 2: Investment Position

	31/03/2020 Actual Portfolio £'000	30/09/2020 Actual Portfolio £'000	Movement £'000
External Borrowing:			
Short Term Borrowing	(6,000)	0	6,000
Long Term Borrowing	(30,277)	(30,277)	0
Finance Leases	(166)	(136)	30
Total Gross External Debt	**(36,443)**	**(30,413)**	**6,030**
Treasury Investments:			
Short Term Investments	12,063	18,000	5,937
Cash and Cash Equivalents	3,168	17,202	14,034
Total Treasury Investments	**15,231**	**35,202**	**19,971**
Net Investments/(Debt)	**(21,212)**	**4,789**	**26,001**

INVESTMENTS Appendix 1

Table 3: Benchmarking Information

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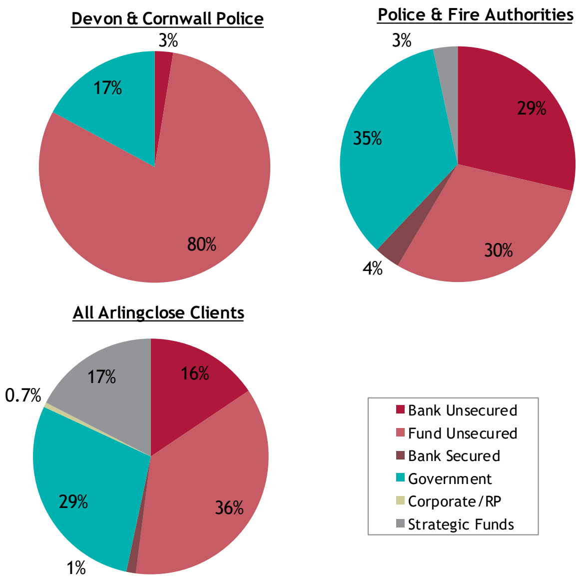
Investment Benchmarking
30 September 2020

	Devon & Cornwall Police	12 Police & Fire Authorities Average	128 LAs Average
Internal Investments	£23.1m	£26.5m	£74.1m
Cash Plus & Short Bond Funds	£11.9m	£1.0m	£1.8m
Strategic Pooled Funds	£0.0m	£1.7m	£11.8m
TOTAL INVESTMENTS	**£35.0m**	**£29.1m**	**£87.6m**
Security			
Average Credit Score	2.74	3.86	4.16
Average Credit Rating	AA	AA-	AA-
Average Credit Score (time-weighted)	3.65	3.58	4.14
Average Credit Rating (time-weighted)	AA-	AA-	AA-
Number of Counterparties / Funds	7	10	13
Proportion Exposed to Bail-in	48%	57%	64%
Liquidity			
Proportion Available within 7 days	83%	57%	51%
Proportion Available within 100 days	100%	86%	70%
Average Days to Maturity	7	44	18
Market Risks			
Average Days to Next Rate Reset	38	55	56
Strategic Fund Volatility	-	2.0%	8.2%
Yield			
Internal Investment Return	0.14%	0.11%	0.27%
Cash Plus & Short Bond Fund - Total Return	0.88%	0.94%	1.06%
Strategic Funds - Total Return	-	-4.66%	-3.92%
Total Investments - Total Return	**0.39%**	**-0.04%**	**-0.46%**
All External Funds - Income Only Return	0.40%	2.76%	3.45%
All External Funds - Capital Gains/Losses	0.48%	-5.18%	-6.78%
Total Investments - Income Only Return	**0.23%**	**0.26%**	**0.90%**



Notes

- Unless otherwise stated, all measures relate to internally managed investments only, i.e. excluding external pooled funds.
- Averages within a portfolio are weighted by size of investment, but averages across authorities are not weighted.
- Credit scores are calculated as AAA = 1, AA+ = 2, etc.
- Volatility is the standard deviation of weekly total returns, annualised.

TREASURY INDICATORS Appendix 2

Table 4: Security

The PCC has adopted a voluntary measure of its exposure to credit risk by monitoring the weighted average credit rating of its investment portfolio.

	2020/21	30/09/2020	Complied ?
	Target	Actual	
Portfolio average credit rating	A+	AA	Yes

Table 5: Liquidity

The PCC has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected variation in the cash flow:

	2020/21	30/09/2020	Complied?
	Target	Actual	
Minimum limit at less than 31 days duration	£7m	£35.1m	Yes

Table 6: Interest Rate Exposures

This indicator is set to control the PCC's exposure to interest rate risk.

	2020/21	30/09/2020	Complied ?
	Limit	Actual	
Upper limit on 1 year revenue impact of a 1% rise in interest rates	£145k	(£228k)	Yes
Upper limit on 1 year revenue impact of a 1% fall in interest rates	£365k	£228k	Yes

Fixed rate 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.

TREASURY INDICATORS Appendix 2

Table 7: Maturity Structure of Borrowing

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

	2020/21		30/09/2020	Complied?
	Upper Limit	Lower Limit	Actual	
Under 12 months	100%	0%	0%	Yes
12 months and within 24 months	100%	0%	0%	Yes
24 months and within 5 years	100%	0%	0%	Yes
5 years and within 10 years	100%	0%	21%	Yes
10 years and above	100%	0%	79%	Yes

Table 8: Principal Sums Invested for Periods Longer than 365 days

The purpose of this indicator is to control the PCC'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:

	2020/21	2021/22	2022/23	2023/24
Limit on principal invested beyond year end	£5m	£5m	£5m	£5m
Actual principal invested beyond year end	£0m	£0m	£0m	£0m
Complied?	Yes	Yes	Yes	Yes

PRUDENTIAL INDICATORS Appendix 3

Table 9: Debt Limits

	2020/21 Estimate £'000	30/09/2020 Actual £'000	Operational Boundary £'000	Authorised Limit £'000	
External Borrowing	50,756	30,277	60,891	70,891	**Complied?**
Finance Leases	134	136			
Total	**50,890**	**30,413**	**60,891**	**70,891**	**Yes**

Table 10: Capital Financing Requirement (CFR)

	2020/21 Estimate £'000	30/09/2020 Actual £'000	2020/21 Forecast £'000
Opening CFR	**64,576**	**64,532**	**64,532**
Capital expenditure to be funded by borrowing	3,495	2,379	7,856
Finance Leases	0	0	0
Less: Minimum Revenue Provision	(1,567)	(842)	(1,683)
Less: Finance Leases	(73)	(29)	(58)
Closing CFR	**66,431**	**65,483**	**70,647**

ECONOMIC UPDATE provided by Arlingclose Ltd. Appendix 4

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 and the government came under fire, both at home and abroad, as it tried to pass the Internal Market Bill which could override the agreed Brexit deal, potentially breaking international law.

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 a massive 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). Despite only a modest rise in unemployment over the period, the rate is expected to pick up sharply in the coming months as the furlough scheme ends in October. On the back of this, 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.

ECONOMIC UPDATE provided by Arlingclose Ltd. Appendix 4

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, albeit that performance being driven by a handful of technology stocks including Apple and Microsoft, with the former up 75% in 2020. 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). The 10-year gilt yield also bounced around, starting at 0.21% and ending at 0.23% over the same period, while the 20-year rose from 0.56% to 0.74%. 1-month, 3-month and 12-month bid rates averaged 0.02%, 0.06% and 0.23% respectively over the period.

At the end of September, the yield on 2-year US treasuries was around 0.13% while that on 10-year treasuries was 0.69%. German bund yields remain negative across most maturities.

Credit review: Credit default swap spreads eased over most of the period but then started to tick up again through September. In the UK, the spreads between ringfenced and non-ringfenced entities remains, except for retail bank Santander UK whose CDS spread remained elevated and the highest of those we monitor at 85bps while Standard Chartered was the lowest at 41bps. The ringfenced banks are currently trading between 45 and 50bps.

After a busy second quarter of the calendar year, the subsequent period has been relatively quiet for credit changes for the names on our counterparty list. Fitch assigned a AA- deposit rating to Netherlands lender Rabobank with a negative outlook and prior to that, while not related to our counterparty list but quite significant, revised the outlook on the US economy to Negative from Stable while also affirming its AAA rating.

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 on our list 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. The institutions on Arlingclose's counterparty list and recommended duration remain under constant review, but at the end of the period no changes had been made to the names on the list or the recommended maximum duration of 35 days.

OUTLOOK FOR THE REMAINDER OF 2020/21 provided by Arlingclose Ltd. Appendix 5

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 0.1%, 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.