Report to Cabinet

Subject: Prudential Code Indicator Monitoring 2020/21 and Quarterly Treasury Activity Report for Quarter ended 31 December 2020

Date: 28 January 2021

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Wards Affected

All

Purpose

To inform Members of the performance monitoring of the 2020/21 Prudential Code Indicators, and to advise Members of the quarterly Treasury activity as required by the Treasury Management Strategy.

Key Decision

This is **not** a key decision.

Recommendation

That:

1. Members note the report, together with the Treasury Activity Report 2020/21 for Quarter 3 at Appendix 1, and the Prudential and Treasury Indicator Monitoring 2020/21 for Quarter 3, at Appendix 2.

1 Background

1.1 The Council is required by regulations issued under the Local Government Act 2003 to report on its Prudential Code indicators and treasury activity. 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).

1.2 For 2020/21 the minimum reporting requirements are that the Full Council should receive the following reports:

- An annual Treasury Strategy in advance of the year (the TMSS, considered by Cabinet on 13 February 2020 and subsequently approved by Full Council on 5 March 2020);
- A mid-year treasury update report (considered by Cabinet on 24 November 2020);
- An annual review following the end of the year describing the activity compared to the Strategy.

In accordance with best practice, quarterly monitoring reports for treasury activity are provided to Members, and this exceeds the minimum requirements.

1.3 The regulatory environment places responsibility on Members for the review and scrutiny of treasury management policy and activities. This report provides details of the position at 31 December 2020 and highlights compliance with the Council's policies.

2 Proposal

2.1 Economic update - UK

General:

As expected, the Bank of England's Monetary Policy Committee (MPC) kept bank rate unchanged at its meeting on 5 November 2020, however it revised its economic forecasts to take account of a second national lockdown from 5 November to 2 December, which would clearly do further economic damage and put back economic recovery. It therefore decided to implement a further £150bn tranche of quantitative easing (QE) to start in January 2021 when the existing programme of £300bn ended.

The Bank's forecasts in November expressed optimism in three areas:

- The economy would recover to reach pre-pandemic levels in Q1 2022;
- There would be excess demand in the economy by Q4 2022;
- CPI inflation was therefore projected to be a little above its target 2% by the start of 2023 and the inflation risks were judged to be balanced.

Significantly, there was no mention of negative interest rates in the MPC minutes or report, suggesting that it remained some way from being persuaded of the case for such a policy, at least for the next 6-12 months. However, rather than saying it stands ready to adjust monetary policy, the MPC this time said that it would take whatever additional action was necessary to achieve its remit – which seems stronger and wider and may indicate the Bank's willingness to embrace new tools.

One key addition to the Bank's forward guidance in August 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, action from the MPC to raise Bank Rate should not be expected until it can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate. Link's Bank Rate forecast currently shows no increase, (or decrease), through to Q1 of 2024, but there could well be no increase during the next five years as it will take some years to eliminate spare capacity in the economy, and therefore for inflationary pressures to rise to cause the MPC concern. It is expected that inflation will peak briefly at just over 2% towards the end of 2021, but this is a temporary short-lived factor and so is not considered a concern.

Covid-19:

Hopes grew that several COVID-19 vaccines would be cleared as safe and effective for administration to the general public, and the Pfizer announcement on 9 November was encouraging as its 90% effectiveness was much higher than the 50-60% rate of effectiveness of flu vaccines, which might otherwise have been expected. However, this vaccine demands cold storage at minus 70c, which impairs the speed of application to the general population. It has therefore been particularly welcome that the Oxford University/AstraZeneca vaccine has also now been approved, and this is much cheaper, and only requires fridge temperatures for storage. The Government has ordered 60m doses and is aiming to vaccinate at a rate of 2m people per week - starting in January, though this rate is currently restricted by bottlenecks in production. A new UK production facility is due to be completed in June).

These announcements, plus expected further announcements that other vaccines could be approved soon, have boosted confidence that life could largely return to normal during the second half of 2021, with activity in the still-depressed hospitality sector returning to its pre-pandemic levels – and this would help to bring the unemployment rate down. Household saving rate have been exceptionally high since the first lockdown in March, therefore there is pent-up demand and purchasing power stored up for these services. A comprehensive rollout of vaccines might take until late 2021 or further to fully complete, but if these vaccines prove to be highly effective, there is a possibility that some restrictions might be eased, from Q2 of 2021 - once more vulnerable, and front-line workers, have been vaccinated. At that point, there would be less reason to fear that hospitals might become overwhelmed. Effective vaccines would radically improve the economic outlook once they have been widely administered, and may allow GDP to rise to its pre-virus level a year earlier than otherwise, meaning that the unemployment rate might peak at 7% in 2021 instead of 9%.

Overall, the pace of recovery is not expected to be in the form of a rapid V shape, but more elongated and prolonged. Initial recovery was sharp after Q1 saw growth at -3.0%, followed by -18.8% in Q2, and then an upswing of +16.0% in Q3; but this still left the economy 8.6% smaller than in Q4 of 2019. It is likely that the one-month national lockdown that started on 5 November will have caused a further contraction of 8% in November, so the economy may have then been 14% below its pre-crisis level.

Since November, there has been a backtracking on the easing of restrictions, due to the spread of a new mutation of the virus, and more severe restrictions were imposed across all four nations. These restrictions were tightened further on 5.January 2021 to national lockdowns of various initial lengths in each of the four nations, as the NHS was under extreme pressure. It is now likely that wide swathes of the UK will remain under these new restrictions for some months, meaning that the near-term outlook for the economy is grim. However, the distribution of vaccines and the expected consequent removal of COVID-19 restrictions, should allow GDP to rebound rapidly in the second half of 2021 so that the economy could climb back to its pre-pandemic peak as soon as late in 2022. Provided that both monetary and fiscal policy are kept loose for a few years, it is still possible that in the second half of this decade the economy may be no smaller than it would have been if COVID-19 had never happened. The significant caveat to this is if another mutation of the virus that defeats the current batch of vaccines. However, now that science and technology have caught up with understanding the virus, new vaccines may be developed more quickly to counter such a development, and vaccine production facilities are being ramped up around the world.

Brexit:

The final agreement reached on 24 December 2020 has eliminated a significant downside risk for the UK economy. The initial agreement only covers trade so there is further work to be done on the services sector where temporary equivalence has been granted in both directions between the UK and EU - that now needs to be formalised on a permanent basis. As Link’s forecasts have been based on the assumption of a Brexit agreement being reached, there is no need to amend these forecasts.

MPC meeting of 17 December 2020

All nine Committee members voted to keep interest rates on hold at +0.10% and the QE target at £895bn. The MPC commented that the successful rollout of vaccines had reduced the downsides risks to the economy, however they were still sufficiently concerned that they voted to extend the availability of the Term Funding Scheme, (cheap borrowing), with additional incentives for small and medium size enterprises for another six months from 30 April 2021 until 31 October 2021. The MPC too had assumed that a Brexit deal would ultimately be agreed.

2.2 Economic update – Rest of the World

US - The Democrats won the presidential election in November, and now that they have won two Senate seats in Georgia in early January, they have effective control of both the House of Representatives and the Senate, although power is more limited in the latter. This is likely to enable the Democrats to provide more fiscal stimulus to the economy and so help the speed of economic recovery. The economy had been recovering quite strongly from its contraction of 10.2% in 2020 due to the pandemic, however the rise in new virus cases during Q4 to the highest level since mid-August suggests that the US could be in the early stages of a fourth wave, posing a threat that economic recovery could stall. The restrictions imposed to control the spread of the virus are once again weighing on the economy with employment growth slowing sharply in November and retail sales dropping.

The Federal Reserve's (Fed) meeting on 16 December 2020 adjusted the guidance for its monthly asset QE easing purchases with new language, which implied that such purchases could continue for longer than previously believed. However, with officials still projecting that inflation will only get back to 2.0% in 2023, the vast majority expect the Fed funds rate to be still at near-zero until 2024 or later.

EU – In early December, figures for Q3 GDP confirmed that the economy staged a rapid rebound from the first lockdowns, providing grounds for optimism about growth prospects for the next year. In Q2, GDP was 15% below its pre-pandemic level but in Q3, the economy grew by 12.5% leaving GDP down by "only" 4.4% - considerably better than had been expected earlier in the year. However, growth is likely to stagnate during Q4 and in Q1 of 2021, as a second wave of the virus has affected many countries. It is likely to hit hardest those countries more dependent on tourism.

With inflation unlikely to rise much above 1% over the next two years, the European Central Bank (ECB) has been struggling to get inflation up to its 2% target. It is currently unlikely that it will cut its central rate even further into negative territory from -0.5%, although it has stated that it retains this as a possible tool to use. The Bank's forecast for a return to pre-virus activity levels was pushed back to the end of 2021, but stronger growth is projected in 2022.

2.3 Interest rate forecast

The Council's treasury advisers, Link Asset Services (LAS) provided a forecast of interest rates on 9 November 2020, and amended this following the conclusion of the HM Treasury review of PWLB margins over gilt yields on 25 November. Rates in the table below include the 1% reduction in the certainty rate, which is now gilts plus 80 basis points.

Link Group Interest Rate View 9.11.20

These Link forecasts have been amended for the reduction in PWLB margins by 1.0% from 26.11.20

	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
BANK RATE	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
12 month ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
5 yr PWLB	0.80	0.80	0.80	0.80	0.90	0.90	0.90	0.90	0.90	1.00	1.00	1.00	1.00
10 yr PWLB	1.10	1.10	1.10	1.10	1.20	1.20	1.20	1.20	1.20	1.30	1.30	1.30	1.30
25 yr PWLB	1.50	1.60	1.60	1.60	1.60	1.70	1.70	1.70	1.70	1.80	1.80	1.80	1.80
50 yr PWLB	1.30	1.40	1.40	1.40	1.40	1.50	1.50	1.50	1.50	1.60	1.60	1.60	1.60

The Covid-19 pandemic has done huge economic damage to the UK, and to economies around the world. After the Bank of England's emergency action in March to cut Bank Rate, first to 0.25% and then to 0.10%, it remained unchanged at the meetings in August and September - although some forecasters had suggested that a cut into negative territory was possible. The Governor of the Bank has made it clear that he currently considers 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 31 March 2024, as economic recovery is expected to be only gradual.

2.4 Investment strategy

The Treasury Management Strategy Statement (TMSS) for 2020/21, which includes the Annual Investment Strategy, was approved by Council on 5 March 2020, and sets out the Council's investment priorities as:

- Security of capital;
- Liquidity;
- Yield.

Whilst the Council will always seek to obtain the optimum return (yield) on its investments, this will at all times be commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate either to keep investments short term to cover cash flow needs, or to extend the period up to 12 months with highly rated financial institutions, selected by the use of the LAS creditworthiness methodology (see below) which includes consideration of sovereign ratings.

Investment counterparty limits for 2020/21 are generally **£3m** per individual counterparty, however a higher limit of **£4m** per Money Market Fund is considered prudent since such funds are already by definition highly diversified investment vehicles. There is no limit on Investment with the Debt Management Office (DMO) since this represents borrowing from central government. The Chief Financial

Officer has delegated authority to vary these limits as appropriate, and then to report any change to Cabinet as part of the next quarterly report.

Members are advised that on 27 November 2020, the CFO approved an extension of the limit with Santander from £3m to £4m, making it equivalent to the limits in place for the MMFs. This was carefully considered and judged to be prudent, since rates with the three MMFs were just 0.01%, 0.035% and 0.056% and short-term rates with the DMO were **negative** – meaning that it would cost the Council to place its own funds. There is inevitably a balance to be struck between security and yield and Santander offers the Council preferential rates of 0.4% and 0.58% respectively on its 95 and 180 day notice accounts, and has to give a 60 day notice period of any change. The Link Asset Services methodology currently indicates that investment with Santander for up to 6 months is appropriate, indicating a satisfactory level of risk for the significantly higher return.

Members are also advised that the CFO has approved a reduced limit of £3m with the CCLA PSDF money market fund in recognition of the existing £1m investment in the CCLA LAPF property fund. This ensures that the overall counterparty exposure remains at only £4m, to include both specified and non-specified investments.

Limits with investment counterparties have not exceeded the prevailing levels approved by the CFO during the period 1 April to 31 December 2020.

Credit ratings advice is taken from LAS and the Chief Financial Officer has adopted the LAS credit rating methodology for the selection of investment counterparties. This employs a sophisticated modelling approach utilising credit ratings from all three of the main rating agencies to give a suggested maximum duration for investments. Accordingly it does not place undue reliance on any one agency's ratings.

The methodology subsequently applies an "overlay" to take account of positive and negative credit watches and/or credit outlook information, which may increase or decrease the suggested duration of investments. It then applies a second overlay based on the credit default swap spreads for institutions, the monitoring of which has been shown to give an early warning of likely changes in credit ratings. It also incorporates sovereign ratings to ensure selection of counterparties from only the most creditworthy countries. The current Treasury Strategy permits the use of any UK counterparties subject to their individual credit ratings under the LAS methodology. It also permits the use of counterparties from other countries with a minimum sovereign rating of AA. For information, the UK currently has a rating of AA minus.

The LAS modelling approach combines all the various factors in a weighted scoring system and results in a series of colour coded bands which indicate the creditworthiness of counterparties. The colour bandings are as follows:

- Yellow 5 years (UK Government debt or its equivalent)
- Dark pink 5 years for Ultra Short Dated Bond Funds (credit score 1.25)
- Light pink 5 years for Ultra Short Dated Bond Funds (credit score 1.50)
- Purple 2 years
- Blue 1 year (nationalised or semi nationalised UK banks only)
- Orange 1 year
- Red 6 months
- Green 100 days
- No colour not to be used

Although the credit rating agencies changed their outlook on many UK banks from stable to negative outlook during the quarter ended 30 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 of 2020, banks did make provisions for "expected" credit losses and the rating changes reflected these provisions. During the 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 further revisit their ratings in due course. 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 6 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 of the major 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.

At the outset of the pandemic Link conducted stress testing on their credit methodology-based list of counterparties to test for the results of a 1-notch downgrade to all long-term ratings from all agencies. Under such a scenario, only a very small number of potential counterparties moved from Green (100 days) to No Colour (not to be used). While there were a further 17 drops in other entities' suggested durations, these entities still remained potentially available for use.

Credit ratings are monitored weekly and the Council is also alerted to interim changes by its use of the LAS creditworthiness service, however ratings under the methodology, including sovereign ratings, will not necessarily be the sole determinant of the quality of an institution. Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

The ultimate decision on what is prudent and manageable for the Council will be taken by the Chief Financial Officer under the approved scheme of delegation.

2.5 Treasury Activity during Quarter 3 of 2020/21

The Treasury Activity Report for the quarter ended 31 December 2020 is attached at Appendix 1, in accordance with the Treasury Management Strategy.

Members will note that investment interest of £79,710 was generated from MMF activity, term deposits with banks and building societies, and the property fund, during the period from 1 April to 31 December 2020. This represents an overall equated rate for the Council of 0.47% and outperforms the benchmark 7 day LIBID rate, which averaged negative 0.06% for the same period. In cash terms this represents additional income to the General Fund of around £89,900 and was achieved by positive investment management, and in particular a favourable return on the property fund (see below). Performance in respect of the longer 3 month LIBID rate, which averaged 0.04%, still represents additional income of £72,900.

During the period from 1 April to 31 December 2020, significant use was made of the Council's three Money Market Funds (MMFs). These are AAA rated investment vehicles which allow the pooling of many billions of pounds into highly diversified funds, thus reducing risk. The current rates of return on these funds are between Nil and 0.04%, which whilst exceptionally low, remain for two of the funds higher than overnight treasury deposit rates, and the rate obtainable from the Debt Management Office (DMO), which for most durations is currently 0.01%, and indeed negative for overnight and very short term deposits.

The Council made an investment of £1m in the CCLA Local Authority Property Fund (LAPF) on 1 December 2017. The LAPF is a local government investment scheme approved by the Treasury under the Trustee Investments Act 1961 (section 11). Dividends are treated as revenue income and have in previous years averaged around 4%. However, in the current economic conditions it was initially anticipated that returns would be only around 70-75% of the previous level, ie approximately 2.8-3.0%, for at least the first two quarters of 2020/21. So far the fund has performed relatively well, and the Q1 and Q2 dividends paid were approximately 3.55% and 3.9% respectively. The confirmed dividend for Q3, due to be paid on 29 January is 4.7%, however economic conditions remain challenging, especially in the light of the latest lockdown.

This investment allows the Council to introduce a property element into its investment portfolio without the risks associated with the direct purchase of assets. It should be noted however that the capital value is **not** guaranteed and can fall as well as rise, as was the case in 2019/20 when the certificated value of the investment fell from £971k to £936k. The capital value has continued to fall and stood at £910k at 31 December, having improved from £895k at 31 August 2020. CCLA fully expect this position to recover, however it serves to demonstrate that the investment must be seen as a long-term commitment (see 2.9 below).

Interest rates in the market remain exceptionally low, and this is likely to continue in view of the pandemic, as well as the ongoing uncertainty surrounding Brexit and the ending of the transition period. As loans mature every effort is made to replace them at favourable rates, however security and liquidity will always be the overriding factors in the Council's treasury management. LAS currently forecast that Bank Rate is unlikely to rise again until at least mid-2024, however there is much uncertainty and interest rates are then expected to rise only gradually, and not significantly.

It is still anticipated that the outturn for investment interest will be broadly in line with the current approved estimate of £95,000 for 2020/21. Whilst rates in the market are below those used in the estimates, the level of cash balances for short term investment has remained significantly higher than that estimated, and every effort has been made to maximise use of the most favourable rates available. In particular, two fixed term deposits made in February 2020 at 1.05% are making a significant contribution, along with the property fund and the extension to the counterparty limit with Santander.

2.6 New borrowing

At 31 December 2020 no new borrowing had been undertaken, and it is not anticipated that any will be required before 31 March. The projected outturn for PWLB interest payable is £341,300, which is in line with the current approved estimate.

Members are aware that the Council previously approved a Commercial Property Investment Strategy (CPIS) aimed at the generation of funding to replace central government support, which had been withdrawn. Significant additional borrowing would be required to support this commercial programme, supported by individual business case assessments and appropriate budget approvals, to demonstrate that each project generated a return sufficient to cover any borrowing costs.

HM Treasury has now concluded its consultation with regard to the use of PWLB for commercial investment and as anticipated, it is now clear that the Council's CPIS programme is no longer viable. Accordingly, it is proposed that the CPIS is withdrawn (Quarter 3 Budget Performance Report elsewhere on this agenda) and the budget of £5m for commercial property investment removed from the capital programme. More details of HMT's conclusion are given at 2.9 below.

Advice will be taken from LAS with regard to the amount and timing of any additional borrowing, and should conditions become advantageous, some borrowing in advance of need will also be considered by the Chief Financial

Officer. The Council's Capital Financing Requirement (CFR) represents its underlying need to borrow to finance capital investment. Due to favourable interest rates, borrowing in advance of need is sometimes desirable, with the result that the CFR can differ to the actual borrowing planned in the year. Investment guidance issued in February 2018 reaffirmed that Councils may not borrow in advance of need purely to profit from the investment of the extra sums borrowed, rather than prudent early borrowing for a demonstrable service objective, which is permitted.

Whilst HMT's review removed the possibility of using PWLB to finance commercial property investment, it also reduced interest rates by 1% across the board from 26 November 2020. However, investment rates remain exceptionally low, and serious consideration must be given to the cost of carrying any additional borrowing during the period prior to it being required for the financing of capital expenditure since this places a further burden on the General Fund.

2.7 Debt rescheduling

When the current day PWLB rate for the same term is higher than that being paid on an existing loan there is the potential for a discount to be receivable if the loan is repaid prematurely.

However, debt rescheduling opportunities are limited in the current economic climate, and due to the structure of PWLB interest rates. Advice in this regard will continue to be taken from LAS. No debt rescheduling has been undertaken during the period from 1 April to 31 December 2020.

2.8 Compliance with Prudential and treasury indicators

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limit. The Council's approved Prudential and Treasury Indicators (affordability limits) are included in the Treasury Management Strategy Statement (TMSS) approved by Full Council on 5 March 2020.

During the financial year to date the Council has at all times operated within the treasury limits and Prudential Indicators set out in the Council's TMSS, and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators as at 31 December 2020 are shown at Appendix 2.

A) Prudential Indicators:

These indicators are based on estimates of expected outcomes, and are key indicators of "affordability". They are monitored on a quarterly basis, and Appendix 2 compares the approved indicators with the projected outturn for 2020/21, and shows variances on the indicators, as described below:

a. Capital Expenditure

The capital programme previously included both service related expenditure and commercial property investment, however as discussed at 2.6 above and 2.9 below the budget for commercial property investment has now been removed. The latest projected outturn shows that total capital expenditure is expected to be £3,970,900. This differs to the approved indicator of £11,225,600 due to the inclusion of approved carry-forward requests from 2019/20 and variations on the current year's capital programme. These variations include the removal of £5m in respect of commercial property investment.

b. Capital Financing Requirement (CFR)

The CFR represents the historic outstanding capital expenditure which has not yet been paid for from capital or revenue resources, and is essentially a measure of the Council's underlying borrowing need. The CFR does not increase indefinitely since the minimum revenue provision (MRP) is a statutory annual revenue charge for the economic consumption of capital assets.

The projected closing CFR for 2020/21 is £10,506,700. This differs to the approved indicator of £17,353,900, due to savings and deferrals on the 2019/20 capital programme, as well as to variations to the current year's capital programme. Again, these variations include the removal of £5m in respect of commercial property investment.

c. Gearing ratio

The concept of "gearing" compares the total underlying borrowing need (the CFR) to the Council's total fixed assets and the gearing ratio can provide an early indication where debt levels are rising relative to long term assets held.

The projected gearing ratio at 31 March 2021 is 30%, which is lower than the approved indicator of 37% but remains broadly comparable with the average gearing ratio for councils of a similar size.

d. Ratio of financing costs to net revenue stream – service related and commercial property

These indicators identify the trend in the cost of borrowing net of investment income against the net revenue stream. Financing costs represent the element of the Council's budget to which it is committed even before providing any services.

The projected outturn of 11.50% for service related expenditure differs to the approved indicator of 18.61% due to a reduction in MRP arising from savings and deferrals on the capital programme in 2019/20 and reduced PWLB interest payable in 2020/21 due to the timing of new borrowing. In addition, variations to the 2020/21 capital programme including slippage to 2021/22 have associated reductions in requirement for direct revenue financing.

The projected outturn in respect of commercial property is Nil. This differs to the approved indicator of 0.72% because no commercial investment activity was undertaken in 2019/20, and hence no MRP falls due in 2020/21, and similarly no PWLB interest will now be attributable to commercial activities in 2020/21 following the proposed withdrawal of the CPIS (see 2.6 above and 2.9 below).

e. Ratio of commercial property income to net revenue stream

This indicator seeks to demonstrate the extent to which the loss of commercial property income would impact on the Council, ie. to measure the "proportionality" of commercial activity.

No commercial property acquisitions had been made at 31 December 2020, and as noted at 2.6 above, it is now proposed that the CPIS programme be withdrawn and the £5m budget removed from the 2020/21 capital programme. The projected outturn for this indicator is therefore now Nil, which differs to the approved indicator of 1.41%.

f. Maximum gross debt

The Council must ensure that its gross debt does not, except in the short term, exceed the opening capital financing requirement, plus estimates of any additional CFR for 2020/21 and the following two financial years. This allows flexibility for early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes. The Council's gross debt at 31 December 2020 was £9.812m, which was within the approved indicator.

g. Ratio of internal borrowing to CFR

The Council is currently maintaining an "internal borrowing" position, ie. the underlying borrowing need (CFR) has not yet been fully funded with loan debt as cash supporting the Council's reserves and balances is being used as a temporary measure.

The projected outturn for internal borrowing is 7%, which is lower than the approved indicator of 26% due to variations to the capital programme - which in turn reduce the projected outturn for CFR and hence the difference between CFR and projected external borrowing.

B) Treasury Management Indicators:

These indicators are based on limits, beyond which activities should not pass without management action. They include two key indicators of affordability and four key indicators of prudence.

Affordability:

a. Operational boundary for external debt

This is the limit which external debt is not “normally” expected to exceed. In most cases, this would be a similar figure to the CFR, but it may be lower or higher depending on the levels of actual debt, and must allow for unusual cashflow movements.

b. Authorised limit for external debt

This limit represents a control on the “maximum” level of borrowing. It is the statutory limit determined under s3 (1) of the Local Government Act 2003 and represents the limit beyond which external debt is prohibited. The Authorised Limit must be set, and revised if necessary, by Full Council. It reflects a level of external debt which, while not desirable, could be afforded in the short term, but is not sustainable in the longer term. The Government retains an option to control either the total of all councils’ plans, or those of a specific council, although this power has not yet been exercised.

Prudence:

c. Upper limits for the maturity structure of borrowing

These are set to reduce the Council’s exposure to large fixed rate sums falling due for refinancing.

d. Maximum new principal sums to be invested during 2020/21 for periods in excess of one year (365 days)

All such investments are classified as “non-specified”. This indicator is subject to the overall limit for non-specified investments set out in the TMSS, and to the overall limit per counterparty.

e. Interest rate exposure

The latest Treasury Management Code requires a statement in the TMSS explaining how interest rate exposure is managed and monitored by the Council, and this is repeated below:

The Council has a general preference for fixed rate borrowing in order to minimse uncertainty and ensure stability in the charge to revenue, however it is acknowledged that in certain circumstances, some variable rate borrowing may be prudent, for example if interest rates are expected to fall. The Council’s investments are generally for cashflow purposes and accordingly a mix of fixed and variable rates will be used to *maximise flexibility and liquidity. Interest rate exposure will be managed and monitored on a daily basis by the Chief Financial Officer.*

Local indicators for the proportions of fixed and variable rate loans, have been retained by the Council for information purposes.

Appendix 2 shows the actual position as at 31 December 2020, and demonstrates that all activities are contained within the currently approved limits.

2.9 Other Issues

a. PWLB Consultation by HM Treasury (HMT)

Over recent years there has been a significant rise in commercial property investment by local authorities, generally financed by huge amounts of PWLB borrowing. The level of this indebtedness for commercial reasons had become a major concern for HMT and accordingly it undertook a consultation with local authorities with a view to tightening the rules. The outcome of this consultation was published in November 2020.

Put simply, HMT will no longer allow local authorities to borrow money from the PWLB to purchase commercial property if the aim is primarily to generate an income stream (ie debt for yield).

- To access PWLB funds the Council must provide a high level description of its capital spending plans for the next 3 years including expected use of PWLB;

- As part of this the CFO must confirm there is no intention to buy investments assets primarily for yield at any point in the next 3 years;

- This restriction is on a whole plan basis – ie even if the Council intends to buy investments assets primarily for yield at any point in the plan and to finance them other than by borrowing or alternative funding sources, the PWLB will not lend to it;

- When applying for a new loan the Council will have to confirm that the plans they have submitted remain current and that the assurance on investments assets primarily for yield remains valid;

- HMT do not intend to routinely review individual loans but if it has concerns it may contact the Council to gain a fuller understanding. Access to PWLB could be suspended if deliberate misuse is found. In extreme cases full repayment of loans made may be imposed, although this is thought unlikely.

The Council's current Commercial Property Investment Strategy (CPIS) makes clear that its key objectives are to acquire property that provides a "net income return", to "maximise returns whilst minimising risk" and to "prioritise properties that yield optimal net income return". It is also clear that the Council could only undertake commercial property investment if PWLB (or other) borrowing was used. It is therefore impossible to conclude that anything other than "debt for yield" would be undertaken, and that in the light of the HMT review this would preclude the Council from accessing any PWLB borrowing.

In addition to the above issues, the Covid-19 pandemic has emphasised the risks of property investment, and the ease with which Councils can expose themselves to unacceptable levels of risk. The current economic conditions simply do not make commercial property investment a prudent option.

Accordingly, it is proposed that the Commercial Property Investment Strategy (CPIS) is withdrawn (Quarter 3 Budget Performance Report elsewhere on this agenda) and the budget of £5m removed from the capital programme for 2020/21.

On a more positive note, PWLB interest rates are linked to gilt yields, and on 9 October 2019, HM Treasury (HMT) imposed an additional margin of 1% over gilts to all PWLB rates across the board with no prior warning. Following the HMT consultation with local authorities and the imposition of a curb on lending for commercial debt-for yield projects, this increase was reversed, and the certainty rate for which the Council qualifies, fell by 1% from 9am on 26 November 2020. This should allow access to cheaper borrowing for service investment where necessary.

b. Suspension of the LAPF Property Fund

As discussed at 2.5 above, the Council has an investment of £1m in the CCLA Local Authority Property Fund (CCLA LAPF). Notice was received from CCLA in March 2020 that the LAPF would be suspended, and that no subscriptions or redemptions could be made. Such suspension is a normal course of action in exceptional market conditions such as those experienced due to the coronavirus pandemic. Valuers could not be confident that their valuations truly reflected prevailing conditions, and where there is a material risk of disadvantage to either party, all transactions must be suspended until the required level of certainty is re-established.

Dealing in the Fund recommenced on 30 September, on the basis that conditions in the property market were deemed to have stabilised, and valuation clarity and certainty had improved. A 90-day notice period for redemptions from the property fund was introduced in order to align the dealing terms of the fund with the liquidity of the underlying assets, and to ensure resilience during periods of market stress.

The property fund is viewed as a long-term investment and the recent suspension should not cause undue concern. The latest valuation at 31 December shows a slight improvement to £910k from a low of £895k in August, and the confirmed dividend for Q3 was better than expected, due to a number of factors including one-off receipts and continued success with rent collections.

c. Negative investment rates

While the Bank of England has indicated 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 crisis. This has caused some local authorities to have sudden large increases in investment balances searching for an investment counterparty, some of which was only very short-term until those sums were able to be passed on. A glut of money, which was particularly acute in the run up to the end of 2020, led to some financial entities offering yet deeper negative yields - or simply closing their books to new money until 2021 began.

Money market fund (MMF) yields have continued to fall. Fund managers have resorted to trimming fee levels to ensure that net yields for investors remain positive wherever possible and practical, however at the time of writing the Blackrock fund is paying 0%. This is not universal, and some 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 in accurately forecasting when disbursements of funds received (for business support grants etc) will occur or when further large receipts will be received from the Government. In addition, the impact of the change in the PWLB margin has had a marked impact on the rates being offered.

No other significant treasury management issues have arisen since approval of the TMSS on 5 March 2020 that should be brought to the attention of Members.

3 Alternative Options

An alternative option is to fail to present a quarterly Prudential Code Indicator Monitoring and Treasury Activity Report, however this would contravene the requirement of the Council’s Treasury Management Strategy Statement (TMSS).

4 Financial Implications

No specific financial implications are attributable to this report.

5 Legal Implications

There are no legal implications arising from this report.

6 Equalities Implications

There are no equalities implications arising from this report.

7 Carbon Reduction/Environmental Sustainability Implications

There are no carbon reduction/environmental sustainability implications arising from this report.

8 Appendices

1. Treasury Activity Report 2020/21 for Quarter 3 (31 December 2020).
2. Prudential and Treasury Indicator Monitoring 2020/21 for Quarter 3.

9 Background Papers

None identified.

10 Reasons for Recommendation

To comply with the requirements of the Council's Treasury Management Strategy Statement.

Statutory Officer approval:

Approved by: Chief Financial Officer

Date: 19.01.21

Approved by: Monitoring Officer

Date: 20.01.21