City of BRADFORD
METROPOLITAN DISTRICT COUNCIL

Report of the Director of Finance & IT to the meeting of Governance and Audit to be held on 25 June 2020

AG

Subject:

Annual Treasury Management Report 2019-20

Summary statement:

This report shows the Council's Treasury Management activities for the year ending 31 March 2020

Chris Chapman
Director of Finance & IT

Report Contact: David Willis
Phone: (01274) 432361
E-mail: david.willis@Bradford.gov.uk

Portfolio: Corporate Services

Overview & Scrutiny Area:

Corporate Services

1. Introduction

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

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

- An annual treasury strategy in advance of the year (Council 19/03/2019). Due to the cancellation of Full Council meetings in March and May the 2020-21 strategy will go to the next available Full Council meeting
- A mid-year treasury update report (Council 19/09/2019).
- An annual review following the end of the year describing the activity compared to the strategy (this report).

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

This Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Governance and Audit Committee, before they were reported to the full Council. Member training on treasury management issues was undertaken at the start of the year on 14th March 2019 in order to support Members' scrutiny role.

2. Overall Treasury Position as at 31 March 2020

At the beginning and the end of 2019-20 the Council's treasury, (including borrowing by PFI and finance leases), position was as follows:

	31 March 2019 Principal £'m	Rate/ Return	31 March 2020 Principal £'m	Rate/ Return
Fixed rate funding:				
-PWLB	275.8		299.7	
-Market	36.2		36.2	
PFI and other finance leases	170.0		163.0	
Short term borrowing	0		10.0	
Total debt	**482.0**	5.4%	**508.9**	4.5%
CFR	700.1		710.7	
Over / (under) borrowing	(218.1)		(201.8)	
Total investments	56.9	0.74%	95.1	0.8%
Net debt	**425.1**		**413.8**	

3. Prudential Indicators

3.1 Capital Expenditure

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

Actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

	2018-19 Actual £'m	2019-20 Estimate £'m	2019-20 Actual £'m
Capital expenditure	**84.3**	**146.5**	**80.6**
Financed in year	52.7	75.0	51.1
Unfinanced capital expenditure	**31.6**	**71.5**	**29.5**

3.2 The Council's Overall Borrowing Need

The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure, which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's indebtedness and so the underlying borrowing need. Any capital expenditure above, which is not immediately paid for through a revenue or capital resource, will increase the CFR.

In order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2018-19), plus the estimates of any additional capital financing requirement for the current (2019-20) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allowed the Council some flexibility to borrow in advance of its immediate capital needs in 2019-20. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2019 Actual £'m	31 March 2020 Budget £'m	31 March 2020 Actual £'m
Capital Financing Requirement	700.1	764.0	710.7
Gross borrowing position	482.0	542.0	508.9
(Under) / over funding of CFR	**(218.1)**	**(222.0)**	**(201.8)**

3.3 Treasury Indicators

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

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary are acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital, (borrowing and other long term obligation costs net of investment income), against the net revenue stream.

	2019-20
Authorised limit	£630m
Maximum gross borrowing position during the year	508.9m
Operational boundary	£590m
Financing costs as a proportion of net revenue stream	12.5%

The maturity structure of the debt portfolio was as follows:

	31 March 2019 Actual £'m	31 March 2020 Actual £'m
Under 12 months	17.1	11.8
12 months and within 24 months	1.8	5.5
24 months and within 5 years	27.5	31.7
5 years and within 10 years	58.7	57.8
10 years and within 20 years	61.9	53.5
20 years and within 30 years	0	0
30 years and within 40 years	95.2	95.2
40 years and within 50 years	49.8	90.8

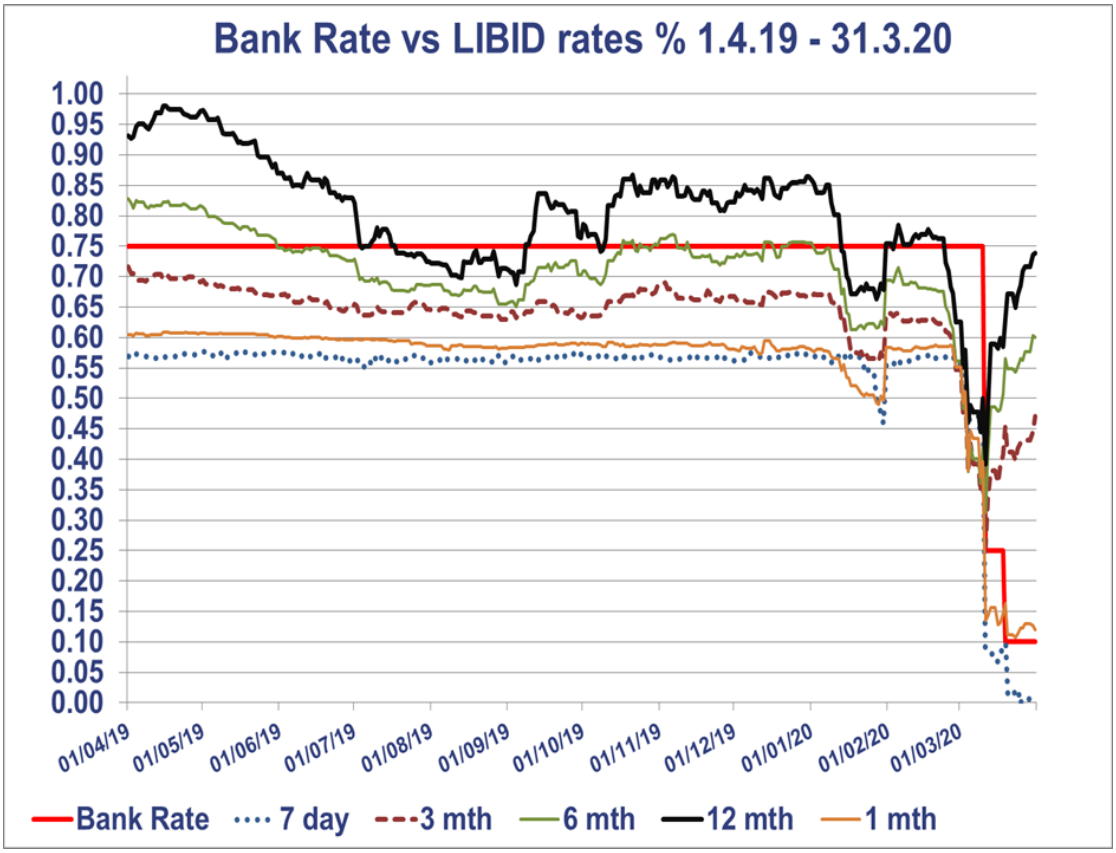
4 The Treasury Strategy for 2019-20

4.1 Investment strategy and control of interest rate risk

Investment returns remained low during 2019-20. The expectation for interest rates within the treasury management strategy for 2019-20 was that Bank Rate would stay at 0.75% during 2019-20 as it was not expected that the MPC would be able to deliver on an increase in Bank Rate until the Brexit issue was finally settled. However, there was an expectation that Bank Rate would rise after that issue was settled, but would only rise to 1.0% during 2020.

Rising concerns over the possibility that the UK could leave the EU at the end of October 2019 caused longer term investment rates to be on a falling trend for most of April to September. They then rose after the end of October deadline was rejected by the Commons but fell back again in January before recovering again after the 31 January departure of the UK from the EU. When the coronavirus outbreak hit the UK in February/March, rates initially plunged but then rose sharply back up again due to a shortage of liquidity in financial markets.

Investment balances have been kept to a minimum through the agreed strategy of using reserves and balances to support internal borrowing, where possible rather than borrowing externally from the financial markets. External borrowing has been taken from the PWLB as there was an expectation that the capital schemes would reduce the investment balances significantly.



4.2 Investment Outturn 2019-20

The Council's investment position at the end of 2019-20 is summarised below.

INVESTMENT PORTFOLIO	Actual 31.3.19 £m	Actual 31.3.19 %	Actual 31.3.20 £m	Actual 31.3.20 %
Treasury investments				
Banks	29.4	52	36.3	38
Building Societies - rated	5.0	9	0.0	0
DMADF	0.0	0	53.8	57
Treasury Bills	0.0	0	5.0	5
Money Market Funds	22.5	39	0.0	0
Total managed in house	**56.9**	**100**	**95.1**	**100**

The maturity structure of the treasury investment portfolio was as follows:

	2018-19 Actual £'m	2019-20 Actual £'m
Investments		
Longer than 1 year	0.0	0.0
Up to 1 year	56.9	95.1

Investments held by the Council - The Council maintained an average balance of £65.9m of internally managed funds. The internally managed funds earned an average rate of return of 0.8%. The comparable performance indicator is the average 7-day LIBID rate, which was 0.54%.

4.3 Treasury Investment Policy

The Council's investment policy is governed by Ministry of Housing, Communities and Local Government (MHCLG) investment guidance, which has been implemented in the annual investment strategy approved by the Council on 19th March 2019. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data, (such as rating outlooks, credit default swaps, bank share prices etc.).

The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

5 Borrowing

5.1 Borrowing strategy and control of interest rate risk

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

A cost of carry remained during the year on any new long-term borrowing that was not immediately used to finance capital expenditure, as it would have caused a temporary increase in cash balances; this would have incurred a revenue cost – the difference between (higher) borrowing costs and (lower) investment returns.

The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this was kept under review to avoid incurring higher borrowing costs in the future when the Council may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt. Due to the high capital program over the next few years and the maturing of debt this year £17.1m in total, it was felt prudent to take out new borrowing of £41m.

Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. The Director of Finance & IT monitored interest rates in financial markets and adopted a pragmatic strategy based upon the following principles to manage interest rate risks:

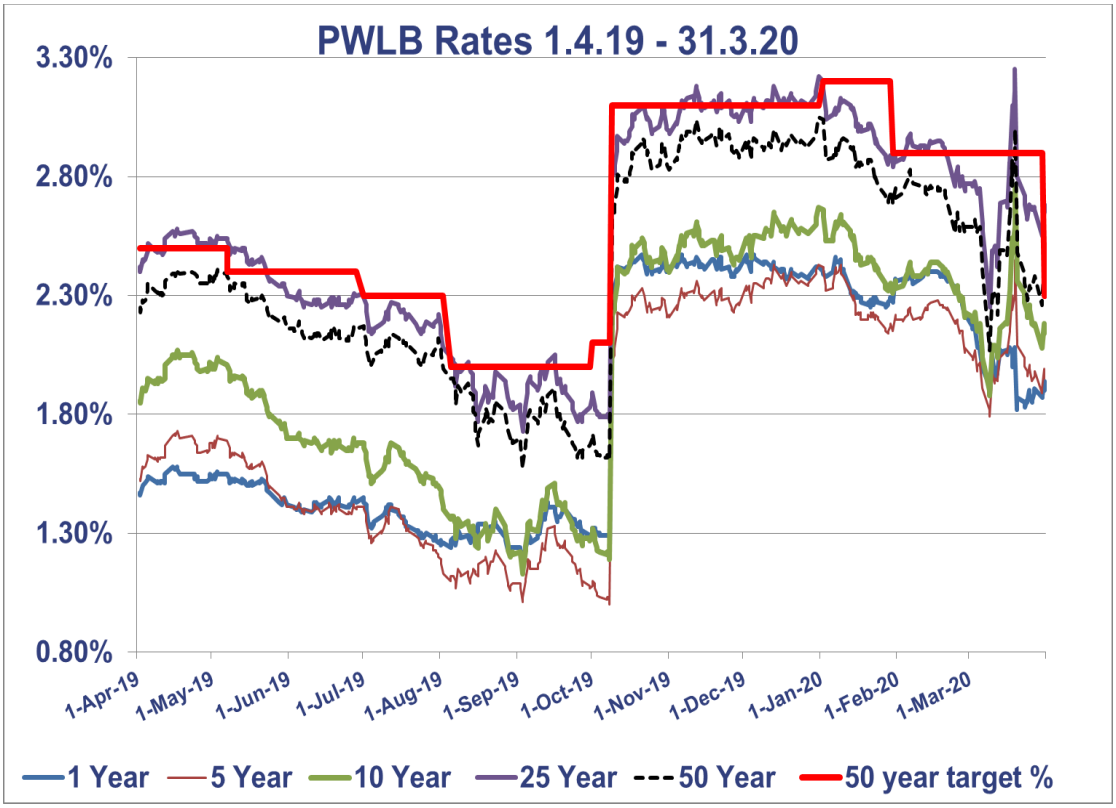
- If it had been felt that there was a significant risk of a sharp FALL in long and short term rates, (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings would have been postponed, and potential rescheduling from fixed rate funding into short term borrowing would have been considered.

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

Interest rate forecasts expected only gradual rises in medium and longer term fixed borrowing rates during 2019-20 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period.

Below are Links forecasts for interest rates set at 05/08/2019.

Link Asset Services Interest Rate View 5.8.19											
	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.25
3 Month LIBID	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.10	1.20
6 Month LIBID	0.80	0.80	0.80	0.80	0.90	1.00	1.10	1.10	1.20	1.30	1.40
12 Month LIBID	1.00	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60
5yr PWLB Rate	1.20	1.30	1.50	1.60	1.70	1.70	1.80	1.90	2.00	2.00	2.10
10yr PWLB Rate	1.50	1.60	1.80	1.90	2.00	2.00	2.10	2.20	2.30	2.30	2.40
25yr PWLB Rate	2.10	2.30	2.40	2.50	2.60	2.70	2.70	2.80	2.90	3.00	3.00
50yr PWLB Rate	2.00	2.20	2.30	2.40	2.50	2.60	2.60	2.70	2.80	2.90	2.90



PWLB rates are based on, and are determined by, gilt (UK Government bonds) yields through H. M. Treasury determining a specified margin to add to gilt yields. 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, and a general background 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; 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. This has pulled down the overall level of interest rates and bond yields in financial markets over the last 30 years. We have therefore seen, over the last year, many bond yields up to 10 years in

the Eurozone turn negative. 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 were on a generally falling trend during the last year up until the coronavirus crisis hit western economies. Since then, gilt yields have fallen sharply to unprecedented lows as investors have panicked in selling shares in anticipation of impending recessions in western economies, and moved cash into safe haven assets i.e. government bonds. However, major western central banks also started quantitative easing purchases of government bonds which will act to maintain downward pressure on government bond yields at a time when there is going to be a huge and quick expansion of government expenditure financed by issuing government bonds; (this would normally cause bond yields to rise). At the close of the day on 31 March, all gilt yields from 1 to 5 years were between 0.12 – 0.20% while even 25-year yields were at only 0.83%.

However, HM Treasury has imposed **two changes in the margins over gilt yields for PWLB rates** in 2019-20 without any prior warning; the first on 9 October 2019, added an additional 1% margin over gilts to all PWLB rates. That increase was then partially reversed for some forms of borrowing on 11 March 2020, at the same time as the Government announced in the Budget a programme of increased spending on infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins; this ends on 31 July. It is clear that the Treasury intends to put a stop to local authorities borrowing money from the PWLB to purchase commercial property if the aim is solely to generate an income stream.

Following the changes on 11 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)

There is likely to be little upward movement in PWLB rates over the next two years as it will take national economies a prolonged period to recover all the momentum they will lose in the sharp recession that will be 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.

5.2 Borrowing Outturn 2019-20

£5.6m of loans matured in July and August 2019 with an average rate of interest of 6.7% and a further £11.5m matured in February 2020. A total of £17.1m of loans have matured this year with an average rate of interest of 6.6%. To finance

commitments in the capital plan £41m of new borrowing has been undertaken currently this year. Up to the 30th September £35m was borrowed and in Quarter two, loans for £1.5m and £4.5m were completed. The average rate of interest on the new loans is 2.0%.

Summary of debt transactions — management of the debt portfolio resulted in a fall in the average interest rate of 0.48%,from 5.37% to 4.89% representing net General Fund savings of £1.6m per year.

5.3 Borrowing in advance of need

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

5.4 Rescheduling

No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

6 Other considerations

6.1 None

7 Changes to the Treasury Management Policy

At present the Council has a country credit limit on all investments of AA- and once a country goes below that rating no investments can be placed. On the 27-03-20 Fitch, one of the credit rating organisations, placed the UK Government on negative credit watch (at present AA-).

This raises the following issue that if the UK country rating goes below AA- then the Council will be unable to place investment with the Government or any UK bank. With this in mind it is proposed to make the following changes to the Treasury Policy.

The present criteria

The country credit rating should be AA- or above

New criteria

The country credit rating should be AA- or above apart from the UK, which should be A1 or above.

8 Options

8.1 None

9 Financial and Resources Appraisal

9.1 The financial implications are set out in section 1,2,3, 4 and 5.

10 Risk Management

10.1 The principal risks associated with treasury management are:

Risk: Loss of investments as a result of failure of counterparties.
Mitigation: Limiting the types of investment instruments used, setting lending criteria for counterparties, and limiting the extent of exposure to individual counterparties.

Risk: That the Council will commit too much of its investments in fixed term investments and might have to recall investments prematurely resulting in possible additional costs or new borrowing (Liquidity risk).
Mitigation: Ensuring that a minimum proportion of investments are held in short term investments for cashflow purposes.

Risk: The level of investments and surplus cash is higher than needed to fund short term timing differences.
Mitigation: Cash flow forecasting and capital expenditure monitoring.

Risk: Increase in the net financing costs of the Council due to borrowing at high rates of interest.
Mitigation: Planning and undertaking borrowing and lending in light of assessments of future interest rate movements, and by undertaking mostly long term borrowing at fixed rates of interest (to reduce the volatility of capital financing costs).

Risk: Higher interest rates increase borrowing making it more difficult to self-finance capital schemes. Debt servicing becomes less affordable and less sustainable and crowds out revenue spend.
Mitigation: To pause, delay or defer capital schemes. Also review opportunities to borrow in the future at current interest rates.

Risk: Return on non-treasury investments lower than expected.
Mitigation: Review and analysis of risk prior to undertaking non-treasury investments.

Risk: The Council's Minimum Revenue Policy charges an insufficient amount to the Revenue Estimates to repay debt.
Mitigation: Align the Minimum Revenue Policy to the service benefit derived from the Council's assets.

Risk: Associated with cash management, legal requirements and fraud.
Mitigation: These risks are managed through:

- Treasury Management Practices covering all aspects of Treasury management procedures including cashflow forecasting, documentation, monitoring, reporting and division of duties.
- All Treasury management procedures and transactions are subject to inspection by internal and external auditors. The Council also employs external financial advisors to provide information on market trends, credit rating alerts, lending criteria advice and investment opportunities.

Risk: Anticipated borrowing is lower than expected because the 2020-21 capital budget is underspent.
Mitigation: Detailed cash flow monitoring.

Risk: The Coronavirus. The level of uncertainty in the future path of economic growth, unemployment, fiscal and monetary policy make it very difficult to accurately assess the impact on investments, capital spend and borrowing for the Council. The scale of impact will depend on the length of any lockdown and the depth of any recessionary impact.
Mitigation: Cash investments will be mainly held short term until the effects of the virus becomes clearer and we will continue monitoring the situation and report any changes in the next Treasury report.

11 Legal Appraisal

11.1 Any relevant implication considerations are set in the report.

12 Other Implications

12.1 Equality & Diversity implications – no direct implications
12.2 Sustainabilty implications – no direct implications
12.3 Green house Gas Emissions Impact- no direct implications2
12.4 Community safety implications- no direct implications
12.5 Human Rights Act – no direct implication
12.6 Trade Unions – no direct implications
12.7 Ward Implications – no direct implications
12.8 Implications for corporate parenting – no direct implications

13 Not for publications documents

13.1 None

14 Recommendations

14.1 That the report and the changes to the Treasury Management Policy, detailed in paragraph 7, be received and referred to Council for adoption.

15 Appendices

Appendix 1: Prudential and treasury indicators

Appendix 2: Borrowing and investment rates

16 Background Documents

Treasury Management Schedules
Treasury Management Practices
Treasury Policy

Appendix 1: Prudential and treasury indicators

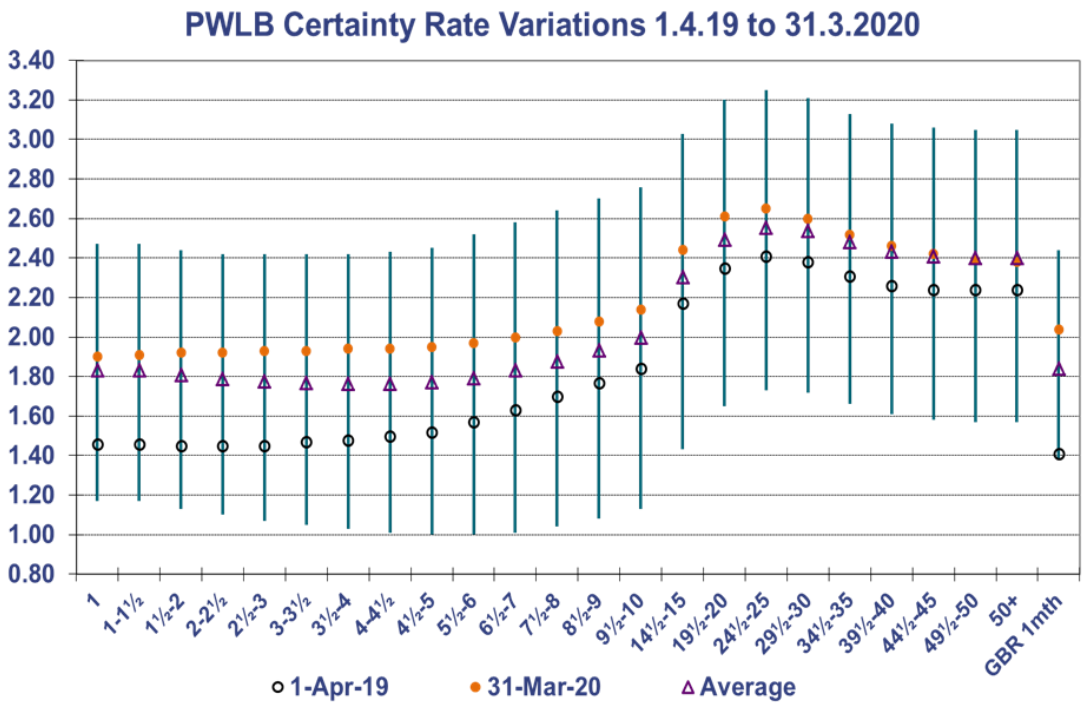
1. PRUDENTIAL INDICATORS	2018/19 Actual £'000	2019/20 Estimate £'000	2019/20 Actual £'000
Capital Expenditure	84,343	146,500	80,620
Ratio of financing costs to net revenue stream	9.0%	14.5%	12.5%
Gross borrowing requirement General Fund	312,000	384,000	335,900
Capital Financing Requirement	700,124	764,000	710,701

2. TREASURY MANAGEMENT INDICATORS	2018/19 Actual £'000	2019/20 Original £'000	2019/20 Actual £'000
Authorised Limit for external debt -			
borrowing	312,000	430,000	335,900
other long term liabilities	169,000	200,000	161,000
TOTAL	**481,000**	**630,000**	**496,900**
Operational Boundary for external debt -			
borrowing	312,000	410,000	335,900
other long term liabilities	169,000	180,000	161,000
TOTAL	**481,000**	**590,000**	**496,900**
Actual external debt	312,000	410,000	335,900

Maturity structure of fixed rate borrowing during 2019-20	upper limit	lower limit
under 12 months	20%	0%
12 months and within 24 months	20%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	50%	0%
10 years and within 20 years	90%	0%
20 years and within 30 years	90%	0%
30 years and within 40 years	90%	0%
40 years and within 50 years	90%	0%
Maturity structure of investments during 2019-20	upper limit	lower limit
Longer than 1 year	£20m	£0m

Appendix 2: Borrowing and investment rates

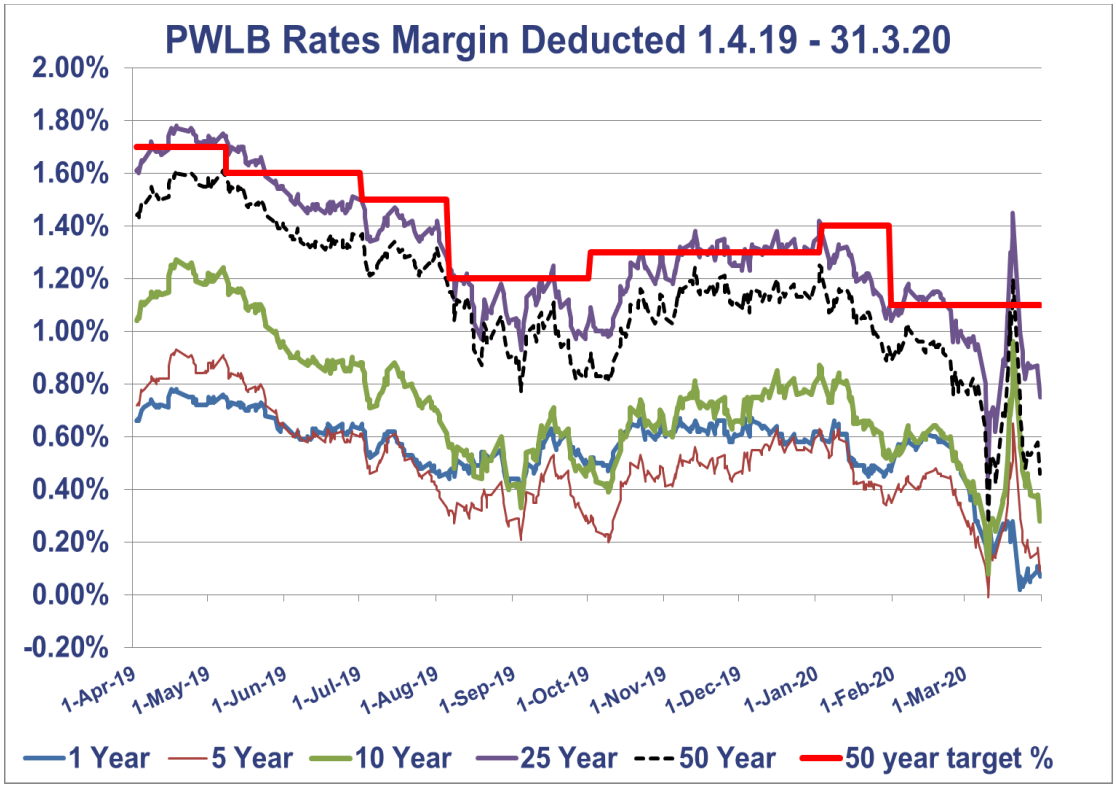
a) PWLB borrowing rates



	1 Year	5 Year	10 Year	25 Year	50 Year
01/04/2019	1.46%	1.52%	1.84%	2.41%	2.24%
31/03/2020	1.90%	1.95%	2.14%	2.65%	2.39%
Low	1.17%	1.00%	1.13%	1.73%	1.57%
Date	03/09/2019	08/10/2019	03/09/2019	03/09/2019	03/09/2019
High	2.47%	2.45%	2.76%	3.25%	3.05%
Date	21/10/2019	19/03/2020	19/03/2020	19/03/2020	31/12/2019
Average	1.83%	1.77%	2.00%	2.56%	2.40%

b) Gilt yields

The graphs and tables in Section 5 are for PWLB certainty rates. On 9.10.19, the margin over gilt yields for PWLB certainty rates was increased from 80 bps to 180 bps. The graph below shows PWLB rates less the margins added over gilt yields. This graph therefore shows more clearly the ***actual movements in gilt yields*** during the year on which PWLB rates are based.



	1 Year	5 Year	10 Year	25 Year	50 Year
01/04/2019	0.66%	0.72%	1.04%	1.61%	1.44%
31/03/2020	0.10%	0.15%	0.34%	0.85%	0.59%
Low	0.02%	-0.01%	0.08%	0.45%	0.27%
Date	20/03/2020	09/03/2020	09/03/2020	09/03/2020	09/03/2020
High	0.78%	0.93%	1.27%	1.78%	1.61%
Date	15/04/2019	17/04/2019	17/04/2019	17/04/2019	17/04/2019
Average	0.55%	0.49%	0.72%	1.28%	1.12%

c) Money market investment rates and forecasts 2019/20

	Bank Rate	7 day	1 mth	3 mth	6 mth	12 mth
High	0.75	0.58	0.61	0.72	0.83	0.98
High Date	01/04/2019	09/05/2019	15/04/2019	01/04/2019	01/04/2019	15/04/2019
Low	0.10	0.00	0.11	0.26	0.31	0.39
Low Date	19/03/2020	25/03/2020	23/03/2020	11/03/2020	11/03/2020	11/03/2020
Average	0.72	0.53	0.56	0.63	0.70	0.80
Spread	0.65	0.58	0.50	0.46	0.52	0.59