Item: 7

Policy and Resources Committee: 3 December 2020.

Treasury Management – Mid-Year Update.

Report by Head of Finance.

1. Purpose of Report

To provide a mid-year update in respect of the Council's treasury management function for the period 1 April to 30 September 2020.

2. Recommendations

The Committee is invited to scrutinise:

2.1.

The mid-year update, attached as Appendix 1 to this report, prepared by Link Treasury Services, the Council's Treasury Adviser, which covers the following elements of treasury management, in order to obtain assurance that the Treasury Management Practices have operated effectively:

- An economic update for the period 1 April to 30 September 2020.
- A review of the Treasury Management Strategy Statement 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 compliance with Treasury and Prudential Limits for 2020/21.

3. Background

3.1.

Section 21 of the Financial Regulations confirms that the Council has adopted the key recommendations of Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Sector Code of Practice (the Code).

3.2.

The revised Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management in the Public Services (2011) further expands the definition of treasury management to include investment activities.

3.3.

The Council's investment priorities can be summarised as maintaining:

- The security of capital.
- The liquidity of its investments.

3.4.

The Council aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of the Council is low in order to give priority to security of its investments. This is in keeping with the nature of the Strategic Reserve Fund, which is to provide for the benefit of Orkney and its inhabitants, whilst having regard to the Fund's long term obligations in terms of the decline and decommissioning of the Flotta Oil Terminal in the future.

3.5.

The Financial Regulations refer to maintenance of the Treasury Management Policy Statement and Treasury Management Practices as the cornerstone for effective treasury management and the requirement to report annually on the Treasury Management function.

4. Treasury Management Performance

4.1.

A detailed analysis of the Treasury Management Performance for financial year 2020/21, as at 30 September 2020, is attached as Appendix 1 to this report, and covers the following activities:

- Borrowing activity.
- Temporary loans.
- Strategic Reserve Fund.

4.2.

The conclusion of the analysis of performance is that existing treasury management practices have operated effectively over the first six months of financial year 2020/21.

4.3.

Recurring slippage continues to be a feature within the approved capital programme. In financial year 2019/20 works valued at £14,356,000 were re-profiled into future financial years. Not only does this impact on the cost of delivering the capital programme works, it also delays the timescale over which the capital finance is required.

4.4.

The Council has established an authorised limit for external debt of £75,000,000 for the three-year period 2020 to 2023, together with an operational boundary of £65,000,000, as part of its Treasury Management Strategy for 2020 to 2023.

4.5.

The Council supports its capital financing requirement through a combination of borrowings and use of internal reserves. In determining this combination, the cost of raising additional finance or borrowing is compared against the opportunity cost of using internal reserves and balances, in that these funds could otherwise be generating an investment return for the Council. On the basis the capital financing requirement can be externalised through borrowings, and investment returns generated in excess of the cost of any borrowings to meet the requirements of the capital programme, the potential exists for a net saving to be realised by the treasury management function over the longer term.

4.6.

As at 30 September 2020, the Council's debt portfolio stood at £35,128,000, with loan maturities ranging over periods from 2 to 50 years. Overall this represents an average cost of borrowing of 3.15% per annum, with an average weighted duration of 44.4 years.

4.7.

The cost of this debt is managed as part of the loan charges associated with the capital programme and has been offset in the short term with surplus funds placed on deposit for periods of up to one year at an average rate of 0.65% for the first half of financial year 2020/21.

4.8.

Although there remains much uncertainty over interest rates, with the long-term trend prediction for rates to rise, the Council should be well placed to benefit from savings on loan charges over the longer term.

4.9.

The prime objective for the managed funds remains to maintain or increase their real value over time, while at the same time generating an annual return which meets the targets set by the Council. These objectives normally require to be measured over a number of years while acknowledging that abnormal fluctuations in the short term do create a cause for concern.

4.10.

The Head of Finance developed an Action Plan, in consultation with Hymans Robertson, to commence the process of implementation of revisions to the investment strategy previously agreed by the Investments Sub-committee on 25 February 2019, including further diversification. Interviews with potential fund managers took place in August and October 2019 after which fund managers were appointed to three new mandates, as follows:

- Global Alpha.
- Global Private Loan Fund III.
- UK Strategic Alternative Income Fund.

4.11.

The process of diversification to the new mandates commenced in financial year 2019/20 and continues in financial year 2020/21.

5. Corporate Governance

This report relates to the Council complying with its governance and financial processes and procedures and therefore does not directly support and contribute to improved outcomes for communities as outlined in the Council Plan and the Local Outcomes Improvement Plan.

6. Financial Implications

The financial implications are contained within the body of the report.

7. Legal Aspects

7.1.

Treasury Management arrangements help the Council meet its statutory obligation to secure best value.

7.2.

Section 40 of the Local Government in Scotland Act 2003 provides local authorities with the power to invest money. This power may be exercised in accordance with regulations made by Scottish Ministers under this section.

7.3.

Section 95 of the Local Government (Scotland) Act 1973 states that every local authority shall make arrangements for the proper administration of their financial affairs and shall secure that the proper officer has responsibility for the administration of those affairs.

8. Contact Officers

Gareth Waterson, Head of Finance, extension 2103, Email
gareth.waterson@orkney.gov.uk

Colin Kemp, Corporate Finance Senior Manager, extension 2106, Email
colin.kemp@orkney.gov.uk

9. Appendix

Appendix 1: Treasury Management Update – Mid-year review 2020/21

Appendix 1.

Treasury Management Strategy Statement and Annual Investment Strategy

Mid-Year Review Report 2020/21
Orkney Islands Council

1. Background

1.1 Capital Strategy
In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued revised Prudential and Treasury Management Codes. As from 2020/21, all local authorities have been required to prepare a Capital Strategy which is to provide the following: -

- a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services;
- an overview of how the associated risk is managed;
- the implications for future financial sustainability.

1.2 Treasury management
The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

Accordingly, treasury management is defined as:

> "The management of the local authority'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. Introduction

This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).
The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. Receipt by the full Council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report covering activities during the previous year.
4. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
5. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is Policy and Resources Committee.

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

- An economic update for the first half of the 2020/21 financial year;
- A review of the Treasury Management Strategy Statement 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.

3. Economics and interest rates

3.1 Economics update

- As expected, the Bank of England's Monetary Policy Committee kept Bank Rate unchanged on 6th August. 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 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.
- 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.

3.2 Interest rate forecasts

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

Link Group Interest Rate View 11.8.20	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
3 month average earnings	0.05	0.05	0.05	0.05	0.05	-	-	-	-	-
6 month average earnings	0.10	0.10	0.10	0.10	0.10	-	-	-	-	-
12 month average earnings	0.15	0.15	0.15	0.15	0.15	-	-	-	-	-
5yr PWLB Rate	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	2.20	2.20	2.20	2.30	2.30	2.30
25yr PWLB Rate	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	2.40	2.40	2.40	2.50	2.50	2.50	2.50

Additional notes by Link on this forecast table: -

- *Please note that we have made a slight change to our interest rate forecasts table above for forecasts for 3, 6 and 12 months. Traditionally, we have used LIBID forecasts, with the rate calculated using market convention of 1/8th (0.125%) taken off the LIBOR figure. Given that all LIBOR rates up to 6 months are currently running below 0.1%, using that convention would give negative figures as forecasts for those periods. However, the liquidity premium that is still in evidence at the short end of the curve, means that the rates actually being achieved by local authority investors are still modestly in positive territory. While there are differences between counterparty offer rates, our analysis would suggest that an average rate of around 0.05% is achievable for 3 months, 0.1% for 6 months and 0.15% for 12 months.*
- *During 2021, Link will be continuing to look at market developments in this area and will monitor these with a view to communicating with clients when full financial market agreement is reached on how to replace LIBOR. This is likely to be an iteration of the overnight SONIA rate and the use of compounded rates and Overnight Index Swap (OIS) rates for forecasting purposes.*
- *If clients require forecasts for 3 months to 12 months beyond the end of 2021, a temporary fix would be to assume no change in our current forecasts.*

We will maintain continuity by providing clients with LIBID investment benchmark rates on the current basis.

The coronavirus outbreak has done huge economic damage to the UK and 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 meeting on 6th August (and the subsequent September meeting), 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 last 30 years. 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 spiked up during the initial phases of the health crisis in March, we have seen these yields fall sharply 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: this 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 of the day on 30th September, all gilt yields from 1 to 6 years were in negative territory, while even 25-year yields were at only 0.76% and 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 General Fund capital schemes, at the same time as 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; this was to end on 4th June, but that date was subsequently put back to 31st July. It is clear HM Treasury will no longer allow local authorities to borrow money from the PWLB to purchase commercial property if the aim is solely 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 PWLB 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.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably relatively even but is subject to major uncertainty due to the virus.
- There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away 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 so PWLB rates), in the UK.

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

- **UK** - second nationwide wave of virus infections requiring a national lockdown
- **UK / EU trade negotiations** – if it were to cause significant economic disruption and a fresh major downturn in the rate of growth.

- **UK - Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis.** The ECB has taken monetary policy action to support the bonds of EU states, with the positive impact most likely for "weaker" countries. In addition, the EU recently agreed a €750bn fiscal support package. These actions will help shield weaker economic regions for the next year or so. However, in the case of Italy, the cost of the virus crisis has added to its already huge debt mountain and its slow economic growth will leave it vulnerable to markets returning to taking the view that its level of debt is unsupportable. There remains a sharp divide between northern EU countries favouring low debt to GDP and annual balanced budgets and southern countries who want to see jointly issued Eurobonds to finance economic recovery. This divide could undermine the unity of the EU in time to come.
- Weak capitalisation of some **European banks**, which could be undermined further depending on extent of credit losses resultant of the pandemic.
- **German minority government & general election in 2021.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. The CDU has done badly in subsequent state elections, but the SPD has done particularly badly. Angela Merkel has stepped down from being the CDU party leader, but she intends to remain as Chancellor until the general election in 2021. This then leaves a major question mark over who the major guiding hand and driver of EU unity will be when she steps down.
- **Other minority EU governments.** Austria, Sweden, Spain, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been a rise in anti-immigration sentiment in Germany and France.
- **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.
- **US – the Presidential election in 2020:** this could have repercussions for the US economy and SINO-US trade relations.

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

- **UK -** stronger than currently expected recovery in UK economy.
- **Post-Brexit** – if an agreement was reached that removed the majority of threats of economic disruption between the EU and the UK.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.

4. Treasury Management Strategy Statement and Annual Investment Strategy Update

The Treasury Management Strategy Statement, (TMSS), for 2020/21 was approved by this Council on 18th February 2020.

There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

Prudential Indicator 2020/21	£m
Authorised Limit	75.000
Operational Boundary	65.000
Capital Financing Requirement	63.958

5. The Council's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

5.1 Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed.

Capital Expenditure by Service	2020/21 Original Estimate £m	Current Position £m	2020/21 Revised Estimate £m
Social Care	9.682	(0.337)	0.974
Roads and Transportation	0.977	0.294	1.782
Education and Leisure	3.585	0.307	2.357
Marine Services	5.262	6.708	9.404
Other Services	5.198	0.716	4.480
HRA	2.530	0.575	2.825
Total capital expenditure	27.234	8.263	21.822

5.2 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	2020/21 Original Estimate £m	Current Position £m	2020/21 Revised Estimate £m
Total capital expenditure	**27.234**	**8.263**	**21.822**
Financed by:			
Capital receipts	**0.150**	**0.251**	**0.251**
Capital grants	**8.258**	**3.551**	**8.481**
Capital reserves	**8.713**	**0.000**	**0.893**
Revenue	**0.866**	**0.000**	**0.648**
Total financing	**17.987**	**3.802**	**10.273**
Borrowing requirement	**9.247**	**4.461**	**11.549**

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

The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. Note - this figure includes approximately £15m of local investment property assets that were purchased or developed directly through the Strategic Reserve Fund prior to the current capital accounting requirements being introduced on 1 April 2007. It also shows the expected debt position over the period, which is termed the Operational Boundary.

Prudential Indicator – Capital Financing Requirement

We are currently estimating an increase in our forecast Capital Financing Requirement due to the addition of Harbour and Housing Revenue projects, which are to be fully funded by borrowing from the loans fund.

Prudential Indicator – the Operational Boundary for external debt

	2020/21 Original Estimate £m	2020/21 Revised Estimate £m
Prudential Indicator – Capital Financing Requirement		
CFR – non housing	50.861	53.423
CFR – housing	13.097	12.837
Total CFR	63.958	66.260
Net movement in CFR	**7.056**	**9.358**
Prudential Indicator – the Operational Boundary for external debt		
Borrowing	65.000	65.000
Total debt (year-end position)	**35.114**	**35.114**

5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. **Gross external borrowing** should not, except in the short term, exceed the total of 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.

	2020/21 Original Estimate £m	2020/21 Revised Estimate £m
Borrowing	10.000	10.000
Total debt	35.114	35.114
CFR (year end position)	63.958	66.260

A further prudential indicator controls the overall level of borrowing. This is **the Authorised Limit** which represents the limit beyond which borrowing is prohibited and needs to be set and revised by Members. 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. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government in Scotland Act 2003.

Authorised limit for external debt	2020/21 Original Indicator	2020/21 Revised Indicator
Borrowing	75.000	75.000
Total	75.000	75.000

6. Borrowing

The Council's capital financing requirement (CFR) for 2020/21 is estimated at £66.260m. The CFR denotes the Council's underlying need to borrow for capital purposes. 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). The balance of external and internal borrowing is generally driven by market conditions. Table 5.4 shows the Council has borrowings of £35.114m and has utilised £31.146m 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.

Due to the overall financial position and the underlying need to borrow for capital purposes (the CFR), new external borrowing of £10.000m was undertaken on 26th March 2020. However, due to the increase in PWLB margins over gilt yields in October 2019, and the subsequent consultation on these margins by HM Treasury - which ended on 31st July 2020 - the Authority has refrained from undertaking new long-term PWLB borrowing for the present and has met its requirements for additional borrowing by using short-term borrowing until such time as new PWLB margins are finally determined. In addition, the effect of coronavirus on the capital programme objectives are being assessed. Therefore, our borrowing strategy will be reviewed and then revised in order to achieve optimum value and risk exposure in the long-term.

It is anticipated that further borrowing will not be undertaken during this financial year.

PWLB maturity certainty rates (gilts plus 180bps) year to date to 30th September 2020

PWLB rates varied within a relatively narrow range between April and July but the longer end of the curve rose during August. This increase came in two periods; the first in the second week of the month was on the back of hopes for fresh US stimulus. This saw investors switch monies out of government bonds and into equities. The second shift higher at the longer end of the curve came in the latter stages of the month as investors reacted to the announcement of the tweak to the Fed's inflation target. Despite moves further out in the yield curve, the short end remained anchored on the basis of no fundamental change to the interest rate outlook.

The 50-year PWLB target rate for new long-term borrowing was unchanged at 2.30%.

7. Debt Rescheduling

Debt rescheduling opportunities have been very limited in the current economic climate and following the various increases in the margins added to gilt yields which have impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

8. Compliance with Treasury and Prudential Limits

It is a statutory duty for the Council to determine and keep under review the affordable capital expenditure limits. 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. The Head of Finance reports that no difficulties are envisaged for the current or future years in complying with these indicators.

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

9. Annual investment strategy

The Treasury Management Strategy Statement (TMSS) for 2020/21, which includes the Annual Investment Strategy, was approved by the Council on 18th 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

The Council will aim 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 investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with high credit rated financial institutions, using the Link suggested creditworthiness approach, including a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information.

As shown by the interest rate forecasts in section 2, it is now impossible to earn the level of interest rates 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 this risk environment and the fact that 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.

Negative investment rates
While the Bank of England has said that it is unlikely to introduce a negative Bank Rate, at least in the next 6 -12 months, some deposit accounts are already offering negative rates for shorter periods. As part of the response to the pandemic and lockdown, the Bank and the Government have provided financial markets and businesses with plentiful access to credit, either directly or through commercial banks. In addition, the Government has provided large sums of grants to local authorities to help deal with the Covid-19 crisis; this has caused some local authorities to have sudden large increases in investment balances searching for an investment home, some of which was only very short term until those sums were able to be passed on.

As for money market funds (MMFs), yields have continued to drift lower. Some managers have suggested that they might resort to trimming fee levels to ensure that net yields for investors remain in positive territory where possible and practical. Investor cash flow uncertainty, and the need to maintain liquidity in these unprecedented times, has meant there is a glut of money swilling around 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 MMFs are still offering a marginally positive return, as are a number of financial institutions.

Inter-local authority lending and borrowing rates have also declined due to the surge in the levels of cash seeking a short-term home at a time when many local authorities are probably having difficulties over accurately forecasting when disbursements of funds received will occur or when further large receipts will be received from the Government.

Creditworthiness.
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 were affirmed due to the continuing strong credit profiles of UK banks. However, during Q1 and Q2 2020, banks made provisions for *expected* credit losses and the rating changes reflected these provisions. As we move into the next quarters ahead, more information will emerge on *actual* levels of credit losses. (Quarterly performance is normally announced in the second half of the month following the end of the quarter.) This has the potential to cause rating agencies to revisit their initial rating adjustments earlier in the current year. 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". They stated that in their 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%.

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.

Link have conducted some stress testing on the Link 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 to No Colour. 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.)

Investment Counterparty criteria
The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

CDS prices
Although CDS prices, (these are market indicators of credit risk), for UK banks spiked upwards at the end of March / early April due to the liquidity crisis throughout financial markets, CDS prices have returned to more average levels since then, although they are still elevated compared to end-February. Pricing is likely to remain volatile as uncertainty continues. **However, sentiment can easily shift, so it remains important to undertake continual monitoring of all aspects of risk and return in the current circumstances.**

Investment balances
The average level of funds available for investment purposes during the first 6 months of financial year 2020/21 was **£37.800m**. 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 progress on the capital programme. The temporary loans portfolio has operated within policy during financial year 2020/21 and has realised a return of £122,000 at a rate of 0.65%, as at 30 September 2020. This is ahead of the average 3 months LIBOR (London Inter-Bank Offered Rate) performance benchmark (0.06%) and is therefore considered an acceptable return.

Treasury Portfolio investments held at 30 September 2020:

Treasury Investments – Managed in house	Principal (£m)	Interest Rate	Maturity Date
Lancashire County Council	2.000	1.02%	14/10/2020
West Dunbartonshire Council	3.000	0.35%	26/01/2021
West Dunbartonshire Council	4.000	0.15%	29/03/2021
National Westminster Bank Plc	3.000	0.9%	09/06/2021
Bank of Scotland Plc	4.000	0.20%	95-day notice
Santander UK Plc	2.000	0.47%	35-day notice
Bank of Scotland Plc	1.000	0.10%	Call
Santander UK Plc	2.000	0.70%	Call
Bank of Scotland Plc	1.000	0.10%	Call
Santander UK Plc	2.000	0.70%	Call
Santander UK Plc	2.000	0.70%	Call
Aberdeen Standard Investments Money Market Fund	7.700	0.09%	Call
The Royal Bank of Scotland	0.100	0.01%	Call
Total investments	33.800		

Non-Treasury Strategic Reserve Fund Local Investments – Managed in-house	Actual (£m)	Performance in 19/20
Fishing Quota	2.769	5.4%
Private Companies	4.436	5.0%
Other	0.013	0.0%
Total Strategic Reserve Fund Investments – Managed in-house	7.218	

Treasury Strategic Reserve Fund – Managed externally	Actual (£m)	Performance Quarter ending 30/09/20	Benchmark
Equity Portfolio	42.700	-1.9%	3.7%
Global Equity Portfolio	50.800	7.1%	4.0%
Diversified Growth Fund	41.500	3.4%	0.8%
High Yield Credit Strategies Fund	20.200	3.8%	1.3%
Private Loan Fund	4.200	n/a	n/a
UK Property Fund	21.600	0.7%	0.2%
Fixed Income Fund	56.100	1.0%	1.4%
Total investments	237.100		

No performance data is currently available for the Private Loan Fund as we have not completed our full committed investment of £10m.

Approved limits
Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the quarter ended 30 September 2020.

10. Other

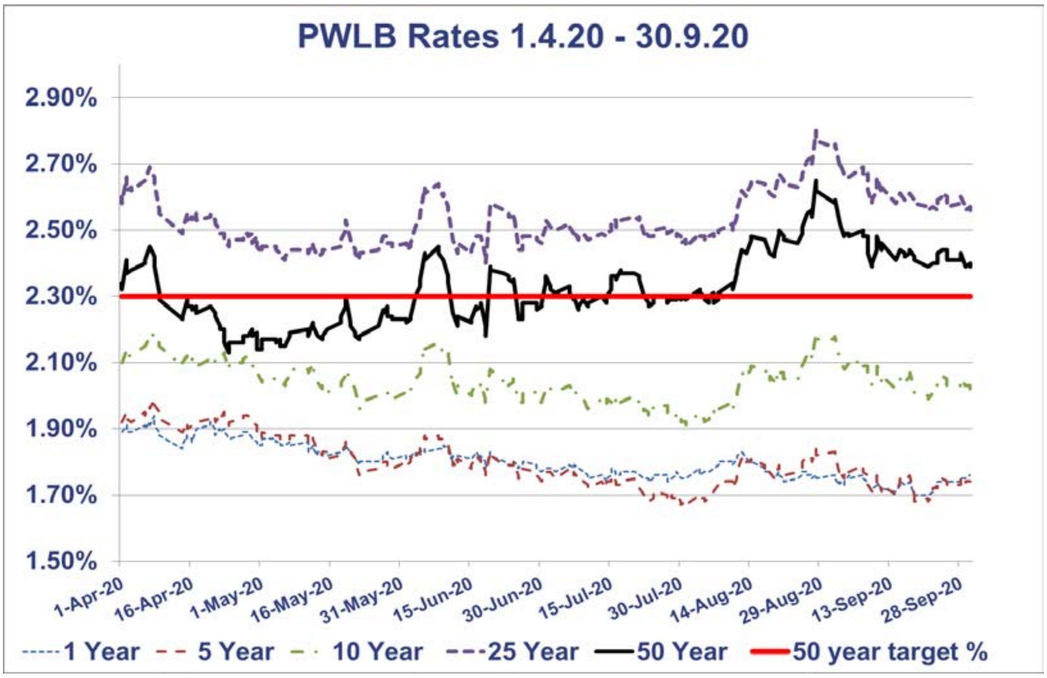
1. Changes in risk appetite
The 2018 CIPFA Codes and guidance notes have placed enhanced importance on risk management. Where an authority changes its risk appetite e.g. for moving surplus cash into or out of certain types of investment funds or other types of investment instruments, this change in risk appetite and policy should be brought to members' attention in treasury management update reports.

No changes have taken place during financial year 2020/21 however it should be noted that the on 28 February 2019, the Investments Sub-committee reviewed the current investment strategy and resolved to further diversify into Illiquid Debt and Secured Income by way of direct investment to a pooled fund. It was further resolved that the equity allocation be split on a 50/50 basis between funds held on a growth basis, with a newly appointed Fund Manager, whilst retaining the existing Fund Manager on a simplified single global equity strategy with the existing value style bias. The Corporate Bonds allocation will be transferred to a specialist passive manager. These diversifications will be matched by a proportionate reduction in growth assets.

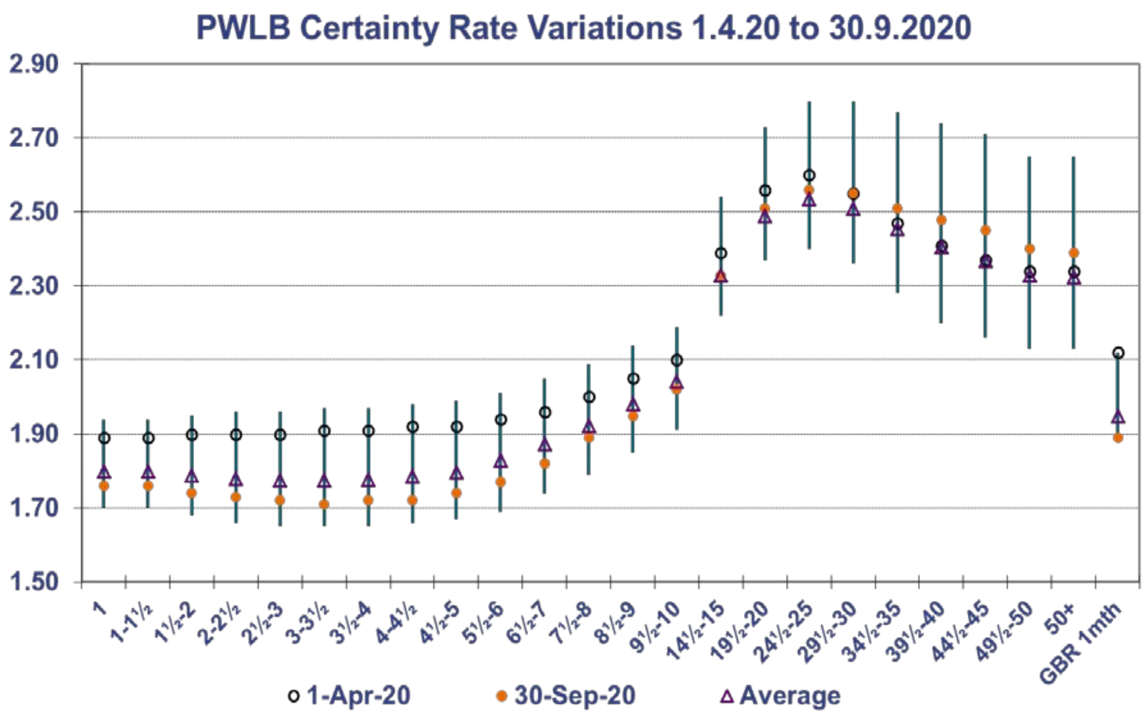
The onboarding process for the new mandates commenced in 2019/20 but is continuing in financial year 2020/21 with the transfer to a growth style Fund Manager now complete and part of the agreed commitment placed in a Private Loan Fund. The onboarding with the Passive Bond Manager is due to take place before the end of this financial year.

APPENDIX 1: Borrowing rates

The following graph and tables are optional for clients to use if they wish.



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.70%	1.67%	1.91%	2.40%	2.13%
Date	18/09/2020	30/07/2020	31/07/2020	18/06/2020	24/04/2020
High	1.94%	1.99%	2.19%	2.80%	2.65%
Date	08/04/2020	08/04/2020	08/04/2020	28/08/2020	28/08/2020
Average	1.80%	1.80%	2.04%	2.54%	2.33%



APPENDIX 2: Approved countries for investments as at 30th September 2020

Clients may wish to draw the attention of members to any changes to their approved list of countries for investments since their last report to members.

Based on lowest available rating

AAA

- Australia
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Canada
- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France

AA-

- Belgium
- Hong Kong
- Qatar
- **U.K.**