Report of Director: Governance and Partnerships Agenda Item No: 4
Meeting: 2 November 2020

NORTH LINCOLNSHIRE COUNCIL

COUNCIL

Treasury Management Annual Report 2019/20

1. OBJECT AND KEY POINTS IN THIS REPORT

1.1. To inform Council of the Treasury arrangements, activity and performance during 2019-20. The key points being:-

1.1.1. Borrowing was within Prudential Indicator Limits

1.1.2. Investment balance levels were increased. Yields initially rose, then fell in the final weeks of the period and into the new year in response to Coronavirus pandemic.

1.1.3. Debt costs were well within budget delivering in-year savings to support pressures elsewhere in the organisation

1.1.4. Investment income exceeded budget to further support other services

2. BACKGROUND INFORMATION

CIPFA defines treasury management as:

2.1 The management of the organisation's borrowing, 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.

2.2. The Treasury Management Strategy Statement (TMSS) for 2019/20 was approved by Council in February 2019. This statement also incorporates the Investment Strategy.

2.3 Whilst the Council has appointed advisors to support effective treasury management arrangements, the Council is ultimately responsible for its treasury decisions and activity. No treasury activity is without risk. The successful identification, monitoring and control of risk is therefore an important and integral element of treasury management activities.

2.4 The Council has nominated Audit Committee to be responsible for ensuring effective scrutiny of treasury management arrangements.

3. OPTIONS FOR CONSIDERATION

3.1 The key issues covered in the attached appendix include: -

- The Treasury Management Strategy for 2019/20 assumed further borrowing would be required during the year. The net increase in council debt in 2019/20 was £8.5m. Long-term debt increased by £3.4m and short-term by £5.1m. The average interest rate on borrowing fell from 3.4% to 3.2%.

- The cost of servicing the council's debt was £11.6m. This remained below the council's guideline of debt management costs being below 10-12% of the council's revenue stream.

- The level of debt was within the operational boundary and authorised limits set in the Treasury Management Strategy.

- Investment balances increased from £13m to £35.3m by the end of 2019-20. The main reason for this increase was various Covid-19 related grants being paid to the council by central government. The average investment interest rate was 0.13%.

4. ANALYSIS OF OPTIONS

4.1 This report is a requirement of the Prudential Code and provides Full Council with assurance on the council's Treasury Management operation in 2019/20.

5. FINANCIAL AND OTHER RESOURCE IMPLICATIONS (e.g. LEGAL, HR, PROPERTY, IT, COMMUNICATIONS etc.)

5.1 The financial implications to this report are covered in section 3.

6. OTHER RELEVANT IMPLICATIONS (e.g. CRIME AND DISORDER, EQUALITIES, COUNCIL PLAN, ENVIRONMENTAL, RISK etc.)

6.1 Not applicable.

7. OUTCOMES OF INTEGRATED IMPACT ASSESSMENT (IF APPLICABLE)

7.1 No impact assessment is required for the purpose of this report.

8. OUTCOMES OF CONSULTATION AND CONFLICTS OF INTERESTS DECLARED

8.1 The annual Treasury Report has been considered by the Audit Committee on 16 October 2020. There are no reported conflicts in respect of Treasury activity.

9. RECOMMENDATIONS

9.1 That Council notes the Treasury Management performance for the 2019/20 financial year.

DIRECTOR OF GOVERNANCE AND PARTNERSHIPS

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Background Papers used in the preparation of this report
CIPFA Treasury Management Code and Guidance Notes
CIPFA Prudential Code for Capital Finance
Treasury Management Strategy 2019-20

Treasury Management Outturn 2019-20

Appendix 1

North Lincolnshire Council

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Director of Governance and Partnerships Overview

The Treasury Management Policy Statement 2019/20 was agreed by Council in February 2019. Treasury Management incorporates the council's borrowing requirements, investments and cash flow activity and money market and capital market transactions with the effective control of risk and pursuit of optimum performance consistent with those risks. The Treasury Management Strategy ensures that security is the overriding priority, followed by liquidity and then yield.

In my capacity as the Council's Chief Finance Officer (Section 151 Officer) I confirm that the objectives of the Treasury Management Strategy 2019/20 have been achieved and performance against the strategy in 2019/20 demonstrates protection of capital over maximising returns.

This report provides a summary of the effectiveness of the Treasury Management Strategy, identifying risk factors affecting those activities of borrowing, investment and cash flow and demonstrating the value for money achieved through the effective delivery of the treasury management arrangements.

Becky McIntyre, Director of Governance and Partnerships
August 2020

Introduction and External Context

This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2019/20. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management, (the Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities, (the Prudential Code).

During 2019/20 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year
- a mid-year treasury update report
- an annual review following the end of the year describing the activity compared to the strategy (this report)

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is, therefore, important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Audit Committee before they were reported to the full Council. Member training on treasury management issues was undertaken during 2019/20 in order to support members' scrutiny role.

The Authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. This report covers treasury activity and the associated monitoring and control of risk.

Introduction and External Context

Investment returns remained low during 2019/20. The expectation for interest rates within the treasury management strategy for 2019/20 was that Bank Rate would stay at 0.75% during 2019/20 as it was not expected that the MPC would be able to deliver on an increase in Bank Rate until the final arrangements for Britain leaving the EU were known. However, there was an expectation that Bank Rate would rise after that issue was finalised, but would only rise to 1.0% during 2020.

There is likely to be little upward movement in rates over the next two years as it is anticipated that national economies will require a prolonged period to recover momentum lost in a sharp recession caused as a result of the coronavirus. Inflation is also likely to be very low during this period and could even turn negative in some major economies during 2020-21.

The Council only has sufficient cash balances to place deposits for up to six months therefore is not able to earn higher rates from longer term deposits. The Council has taken a cautious approach to investing. Although financial institutions are now better able to deal with economic shocks than they were ten years ago.

Investment balances have been kept to a minimum through the strategy of using reserves and balances to delay borrowing externally from the financial markets. External borrowing would have incurred an additional cost, due to the differential between borrowing and investment rates as illustrated in the charts shown on the following slides. Such an approach has also provided benefits in terms of reducing the counterparty risk exposure, by having fewer investments placed in the financial markets.

Local Context

Gross borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council must ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator does still allow the Council some flexibility to borrow in advance of its immediate capital needs in 2019/20 should it desire.

The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31/03/2019 Prinicipal	Rate/ Return	Average Life Yrs		31/03/2020 Principal	Rate/ Return	Average Life Yrs
	£m				£m		
Total debt	195.7	3.24%	9.26		203.8	3.18%	9.43
Capital Financing Requirement (CFR)	235.1				244.3		
Over / (under) borrowing	(39.4)				(40.5)		
Total Investments	13.0	0.59%	0.01		35.3	0.13%	0.01
Net Debt	**182.7**				**168.5**		

The overall level of investment balances held has remained steady in recent years, as the Authority used internal borrowing to both defer more expensive long-term borrowing and reduce it's credit risk exposure, but rose toward the end of 2019-20 as the Authority sought liquidity to assist with it's response to the uncertainty created by the Covid-10 pandemic..

Borrowing Strategy

At 31/03/2020 the Authority held £204m of loans, (up £11m on 2019) as a result of funding previous years' capital programmes.

The structure of our debt portfolio as at 31.3.2020 is shown below

Type of Loan	Amount	% of Portfolio
PWLB Fixed	£156.8m	77%
LOBO	£0.0m	0%
Market Fixed	£0.0m	0%
Short-term Fixed	£47.0m	23%
Variable Rate	£0.0m	0%
Total	**£203.8m**	

During 2019-20, the Council maintained an under-borrowed position. This meant that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as investment returns were low and minimising counterparty risk on placing investments also needed to be considered.

The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this was kept under review to avoid incurring higher borrowing costs in the future when this authority may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt. As a result discussions are being progressed with alternative long-term lenders as at period end.

Borrowing Strategy (continued)

Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. Interest rates in the financial markets are closely and a pragmatic strategy based upon the following principles to manage interest rate risks was adopted:

- where there was a significant perceived risk of a sharp FALL in long and short-term rates, (e.g. due to a marked increased risk of recession or risks of deflation), then long-term borrowings would have been postponed, and potential rescheduling from fixed rate funding into short term borrowing would have been considered.

- if it had been felt that there was a significant risk of a sharp RISE in long and short term rates, perhaps arising from an acceleration in the start date or rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position would have been re-appraised. Most likely, fixed rate funding would have been drawn whilst interest rates were lower than they were projected to be in the future.

PWLB rates are determined by the yields on UK Government bonds known as gilts. H.M. Treasury determine a specified percentage to add to gilt yields. Gilt yields were on a generally falling trend during the last year up until the coronavirus pandemic affected western economies. Thereafter, gilt yields fell sharply to unprecedented lows as investors sold shares in anticipation of impending recessions in western economies and moved cash into safer assets i.e. government bonds.

However HM Treasury increased PWLB rates by 1% on all loans on 9 October 2019, due to concerns over the level and nature of borrowing within councils. That increase was then partially reversed for some forms of borrowing on 11 March 2020. Following this, consultation with local authorities took place on restrictions to prevent councils borrowing from the PWLB to invest purely to generate income. It is likely that interest rates will be reduced by 1% on all loans once these restrictions are in place.

Borrowing in advance of need

The Council has not borrowed more than, or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed.

The effect of Covid-19 and the resultant tightening if short-term liquidity markets from mid-March lead to an increase in short-term interest rates. During that month Local Authorities borrowed £3.1billion (the largest amount ever in a single month) from PWLB on minimum terms of 1 year. We managed to avoid the need to resort to such measures and although year end liquidity cost us more, we were able to mitigate the long-term impact by keeping borrowing short.

Investment Activity

The Council has held significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2019/20 investment balances ranged between £11.1m and £36.2 million. The average balance maintained was £23.4m with a weighted average maturity of 6 days. An average yield of 0.56% was achieved. This compares favourably to our targeted rate of 7-day LIBID (0.53%) and is comparable with 1-month LIBID (0.56%).

Total investment income was £0.132m compared to a budget expectation of £0.050m.

Investment Policy – the Council's investment policy is governed by MHCLG guidance, which has been implemented in the annual investment strategy approved by the Council in February 2019. This policy sets out the approach for choosing investment counterparties and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data, (such as rating outlooks, credit default swaps, bank share prices etc.).

Investment activity during the year conformed to the Investment Strategy for 2019/20 which aimed to reduce risk by;

- Setting value and term limits for counterparties based on Credit rating, available collateral and sector.
- Utilising data tools available via Treasury Live and Link Asset Services to monitor risk.
- Ensuring a minimum level of liquidity was maintained to allow payments to be made as they fell due

During the year there were five occasions when the £2m limit applied to the council's Barclays accounts was exceeded.

Investment Activity

Investments	Balance on 01/04/2019 £m	Investments Made £m	Maturities/ Investments Sold £m	Balance on 31/03/2020 £m	Avg Rate/Yield (%) and Avg Life (years)
UK Government:					
- DMADF	6.0	431.9	(410.0)	27.9	0.47% 8 days
- Treasury Bills	-	49.0	(49.0)	-	0.67% 15 days
Bonds issued by Multilateral Development Banks	-	2.5	(2.5)	-	0.77% 13 days
Direct Unsecured Investments (call accounts, deposits) with financial institutions					
- rated A- or higher	4.4	59.5	(62.5)	1.4	0.40% at Call
- rated below A-	-	-	-	-	
Tradable Investments with Financial institutions Corporates (CDs) rated A- or higher	-	3.4	(3.4)	-	0.80% 40 days
Money Market Funds	2.6	34.5	(31.1)	6.0	0.68% at Call
TOTAL INVESTMENTS	13.0	513.1	(500.0)	35.3	0.59% 10 days
Increase/ (Decrease) in Investments £m				22.2	

Given the increasing risk and continued low returns from short-term unsecured bank investments, but having no funds available for longer-term investment, the Council is unable to simply diversify into more secure and/or higher yielding asset classes such as repurchase agreements or covered bonds which are secured on financial assets. Eliminating Credit Risk by running down balances whilst still maintaining adequate liquidity is therefore a key strand of operational activity.

The Council used short-term borrowing around year end to bolster available cash balances.

Investment Activity (contd.)

Credit Risk

Counterparty credit quality as measured by credit ratings is summarised below:

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating
31/03/2019	3.43	AA
30/06/2019	2.87	AA
30/09/2019	2.70	AA
31/12/2019	2.56	AA
31/03/2020	3.53	AA-

Scoring:
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-AAA = highest credit quality = 1
- D = lowest credit quality = 26
-Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

The council decided to increase its minimum investment balance level from £10m to £20m in March 2020 because of the Covid-19 Pandemic. We used short-term borrowing to maintain our investments at this level. Support programmes from Central Government and more robust income levels than expected have meant that we carried larger balances into Q1 2020-21 allowing the short-term loans to be repaid over the summer.

Investment Activity (contd.)

Benchmarking

- Comparisons are made to other Authorities using the Treasury Live database which looks at over £6Bn of local Authority investments. As at the outturn date this shows that other Authorities:-
  - Hold more cash than NLC. Average balance £72m (estimated) vs £35m at NLC
  - Invest for longer periods. 143 days on average vs only 1 day at NLC
  - Take more risk than us.
  - Deliver higher return than us. 0.78% vs 0.13%
- Whilst the above shows the greater return generated by term premiums the Council is of the view that, in a post Bail-in environment elimination of credit risk through lower balances is worth lower overall return. NLC also recognises that this strategy needs to ensure it does not replace credit risk with liquidity risk and so a liquid balance of £10m was maintained. As an example, this minimum balance was raised in March 2020 in order to ensure the Authority retained access to liquidity during that unprecedented period of uncertainty.

Compliance with Prudential Indicators

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

Interest Rate Exposures: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed were set as:

	2019/20	2020/21	2021/22
Upper limit on fixed interest rate exposure	£288m	£303m	£308m
Actual*	£160m	£207m (est)	£203m (est)
Upper limit on variable interest rate exposure	£70m	£75m	£75m
Actual*	£52m	£52m (est)	£35m (est)

*= Peak position for 2019/20

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

	Upper	Lower	Actual
Under 12 months	60%	0%	35%
12 months and within 24 months	30%	0%	1%
24 months and within 5 years	50%	0%	2%
5 years and within 10 years	50%	0%	7%
10 years and within 20 years	75%	0%	9%
20 years and within 30 years	75%	0%	8%
Over 30 years	100%	0%	38%

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

Compliance with Prudential Indicators (contd.)

Principal Sums Invested for Periods Longer than 365 days*: The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

	2019/20	2020/21	2021/22
Limit on principal invested beyond year end	£2m	£2m	£2m
Actual	£0m	£0m	£0m

*This indicator has been tweaked in recently issued Code of Practice/Guidance Notes. Going forward this indicator will be reported against 365 (rather than 364 days). This is not expected to make any material difference to limits or actuals.

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

	Target	Actual
Portfolio average credit rating	A	AA-

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

	Target	Actual (Low)
Total cash available within 1 month	£10m	£11m

Compliance with Prudential Indicators (contd.)

Other Prudential Indicators

The following prudential indicators are relevant to the treasury function as they concern limits on borrowing and the adoption of the CIPFA Treasury Management Code.

Operational Boundary for External Debt: The operational boundary is based on the Council's estimate of most likely, i.e. prudent, but not worst-case scenario for external debt.

Operational Boundary	2019/20 £m	2020/21 £m	2021/22 £m	2022/23 £m
Borrowing	£226m	£265m	£264m	£267m
Other long-term liabilities	£2m	£22m	£23m	£24m
Total Debt	£228m	£287m	£287m	£291m

Authorised Limit for External Debt: The authorised limit is "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2019/20 the Council has maintained gross borrowing within its authorised limit.

Authorised Limit	2019/20 £m	2020/21 £m	2021/22 £m	2022/23 £m
Borrowing Limit	£236m	£295m	£294m	£297m
Other long-term liabilities	£5m	£30m	£32m	£34m
Total Debt Limit	£241m	£325m	£326m	£331m
Actual/projected Peak Debt levels	£204m	£208m (est)	£203m (est)	£204m (est)

Adoption of the CIPFA Treasury Management Code: The Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition in February 2018.

Compliance with Capital Finance Prudential Indicators

The Local Government Act 2003 requires councils to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Authority has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

Estimates of Capital Expenditure

The Council's planned capital expenditure and financing as at 31 March 2020 may be summarised as follows.

Capital Expenditure and Financing	2019/20 Approved £m	2019/20 Actual £m	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m
Total Expenditure	39.5	32.2	51.5	21.2	19.3
Capital Receipts	3.0	1.0	5.8	5.9	0.0
Government Grants	19.7	16.4	26.9	9.8	9.3
Ring-fenced/External Funding	0.2	0.2	0.0	0.0	0.0
Borrowing	16.6	14.6	18.8	5.5	10.0
Total Financing	39.5	32.2	51.5	21.2	19.3

Compliance with Capital Finance Prudential Indicators (contd.)

Ratio of Financing Costs to Net Revenue Stream

This is a voluntary indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2019/20 Original Estimate %	2019/20 Actual %	2020/21 Estimate %	2021/22 Estimate %	2022/23 Estimate %
General Fund	9.3	8.0	8.8	9.9	9.9