READING BOROUGH COUNCIL

REPORT BY EXECUTIVE DIRECTOR OF RESOURCES

TO: AUDIT & GOVERNANCE	
DATE: 28th JANUARY 2021	
TITLE TREASURY MANAGEMENT STRATEGY MID-YEAR REVIEW 2020/21	
LEAD COUNCILLOR: COUNCILLOR BROCK	**PORTFOLIO: ALL**
SERVICE: FINANCIAL SERVICES	**WARDS: BOROUGHWIDE**
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1. PURPOSE OF REPORT AND EXECUTIVE SUMMARY

1.1 The Council adopted a Treasury Management Strategy and an Annual Investment Strategy for 2020/21 at its meeting on 25th February 2020.

1.2 The purpose of this report is to update Members on the activity of the Treasury Management function during the first half of the year for the period 1st April 2020 to 30th September 2020.

1.3 The Council has not taken out any new external long-term borrowing (loans) during 2020/21 as of 30th September 2020.

1.4 The Council has complied with all elements of its Treasury Management Strategy Statement (TMSS) as agreed by Full Council on 25th February 2020.

2. RECOMMENDED ACTION

That the Committee note:

2.1 The Treasury Management Mid-Year Report for 2020/21.

APPENDICES

Appendix 1 – Economics Update
Appendix 2 – Investment Criteria & Limits

3. INTRODUCTION

3.1 This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An Interest Rates Forecast
- A review of the Treasury Management Strategy Statement (TMSS) and Annual Investment Strategy;
- The Council's capital expenditure, as set out in the Capital Strategy, and prudential indicators;
- A review of the Council's investment portfolio for 2020/21;
- A review of the Council's borrowing strategy for 2020/21;
- A review of any debt rescheduling undertaken during 2020/21;
- A review of compliance with Treasury and Prudential Limits for 2020/21;
- An economic update for the first half of the 2020/21 financial year (Appendix 1).

4 INTEREST RATES FORECAST

4.1 The coronavirus outbreak has had a significant economic impact on both the UK and global economies. The Bank of England took emergency action in March to cut Bank Rate to 0.10%, and it has remained unchanged since then following subsequent meetings of the Monetary Policy Committee (MPC) in August and September 2020. No increase in Bank Rate is expected within the forecast horizon ending on 31st March 2023 as economic recovery is expected to be a prolonged and gradual process.

Gilt Yields/PWLB Rates.

4.2 After gilt yields spiked during the initial phases of the Covid pandemic in March 2020, yields have fallen to unprecedented lows as major western central banks took rapid action to deal with excessive stress in financial markets and started massive quantitative easing purchases of government bonds. Bond yields have also reduced due to the significant increase in issuance to finance Government expenditure. At the close of trading on 30th September 2020, all gilt yields between 1 to 6 years were negative, while 25-year yields were at only 0.76% and 50 year at 0.60%.

4.3 As part of the Spending Review in November 2020, the Government announced; following consultation earlier in the year, that it will reform the Public Works Loan Board (PWLB) lending terms, effectively reversing the additional 1% over gilts it had imposed in October 2019. However, the PWLB will no longer lend to local authorities who invest primarily with the aim of generating a financial return.

4.4 Current UK interest rate forecasts (including the 20-basis point certainty rate reduction) are outlined in the following table:

Table 1. Interest Rate Forecasts

	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22
	%	%	%	%	%	%	%	%
Bank Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
5-year PWLB	0.80	0.80	0.80	0.80	0.80	0.90	0.90	0.90
10-year PWLB	1.10	1.10	1.10	1.10	1.10	1.20	1.20	1.20
25-year PWLB	1.50	1.50	1.60	1.60	1.60	1.60	1.70	1.70
50-year PWLB	1.30	1.30	1.40	1.40	1.40	1.40	1.50	1.50

4.5 As Table 1 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 UKs, a prolonged period to recover the momentum lost as a result of the coronavirus pandemic. Similarly, inflation is also likely to be very low during this period.

The Balance of Risks to the UK

4.6 The Bank of England has effectively ruled out the use of negative interest rates in the near term and as set out above, increases in Bank Rate are likely to be several years hence given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, could impact gilt yields, (and thus PWLB rates), in the UK.

4.7 Downside risks to current forecasts include the impact of:

- Further national lockdowns
- Significant economic disruption caused by Brexit and associated trade deals.
- A resurgence of the Eurozone sovereign debt crisis.
- Minority EU governments: Germany, Austria, Sweden, Spain, Portugal, Netherlands, Ireland and Belgium have vulnerable minority governments dependent on coalitions which could prove fragile which may adversely impact both their own and the wider EU economy which will have ramifications for the UK.
- Geopolitical risks, for example in China, Iran or North Korea, but also in Europe and other Middle Eastern countries, which could lead to increasing safe haven flows.

4.8 Upside risks to current forecasts include:

- A stronger than currently expected recovery in UK economy.
- The Bank of England being slow to revise Bank Rate resulting in inflationary pressures building up too strongly, which then necessitates a later rapid series of interest rate increases in Bank Rate faster than we currently expect in order to control inflation.

5 TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY UPDATE

5.1 The Treasury Management Strategy Statement, (TMSS), for 2020/21 was approved by Full Council on 25th February 2020.

5.2 There are no policy changes required to the TMSS. This report sets out the Council's position compared to the TMSS in the light of the updated economic position, budgetary changes already approved and revised in-year forecasts of capital expenditure.

6 THE COUNCIL'S CAPITAL POSITION (PRUDENTIAL INDICATORS)

Prudential Indicators for Capital Expenditure

6.1 Tables 2 and 3 below show the Council's forecast capital expenditure compared to the Capital Programme agreed in February 2020, including the removal of the £80.000m budget in respect of Purchase of Commercial Property which was recommended as part of the Quarter 2 Monitoring Report, subsequently agreed by Policy Committee at its December meeting.

Table 2. General Fund Capital Programme

General Fund	2020/21 Original Budget	2020/21 Forecast (30th September 2020)
	£m	£m
Adult Social Care & Health Services	1.405	1.022
Economic Growth & Neighbourhood Services	52.797	43.355
Economic Growth & Neighbourhood Services – Education Schemes	19.024	15.104
Resources	8.051	8.658
Corporate	89.169	6.321
Total General Fund	**170.446**	**74.460**

Table 3. HRA Capital Programme

Housing Revenue Account	2020/21 Original Budget	2020/21 Forecast (30th September 2020
	£m	£m
Housing Revenue Account	34.974	21.360
Total Housing Revenue Account	**34.974**	**21.360**

Changes to the Financing of the Capital Programme

6.2 Tables 4 and 5 below identify the expected financing arrangements of the Council's capital expenditure plans. The Borrowing Requirement increases the underlying indebtedness of the Council by increasing the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). It should be noted that borrowing may also need to be taken out to replace maturing debt or for cashflow purposes.

Table 4. Financing of the General Fund Capital Programme

General Fund	2020/21 Original Budget	2020/21 Forecast (30th September 2020)
	£m	£m
Total Capital Expenditure	**170.446**	**74.460**
Financed by:		
Capital Receipts	11.004	5.550
Capital Grants and other Contributions	55.652	49.343
Total Financing	**66.656**	**54.893**
Net Borrowing Requirement	**103.790**	**19.567**

Table 5. Financing of the HRA Capital Programme

Housing Revenue Account	2020/21 Original Budget	2020/21 Forecast (30th September 2020)
	£m	£m
Total Capital Expenditure	**34.974**	**21.360**
Financed by:		
Capital Receipts	2.300	2.166
Capital Grants and other Contributions	4.712	2.000
Capital Reserves	8.064	8.064
Revenue	0.604	0.327
Total Financing	**15.680**	**12.557**
Net Borrowing Requirement	**19.294**	**8.803**

Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

6.3 Table 6 shows the Council's CFR, which is its total underlying indebtedness. It also shows the maximum expected debt position over the period, which is termed the Operational Boundary. The main reason for the significant reduction in the estimated CFR is the approved removal of the £80.000m budget relating to the purchase of commercial property from the Capital Programme as recommended in the Quarter 2 Performance and Monitoring Report to Policy Committee (14th December 2020).

Table 6. Capital Financing Requirement and Operational Boundary

	2020/21 Original Estimate	2020/21 Forecast (30th September 2020)
	£m	£m
Prudential Indicator – Capital Financing Requirement		
CFR – General Fund	495.865	418.611
CFR - HRA	210.798	194.433
Total CFR	**706.663**	**613.044**
Prudential Indicator – Operational Boundary for External Debt		
Borrowing	706.663	613.044
Headroom	20.000	20.000
Total Debt	**726.663**	**633.044**

Limits to Borrowing Activity

6.4 Over the medium term, net borrowing (borrowings less investments) should only be for capital purposes. Gross external borrowing should not, except in the short term, exceed the total of the Council's CFR in the preceding year plus the estimates of any additional CFR for 2020/21 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent. However, as stated above the Council's Capital Programme has been significantly scaled back in-year as the purchase of commercial property scheme has been removed and other capital schemes have had delivery impacted by Covid-19, so it is unlikely in the current year.

Table 7. Capital Financing Requirement and Actual Borrowing

	2020/21 Original Estimate	2020/21 Forecast (30th September 2020)
	£m	£m
Borrowing	469.458	395.711
Other Long-Term Liabilities	25.401	25.401
Total Debt	**494.859**	**421.112**
CFR (year end position)	**706.663**	**613.044**
Over/(under) Borrowing		**(191.932)**

6.5 The Authorised Borrowing Limit is the expected maximum borrowing need with some headroom for unexpected movements. This is a statutory limit determined under section 3 (1) of the Local Government Act 2003 and sets the limit beyond which borrowing is prohibited without Member approval. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. Table 8 below sets out the current forecast against the Authorised Limit.

Table 8. Authorised Limit

	2020/21 Original Indicator	2020/21 Forecast (30th September 2020)
	£m	£m
Borrowing	726.663	633.044
Other Long-Term Liabilities	40.000	40.000
Total Authorised Limit	**766.663**	**673.044**

7 BORROWING

7.1 The Council's estimated capital financing requirement (CFR) for 2020/21 as at 30th September 2020.9 is £613.044m. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing) to fund capital expenditure. The balance of external and internal borrowing is generally driven by market conditions. Table 7 above shows that the Council has external borrowing (including prior year borrowing) of £421.112m and has utilised £191.932m of cash flow funds in lieu of borrowing. This is a prudent and cost-effective approach in the current economic climate but will require ongoing monitoring in the event that any upside risk to gilt yields prevails and further borrowing becomes more advantageous.

7.2 Due to the increase in PWLB rates in October 2019, the subsequent consultation on these rates by HM Treasury - which ended on 31st July 2020 and the significant reduction in the Council's Capital Programme in respect of commercial property investment, the Council has not undertaken any new long-term PWLB borrowing during 2020/21. It is possible that the Council may need to borrow at the end of the financial year, however the current expectation is that this would be met by temporary or short-term borrowing. The Council's Borrowing Strategy will be reviewed and revised as part of the Treasury Management Strategy Statement 2021/22 in order to achieve optimum value and risk exposure in the long-term.

8 DEBT RESCHEDULING

8.1 Debt rescheduling is currently not attractive due to the associated high cost premiums of rescheduling PWLB loans outweighing any potential savings. No debt rescheduling has therefore been undertaken to date in the current financial year.

9 COMPLIANCE WITH TREASURY AND PRUDENTIAL LIMITS

9.1 During the half year ended 30th September 2020, the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement for 2020/21. The Executive Director of Resources reports that no difficulties are envisaged for the current or future years in complying with these indicators.

9.2 All treasury management operations have also been conducted in full compliance with the Council's Treasury Management Practices.

10 ANNUAL INVESTMENT STRATEGY

10.1 The Treasury Management Strategy Statement (TMSS) for 2020/21, which includes the Annual Investment Strategy, was approved by the Council on 25th February 2020. In accordance with the CIPFA Treasury Management Code of Practice, it sets out the Council's investment priorities as being:

- Security of capital
- Liquidity
- Yield

10.2 The Council aims to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the Council's risk appetite. In the current economic climate, it is considered appropriate to keep treasury investments short term to cover cash flow needs, but also to seek out value available in periods up to twelve months with high credit rated financial institutions, using the Link suggested creditworthiness approach, including minimum sovereign credit rating and Credit Default Swap (CDS) overlay information. As shown by the interest rate forecasts in section 4, it is now impossible to achieve the level of returns on investments commonly seen in previous decades as all investment rates are barely above zero now that Bank Rate is at 0.10%, while some entities, including more recently the Debt Management Account Deposit Facility (DMADF), are offering negative rates of return in some shorter time periods. Given increases in Bank Rate are unlikely to occur before the end of the current forecast horizon of 31st March 2023, investment returns are expected to remain low. In large part this is due to the fact that as part of the response to the pandemic and lockdown, the Bank of England and Government have provided financial markets and businesses with plentiful access to credit, either directly or through commercial banks. In addition, the Government has provided significant grant funding to local authorities to help deal with the Covid crisis; this has caused some local authorities to have sudden large increases in cash balances, albeit temporarily, searching for an investment home.

10.3 Investor cash flow uncertainty, and the need to maintain liquidity in these unprecedented times, has led to significant sums of money being invested at the very short end of the market. This has seen a number of market operators, now including the DMADF, offer nil or negative rates for very short-term maturities. This is not universal, and Money Market Funds are still offering a marginally positive return, as are a number of financial institutions.

10.4 Inter-local authority lending and borrowing rates have also declined due to the surge in the levels of cash in the system and authorities natural forecasting prudence.

Creditworthiness

10.5 Although the credit rating agencies changed their outlook on many UK banks from stable to negative outlook during the quarter ended 30th June 2020 due to upcoming risks to banks' earnings and asset quality during the economic downturn caused by the pandemic, the majority of ratings remained unchanged due to the continuing strong credit profiles of UK banks. However, during Q1 and Q2 of 2020, banks made provisions for expected credit losses and the rating changes reflected these provisions. Rating agencies will review their initial rating adjustments throughout the remainder of the current year, and these adjustments could be negative or positive, although it should also be borne in mind that UK banks went into this pandemic with strong balance sheets. Indeed, the Financial Policy Committee (FPC) report on 6th August revised down their expected credit losses for the banking sector to "somewhat less than £80bn". 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%.

10.6 All three rating agencies have reviewed banks around the world with similar results in many countries of most banks being placed on negative watch, but with a small number of actual downgrades.

10.7 Link, the Council's treasury management advisors, have conducted some stress testing on their credit methodology-based list of counterparties supplied to clients, to test for the results of a 1 notch downgrade to all Long-Term Ratings from all agencies. Under such a scenario, only Commerzbank, Norddeutsche Landesbank, NatWest Markets Plc (non-ring-fenced entity), Leeds, Skipton and Yorkshire Building Societies moved from Green (maximum suggested duration of 100 days) to No Colour (not to be used). While there are a further 17 drops in other entities' suggested durations, in these instances, these entities still remain potentially available for use. (Note that this scenario excludes any additional impact from relative movement in CDS pricing).

10.8 The current investment counterparty criteria selection approved in the TMSS, and attached as Appendix 2, is meeting the requirement of the treasury management function.

Investment Balances

10.9 The average level of funds available for investment purposes during the year to 30th September 2020 was £17.136m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and Capital Programme expenditure.

Table 9. Investment Performance Year to Date as at 30th September 2020

Period	LIBID Benchmark Return	Council Performance	Investment Interest Earned
	%	%	£m
7 Day	(0.06)	0.22	0.037

10.10 The Council also has £15.000m invested in the CCLA Property Fund which is a long-term investment and has received an income of £0.300m over the six-month period to September 2020. The total return on the fund is 3.95%.

10.11 Officers can confirm that the approved limits within the Annual Investment Strategy (attached as Appendix 2) were not breached during the quarter ended 30th September 2020.

11 CONTRIBUTION TO STRATEGIC AIMS

11.1 The Council's vision to ensure that Reading realises its potential – and to ensure that everyone who lives and works in Reading can share the benefits of its success. The Council has six priorities which contribute to delivering this vision. The priorities are:

- Securing the economic success of Reading;
- Improving access to decent housing to meet local needs;
- Protecting and enhancing the lives of vulnerable adults and children;
- Keeping Reading's environment clean, green and safe;
- Promoting health, education, culture and wellbeing; and
- Ensuring the Council is fit for the future.

11.2 Delivery of the Council's revenue and capital budgets is essential to ensuring the Council meets its strategic aims and remains financially sustainable going forward. The treasury management functions are crucial in ensuring that the Council has access to funds when required and in investing surplus funds in secure investments.

12 COMMUNITY ENGAGEMENT AND INFORMATION

12.1 Budget-related communications and consultations will continue to be a priority over the next three years as we work to identify savings.

13 ENVIRONMENTAL IMPACT

13.1 None have been identified as arising directly from this report.

14 EQUALITY IMPACT ASSESSMENT

14.1 None have been identified as arising directly from this report.

15 LEGAL IMPLICATIONS

15.1 None have been identified as arising directly from this report.

16 FINANCIAL IMPLICATIONS

16.1 The financial implications are set out in the body of the report.

17 BACKGROUND PAPERS

- Treasury Management Strategy 2020/21
- Quarter 2 Performance Report 2020/21

Appendix 1 – Economics Update

1. As expected, the Bank of England's Monetary Policy Committee kept Bank Rate unchanged on 6th August at 0.10%. 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 7.5% 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.

2. 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.

3. 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 1st 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.

4. 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 quantitative easing.

5. 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 is one area that has already seen huge growth.

6. 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

7. 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%.

Appendix 2 - Investment Criteria & Limits

	Credit Rating	Cash Limit	Time Limit
Banks and organisations and securities whose lowest long-term credit rating published by Fitch, Moody's or Standard & Poor is:	AAA	£20m each	5 Years
	AA+		3 Years
	AA		
	AA-		2 Year
	A+		
	A		1 Year
	A-		
The Council's current account, Lloyds Bank Plc should circumstances arise when it does not meet above criteria	N/A	£1m	Next Day
UK Building Societies without credit rating	N/A	£10m	1 Year
UK Government (irrespective of credit rating)	N/A	Unlimited	50 Years
UK Local Authorities (irrespective of credit rating)	N/A	£20m each	50 Years
UK Registered Providers of Social Housing whose published long-term credit rating is A- or higher	A-	£5m	2 Years
UK Registered Providers of Social Housing whose published long-term credit rating is lower than A- or without a long-term credit rating	N/A	£2m	1 Year
	Fund rating	**Cash Limit**	**Time**
Money Market Funds	AAA	£20m	liquid
Pooled Funds (including pooled property funds)	AAA	£20m	liquid

Other Limits

a) **Non-specified investment limit.** The Council has determined that it will limit the maximum total exposure to non-specified investments at £20m maximum.

b) **Country limit.** The Council has determined that it will only use approved counterparties from the UK and from countries with a minimum sovereign credit rating of *AA-* from Fitch or equivalent.

c) **Other limits.** In addition:

- no more than £20m will be placed with any non-UK country at any time;
- limits in place above will apply to a group of companies;
- sector limits will be monitored regularly for appropriateness.

Upper limit for principal sums invested for longer than 365 days

	2020/21	2021/22	2022/23
Principal sums invested for longer than 365 days	£20m	£20m	£20m