Somerset County Council

Cabinet
– 20th July 2020

PAPER B - Annual Treasury Management Outturn Report 2019-20

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Division and Local Member: All
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Report Sign off	**Seen by:**	**Name**	**Date**
	County Solicitor	Honor Clarke	08/07
	Monitoring Officer	Scott Wooldridge	08/07
	Corporate Finance	Stephen Morton	01/06
	Human Resources	Chris Squire	16/06
	Senior Manager	Jason Vaughan	03/06
	Cabinet Member	Cllr Mandy Chilcott	15/06
Forward Plan Reference:	FP/19/05/11		
Summary:	The Annual Treasury Management Outturn Report is a requirement of the CIPFA Treasury Management Code and covers the Treasury Management activity for 2019-20. This report: • Is prepared in accordance with the CIPFA Treasury Management Code and the Prudential Code. • Gives details of the outturn position on treasury management transactions in 2019-20. • Presents details of capital financing, borrowing, and investment activity. • Reports on the risk implications of treasury decisions and transactions. • Confirms compliance with treasury limits and Prudential Indicators or explains non-compliance.		
Recommendations:	This is a formal report and the Cabinet is asked to approve it and submit it to Full Council on 29th July 2020.		
Reasons for Recommendations:	The Local Government Act 2003 requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services. The Code requires Full Council to receive as a minimum, an annual strategy and plan in advance of the year, a mid-year review, and an annual report after its close. This is the full-year review for 2019-20.		

Links to Priorities and Impact on Service Plans:	Effective Treasury Management provides support to the range of business and service level objectives that together help to deliver the Somerset County Plan.
Consultations undertaken:	Not Applicable
Financial Implications:	None directly
Legal Implications:	None
HR Implications:	None
Risk Implications:	There are no specific risks associated with this outturn report. The risks associated with Treasury Management are dealt with in the Annual Treasury Management Strategy, Annual Investment Strategy, and Treasury Management Practice documents.
Other Implications (including due regard implications):	None
Scrutiny comments / recommendation (if any):	The Audit Committee is the nominated body to provide scrutiny for Treasury Management.

1. Background

The Council's treasury management activities are regulated by a variety of professional codes, statutes and guidance. A more detailed outline of these, including the Treasury Management Framework and Policy is given at **appendix A**.

Somerset County Council (SCC) has adopted the CIPFA Code of Practice for Treasury Management and operates its treasury management service in compliance with this Code and the requirements in **appendix A**. The Code requires as a minimum, a formal report on treasury activities and arrangements to Full Council mid-year and after the year-end. These reports enable those tasked with implementing policies and undertaking transactions to demonstrate they have properly fulfilled their responsibilities and enable those with ultimate responsibility/governance of the treasury management function to scrutinise and assess its effectiveness and compliance with policies and objectives.

Whilst headline figures can be a useful guide to performance, they should not be viewed in isolation. It is important to also assess performance against the stated objectives and specific needs of SCC during the year, and to take a wider view in relation to timeframes and overall risk management. There are many factors and circumstances that affect treasury activity and performance that are not immediately apparent from statistical reports. Activities undertaken may be directly attributable to good risk management or preferred risk tolerances. Some limitations to purely statistical analyses are outlined in **appendix B.**

Useful comparison has been further eroded as many Local Authorities are investing in non-financial assets, with the primary aim of generating profit. Others are entering into very long-term investments or are providing loans to local enterprises or third sector entities as part of regeneration or economic growth projects. It is impossible to standardise and meaningfully compare returns, particularly for a given timeframe, and it is also extremely difficult to understand, quantify, and compare risks.

2 Treasury outturn and performance

2.1 Economic background

Financial markets are constantly changing, both proactively in anticipation of upcoming scenarios and events, and reactively, in response to news and outcomes. Whilst it is important to review and report on performance, it must be borne in mind that Treasury decisions are made in dynamic conditions. It is important therefore to give some background and context to Treasury performance.

The UK's exit from the European Union and future trading arrangements had remained one of the major influences on the UK economy and sentiment during 2019-20. The 29th March 2019 Brexit deadline was extended to 12th April, then to 31st October and finally to 31st January 2020. Politics played a major role in financial markets over the period and drove volatility, particularly in foreign exchange markets. The outcome of December's General Election removed a lot of the uncertainty and looked set to provide a 'bounce' to confidence and activity.

GDP growth in Q4 2019 was reported as flat by the Office for National Statistics as service sector growth slowed and production and construction activity contracted on the back of what at the time were concerns over the impact of global trade tensions on economic activity. The annual rate of GDP growth remained below-trend at 1.1%.

The headline rate of UK Consumer Price Inflation fell to 1.5% year-on-year in March, below the Bank of England's target of 2%.

Labour market data remained positive. The International Labour Organisation (ILO) unemployment rate was 3.9% in the three months to March 2020 while the employment rate hit a record high of 76.6%. The average annual growth rate for pay excluding bonuses was 2.7% in March 2020.

Then coronavirus swiftly changed everything. Covid-19, started spreading across the globe causing plummeting sentiment and falls in financial markets not seen since the Global Financial Crisis of 2008, as part of a flight to quality into sovereign debt and other perceived 'safe' assets.

In response to the spread of the virus, governments enforced lockdowns, and central banks and governments around the world cut interest rates and introduced massive stimulus packages in an attempt to reduce some of the negative economic impact to domestic and global growth.

The Bank of England, which had held policy rates steady at 0.75% through most of 2019-20, moved on March 11th to cut rates to 0.25% from 0.75% and then on March 19th brought them down further to the record low of 0.1%. In conjunction with these cuts, the UK government introduced a number of measures to help businesses and households impacted by a series of ever-tightening social restrictions, culminating in pretty much the entire lockdown of the UK.

The US economy grew at an annualised rate of 2.1% in Q4 2019. After escalating trade wars and a protracted standoff, the signing of Phase 1 of the trade agreement between the US and China in January was initially positive for both economies, but Covid-19 severely impacted sentiment and production in both countries. The US Federal Reserve began cutting rates in August, and following a series of five cuts, the rate fell to a range of 0% - 0.25%.

With interest rates already on (or below) the floor, the European Central Bank held its base rate at 0% and deposit rate at -0.5%.

Financial markets: Financial markets sold off sharply as the impact from the coronavirus worsened. After starting positively in 2020, the FTSE 100 fell over 30% at its worst point with stock markets in other countries seeing similar huge falls. In March sterling touched its lowest level against the dollar since 1985. The measures implemented by central banks and governments helped restore some confidence and financial markets have rebounded in recent weeks but remain extremely volatile. The flight to quality caused gilts yields to fall substantially. The 5-year benchmark falling from 0.75% in April 2019 to 0.26% on 31st March. The 10-year benchmark yield fell from 1% to 0.4%, the 20-year benchmark yield from 1.47% to 0.76% over the same period.

Since the start of 2020, the yield on 2-year US treasuries had fallen from 1.573% to 0.20% and from 1.877% to 0.61% for 10-year treasuries. German bund yields remain negative.

With Base Rate remaining at 0.75% for the majority of the year money markets rates for periods up to 3-months averaged similar to those for the previous year. However, due to the negative sentiment caused by Brexit, average rates for periods over 6-months reduced. For a few days in March overnight LIBID actually turned negative.

1-month, 3-month, 6-month, and 12-month LIBID (London Interbank Bid) rates averaged 0.56%, 0.63%, 0.70%, and 0.80% respectively over the period.

A more detailed commentary on the year's events, and tables of relevant rates throughout the year is in **appendix C**.

2.2 The Treasury Position as at 31st March 2020

The Treasury position as at 31st March 2020 and a comparison with the previous year is shown in the table below. More detail behind the figures is given in **appendix D**.

Table 1 – Debt Portfolio

	Balance on 31-03-2019 £m	**Debt Matured / Repaid £m**	**New Borrowing £m**	**Balance on 31-03-2020 £m**	**Increase/ Decrease in Borrowing £m**
Short Term Borrowing	0.00	0.00	0.00	0.00	0.00
PWLB	159.05	0.00	0.00	159.05	0.00
LOBOs	108.00	0.00	0.00	108.00	0.00
Fixed Rate Loans	57.50	0.00	0.00	57.50	0.00
Total Borrowing	**324.55**	**0.00**	**0.00**	**324.55**	**0.00**

Table 2 – Debt interest

	31-03-2019 Rate %	**31-03-2020 Rate %**	**Increase/ Decrease Rate %**
Short Term Borrowing	0.00	0.00	0.00
PWLB	4.59	4.59	0.00
LOBOs	4.74	4.74	0.00
Fixed Rate Loans	4.73	4.73	0.00
Total Borrowing	**4.66**	**4.66**	**0.00**

The Council's need to borrow for capital purposes is determined by the Capital Programme and Capital Strategy. Council Members were aware of the major projects identified for 2019 to 2022. Capital projects identified were to be funded using a combination of grant, capital receipts, and contributions. Although timing of capital expenditure is never totally predictable, it was envisaged that borrowing of up to £90m may have been necessary.

As the differential between investment earnings and debt costs remained negative during 2019-20, a passive borrowing strategy, borrowing funds as they were required was deemed to be most appropriate. With capital spending far less than anticipated, no new borrowing was undertaken. The benefits of this strategy were monitored and weighed against the risk of shorter-term rates rising more quickly than expected.

During 2019-20, there were no scheduled debt maturities. The PWLB portfolio remained the same.

Table 3 – Investments as at 31st March 2020

	Balance as at 31-03-2019 £m	Rate of Return at 31-3-2019 %	Balance as at 31-03-2020 £m	Rate of Return at 31-03-2020 %
Short-Term Balances (Variable)	34.93	0.79	42.09	0.54
Cofund (Fixed)	150.00	1.03	127.00	0.90
CCLA Property Fund	10.00	4.35	15.00	4.63
Total Lending	**194.93**	**1.16**	**184.09**	**1.12**

Table 4 - Investment balances by type

	31 March 2019 £m	31 March 2020 £m	Change
Money Market Funds	34.93	27.09	-7.84
Notice Bank Accounts	25.00	75.00	+50.00
Time Deposits - Banks	77.00	25.00	-52.00
Time Deposits - LAs	48.00	42.00	-6.00
CCLA Property Fund	10.00	15.00	+5.00
Total Lending	**194.93**	**184.09**	**-10.84**

Table 5 - Breakdown of investment balances by source

	31 March 2019 £m	31 March 2020 £m	Change
ENPA / SWC	0.11	-0.04	-0.15
Organisations in the Comfund	7.48	7.40	-0.08
LEP – Growth Deal Grant	35.25	15.77	-19.48
Earmarked funds held on behalf of other decision-making bodies	6.20	13.1	+6.90
Total Externals	**49.04**	**36.23**	**-12.81**
SCC	145.89	154.76	+8.87
Total	**194.93**	**184.09**	**-10.84**

Total investment as at 31st March 2020, including unspent LEP money, stood at over £184m, a decrease of nearly £11m from 2019.

The investments balance was inflated in late March as SCC received £20m in the last few days of March, £15.9m related to a Covid-19 grant from Central Government, with a further £4.7m of Business Rates paid in advance from 2020-21 revenues.

The Comfund investment of £127.0m was £24.15m lower, whilst revenue lending was £7.16m higher as Government sent £20m with only a few days of the year left, to help tackle the Covid-19 pandemic. In February a further £5m was invested in the CCLA (Churches, Charities, Local Authorities) Property Fund, bringing that investment to £15m.

Revenue balances held on behalf of others at year-end decreased from £0.11m to -£0.04m. Investment in the Comfund by external bodies decreased slightly, from £7.48m to £7.40m. A smaller grant and an increase in spending by the LEP meant a reduction of £19.5m of that money. £36.23m was managed on behalf of others at year-end 2020, a decrease of £12.81m.

The cash managed on behalf of others includes that of Exmoor National Park Authority (ENPA) and South West Councils (SWC). Comfund external investors are a limited group of not-for-profit organisations with links to SCC.

In addition, during 2019-20, SCC was retained to manage the Local Enterprise Partnership (LEP) Growth Deal Grant on behalf of the other Enterprise Partners. A further grant of £13.6m was received on 30th April 2019 and added to the £35.25m already held. £15.77m was held on behalf of the LEP at year-end.

2.3 Summary of performance

During the year, Council treasury management policies, practices, and activities remained compliant with relevant statutes and guidance, namely the CLG investment guidance issued under the Local Government Act 2003, and the CIPFA Treasury Management and Prudential Codes. The Council can confirm that it has complied with its Prudential Indicators for 2019-20.

At year-end, with no new debt taken, total debt stood at £324.55m, with an average rate paid on total borrowings of 4.66%.

Security of capital remained the Council's main investment objective. This was achieved by following the counterparty policy as set out in the Annual Treasury Management Strategy, and by the approval method set out in the Treasury Management Practices. SCC has continuously monitored counterparties, and all ratings of proposed counterparties have been subject to verification on the day, immediately prior to investment.

There were few credit ratings changes during most of the year, but the spread of Covid-19, and Governments' responses to it, has meant closer scrutiny and analysis in March and April.

Fitch downgraded the UK sovereign rating to AA- in March 2020 which was followed by a number of actions on UK and Non-UK banks. This included revising the outlook on all banks on the counterparty list to negative, with the exception of Barclays Bank, Rabobank, Handelsbanken and Nordea Bank which were placed on Rating Watch Negative. Close Brothers long-term rating was cut to A-. HSBC Bank and HSBC UK Bank, however, had their long-term ratings increased by Fitch to AA-.

Having revised their outlooks to negative, Fitch upgraded the long-term ratings on Canadian and German banks but downgraded the long-term ratings for Australian banks.

The Bank of England announced its latest stress tests results for the main seven UK banking groups. All seven passed on both a common equity Tier 1 (CET1) ratio and a leverage ratio basis. Under the test scenario the banks' aggregate level of CET1 capital would remain twice their level before the 2008 financial crisis.

After remaining flat in January and February and between a range of 30-55bps, Credit Default Swap spreads rose sharply in March as the potential impact of the coronavirus on bank balance sheets gave cause for concern. Spreads declined in late March and through to mid-April but remain above their initial 2020 levels.

The average Credit Rating of the SCC investment portfolio (Excluding CCLA Property Fund) as at 31st March 2020 was AA-. To give this some perspective, the United Kingdom Government is rated one notch above at AA, although Fitch Ratings did drop their rating of the UK Government to AA- on 27th March.

An account of issues and any restrictions implemented throughout the year can be found in **appendix G.**

Liquidity. In keeping with the CLG guidance, the Council maintained a sufficient level of liquidity through the use of call accounts, Money Market Funds, and short-term deposits. SCC did not need to borrow short-term money during the year.

CCLA Property Fund. SCC added £5m to the existing £10m investment in the CCLA Property Fund, initially invested in May 2017. This Fund has been in existence for more than 25 years and is only available to Local Authorities. It is an actively managed, diversified portfolio of UK Commercial Property with a stated investment objective "to provide investors with a high level of income and long-term capital appreciation".

Yield (excluding property). Interest of £1.93m was earned on cash investments during 2019-20. The increase on the comparator figure for 2018-19 of £1.69m is largely due to placing more deposits for longer when rates were peaking. It was achieved on similar average balances as 2018-19. When compared with average cash rates for the year, the ex-property yield of 0.95% was 0.25% above the average 6-month LIBID rate, and 0.15% more than the average 12-month LIBID rate, on a portfolio with an average duration of less than 5-months.

Property fund. To 31st March the £15m investment (average £10.5m) in the CCLA Property Fund delivered an average net income yield of 4.23%.

Yield (including property). Interest of £2.37m was earned on total investments during 2019-20. When compared to the average risk-free deposit rate of approximately 0.50% offered by the Government Debt Management Office (DMO) throughout the year, the benefit of the SCC investment strategy across the average SCC investment balance of £214m for the year was just over £1.32m (£1.2m in 2018-19).

Security and liquidity have been achieved with the income return of 1.11% achieved for the year, being 0.31% above the average 12-month LIBID rate.

During the year, two further dividends were received from Kaupthing, Singer & Friedlander (KSF), £41,259.73 on 13th June 2019 and £36,102.26 on 19th December 2019 (A further £17,535.38 was received on 1st April 2020). A total of £8,922,415.78 has now been received from KSF. In total, as at 31st March 2020 £23,318,668.62 had been recovered on all Icelandic claims. More detail of the current position is in **appendix G**.

2.4 Temporary borrowing

Temporary borrowing has not been necessary at all during 2019-20.

2.5 Long term borrowing

The borrowing strategy for 2019-20 recognised that borrowing of up to £90m may have been necessary. As the differential between investment earnings and debt costs remained negative during 2019-20, a passive borrowing strategy, borrowing funds as they were required was pursued. With capital spending less than anticipated, no new borrowing was undertaken.

During 2019-20, there were no scheduled debt maturities. The debt portfolio therefore remained at £324.55m during the year. All details of long-term borrowing activity during the year can be found in **appendix F**.

2.6 Cash managed on behalf of others

During 2019-20 SCC provided treasury management services to the Police and Crime Commissioner for Avon and Somerset, after winning a full competitive tender to provide Treasury Management services for 3 years (+ optional 2 years extra) from April 2015.

As from 1st April 2020, a new contract has been signed, for Treasury Management services to be supplied to the Police, by SCC, on an ongoing basis, without the need for periodic tendering. Funds continue to be lent on a segregated basis, with PCC funds lent in its own name.

SCC continues to manage cash on behalf of other not-for-profit organisations including Exmoor National Park Authority (ENPA), and South West Councils (SWRC) via service level agreements and the Comfund vehicle. These balances were just under £7.4m at year-end.

In addition, during 2019-20, SCC was retained to manage the Local Enterprise Partnership (LEP) Growth Deal Grant on behalf of the other Enterprise Partners. A grant of £13.6m was received on 30th April 2019, and an average balance in excess of £43m was managed.

All treasury management activities, including a fee for the management of the LEP money, brought in income of nearly £132k during the year.

2.7 Lending

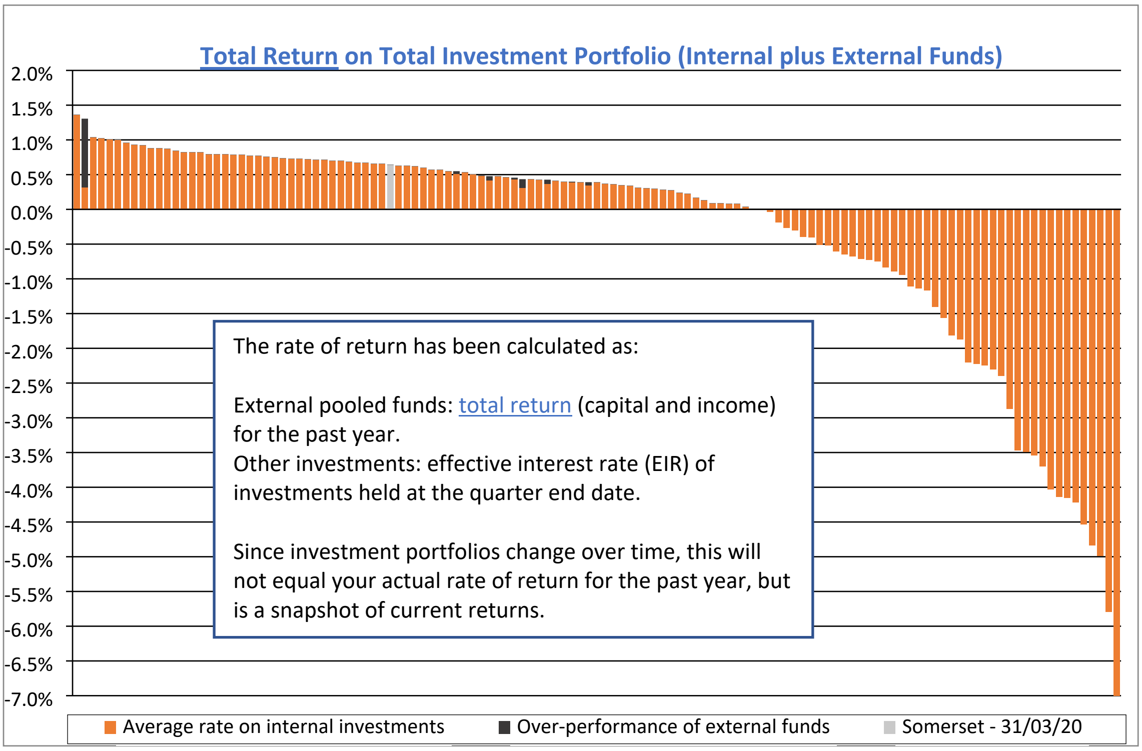
The average daily balance of the Council's investments during 2019-20 was £214.0m, down £0.4m from the previous year.

The weighted investment return of 1.11% was 0.41% better than the average 6-Month LIBID rate for the financial year. A more detailed commentary on activity and analysis of performance for the year can be found in **appendix G**.

2.8 Comparison against other Local Authorities clients of Arlingclose

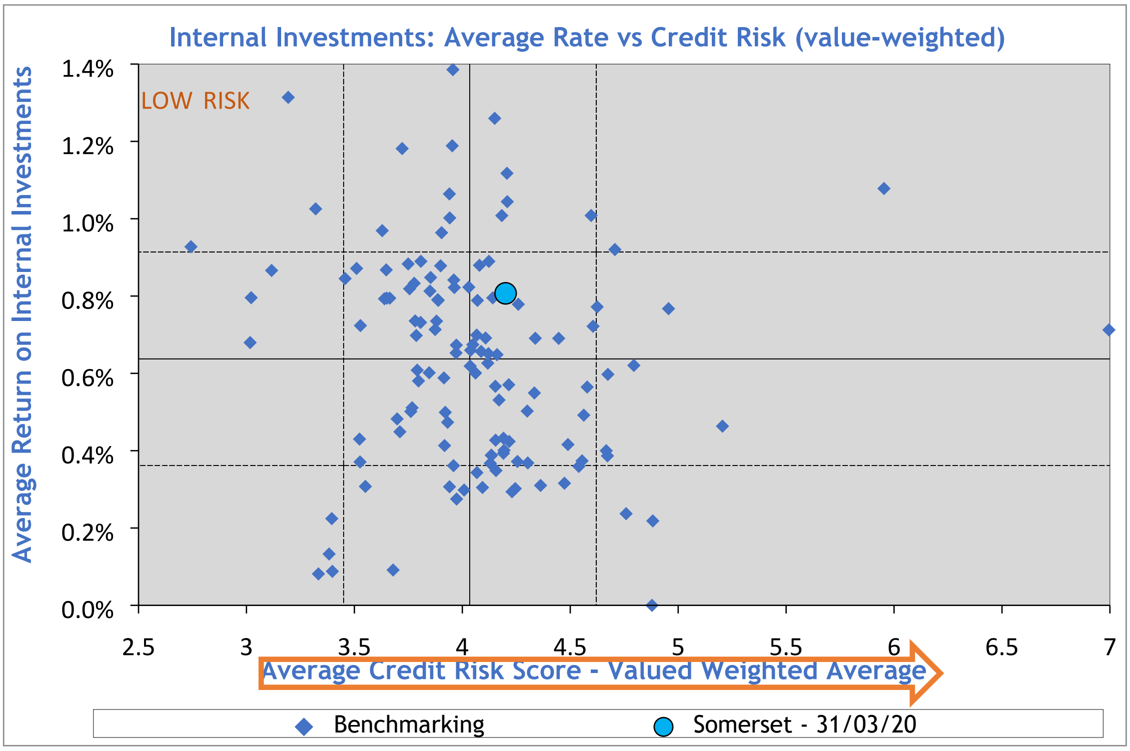
2019-20 was the eleventh complete year that SCC had the services of retained Treasury advisors, Arlingclose. It would therefore seem appropriate to look at SCC performance compared with other Authorities that use Arlingclose, i.e. that share much of the same investment advice, particularly regarding counterparties. However, many of the caveats mentioned in appendix B may apply. Furthermore, it has become apparent that some Authorities have been investing in non-financial assets and entering into very long-term investments or providing loans to local enterprises or third sector entities as part of regeneration or economic growth projects within their Treasury portfolios.

Returns as at 31st March 2020, including esoteric investments can be seen in the graph below (If in black & white, SCC is the bar below the first 'T' in the second 'Total' in the graph title.



A comparison of internally managed investments only is included below, showing performance on a returns v credit risk basis. Note: The Arlingclose report compares quarter-end figures only.

This graph shows that SCC has a return that is better than the average, with the average credit risk score slightly higher than other comparators.



When comparing the average days to maturity with that of other County Councils, the SCC average of 74 days is a full 1.6 years below the 644 days for other County Councils. This in part reflects the fact that the passive borrowing strategy pursued meant investments of shorter duration were held, another factor being that SCC was holding circa £43m of LEP money on behalf of its partners, so needed to retain more liquidity for payments. Performance relative to risk can be seen in the graphs along with more general detail in **appendix G**.

2.9 Prudential indicators

The Council can confirm that it has complied with its Prudential Indicators for 2019-20. Indicators that were set for the 2019-20 year, and the year-end position for each are set out in **appendix H**.

2.10 Non-financial assets, regulatory changes, and risk management

Some Local Authorities have continued to invest in non-financial assets, with the primary aim of generating profit. Others have entered into very long-term investments or providing loans to local enterprises or third sector entities as part of regeneration or economic growth projects. Some recent 'non-financial investments' by other Local Authorities are highlighted in **appendix B.**

The National Audit Office and the Public Accounts Committee continue to voice concerns about Local Authority (investment) behaviour. These are: -

- Local Authorities are exposing themselves to too much financial risk through borrowing and investment decisions
- There is not enough transparency to understand the exposure that LA's have as a result of borrowing and investment decisions
- Members do not always have sufficient expertise to understand the complex transactions that they have ultimate responsibility for approving

The Public Accounts Committee have launched a public enquiry into Local Authority Investments in Commercial Property, with initial questions being posed to MHCLG (Ministry of Housing, Communities and Local Government) officials on 11th May 2020.

Also, during the Budget in March 2020, the Treasury launched a consultation on changes to the Public Works Loan Board, which it said would attempt to "focus PWLB loans on service delivery, housing, and regeneration, and ensure that this money is not diverted into financial investments that serve no direct policy purpose".

As a result of esoteric investments, and the subsequent review, Statutory Guidance on Local Government Investments was revised, effective 1st April 2018. The CIPFA Treasury Management and Prudential Codes were also reviewed and updated.

As SCC is currently looking into the feasibility of alternative investments it is appropriate to consider the main thrust of changes introduced, with further detail in **appendix I.**

The Council has continued to meet the conditions to maintain professional status as prescribed by MiFID II. (This included having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority have at least a year's relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that authorised personnel have the expertise, experience and knowledge to make investment decisions and understand the risks involved). As a result, the Council will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

SCC has continuously monitored counterparties, and all ratings of proposed counterparties have been subject to verification on the day, immediately prior to investment.

Other indicators taken into account have been:

- Credit Default Swaps and Government Bond Spreads.
- GDP and Net Debt as a Percentage of GDP for sovereign countries.
- Likelihood and strength of Parental Support.
- Banking resolution mechanisms for the restructure of failing financial institutions i.e. bail-in.
- Share Price.
- Market information on corporate developments and market sentiment towards the counterparties and sovereigns.

An Internal Audit was conducted by SWAP during summer 2019, reporting on 25th September 2019. It awarded the best possible outcome, as quoted below.

> "We can offer substantial assurance as the areas reviewed were found to be adequately controlled. Internal controls are always in place and operating effectively, and risks against the achievement of objectives are well managed.".

SCC has continuously proactively assessed and implemented mitigation for the risks that have materialised in the new investment environment. Controls/procedures are constantly being assessed and introduced/adapted where needed and embedded into practices to further mitigate risks to SCC investment and borrowing portfolios. Details of risk management and governance can be found in **appendix I.**

Arlingclose has been retained Treasury Advisors throughout the period.

During the year Treasury staff have continued to attend regular courses and seminars provided through the CIPFA Treasury Management Forum (TMF), its advisors, Arlingclose, and other ad hoc events.

3. Options considered and reasons for rejecting them

Not applicable

4. Consultations undertaken

None

5. Financial, Legal, HR and risk implications

There are no direct financial implications arising from this paper. There are no Legal, HR, or other direct risk implications from this report

6. Other implications

None

7. Background papers

Treasury Management Strategy Statement 2019-20 and appendices. These were approved by Full Council at the meeting on 20th February 2019. The full papers can be found under the 11th February 2019 Cabinet meeting at:

http://democracy.somerset.gov.uk/documents/s9718/Treasury%20Management%20Report.pdf

http://democracy.somerset.gov.uk/documents/s9719/Treasury%20Management%20Appendix%20A.pdf

http://democracy.somerset.gov.uk/documents/s9721/Treasury%20Management%20Appendix%20B.pdf

http://democracy.somerset.gov.uk/documents/s9722/Treasury%20Management%20Appendix%20C.pdf

http://democracy.somerset.gov.uk/documents/s9723/Treasury%20Management%20Appendix%20D.pdf