Leicestershire County Council

CORPORATE GOVERNANCE COMMITTEE: 25TH NOVEMBER 2020

QUARTERLY TREASURY MANAGEMENT REPORT

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

Purpose of report

1. The purpose of this report is to update the Committee on the actions taken in respect of treasury management for the quarter ending 30 September 2020 (Quarter 2).

Policy Framework and Previous Decisions

2. The annual investment strategy forms part of the council's medium term financial strategy (MTFS) and was approved by full council in February 2020.

3. An update in respect of Quarter 1 2020/21 was provide to the committee on 24th July 2020

Background

4. Treasury Management is defined as:

   "The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks".

5. A quarterly report is produced for the Committee to provide an update on any significant events in treasury management.

Economic Background

6. The Council's treasury management adviser, Link Asset Management, provides a quarterly update outlining the global economic outlook and monetary policy positions. An extract from this report is attached as Appendix A to this report. The key points are summarised below.

7. The committee should note this update was produced prior to announcement of a new UK national lockdown, the US elections, and the release of vaccine efficacy data by Pfizer and BioNTech.

8. The UK economy has recovered well, so far, following the significant hit to gross domestic product (GDP) caused by the initial lockdown and strong growth is expected when quarter 3 results are published. However, the recent surge in infections and actions being taken to combat this will likely leave growth flat in quarter 4, and possibly into quarter 1 2021.

9. Inflation has been suppressed by schemes such as Eat Out to Help Out and the VAT cut for some sectors, but the ending of these will result in inflation rising steadily, potentially getting towards the Bank of England's 2% target by the end of next year. Further to this, if a trade deal with the EU is not secured this could push inflation higher in 2021 due to a likely negative impact on sterling.

10. The role of central banks, and by extension monetary policy, is not expected to change in the short term due to the need to maintain the stability and viability of financial markets, and to support economic growth. This includes asset purchasing programmes (quantitative easing) remaining for a continued, and likely lengthier period, suppressing interest rate pressures. The Bank of England continues to assess the potential impact of imposing negative rates, although it is thought unlikely these will be used.

<u>Update on UK Sovereign Rating</u>

11. This quarter Link have also provided an update on the UK sovereign rating and the impact of this on individual institutions. This update has been attached as Appendix B to this report. The key points are summarised below.

12. On 16th October 2020 the ratings agency Moody's took the decision to downgrade the UK sovereign rating from Aa2 to Aa3. This decision was driven by a reduction in the UK's economic strength, weakening of the country's fiscal capacity and a further erosion of the UK's institutions and governance.

13. Subsequently, Moody's took a decision to downgrade the long-term ratings of six large UK banks. This is something that was anticipated as most of the UK banks rated by Moody's were on Negative Outlook at the time. It is important to stress that these changes were solely because of the action on the UK sovereign rating, not a reflection of deteriorating conditions at the banks themselves.

14. On the upside, it should be noted that Moody's is one of three credit rating agencies used by Link, the others being Fitch and Standard and Poor (S&P). On 23rd October S&P Global Ratings affirmed the sovereign rating on the UK and left the rating on Stable Outlook. Additionally, despite the down grade, Moody's view also stresses that "The UK's intrinsic economic and institutional strengths, as well as the likely level where debt will stabilise, compare well to peers at the Aa3 rating level".

15. Looking at the UK banking sector, it is important to be mindful of certain negative scenarios that could unfold in the coming months and quarters. UK banks have several credit strengths such as strong levels of capitalisation and stable funding channels, combined with robust liquidity. They also operate under an enhanced regulatory framework which has been subject to a material test over the last six months. At the same time, UK banks and building societies face a range of challenges to their profitability and likely asset quality deterioration because of the COVID 19 pandemic-induced shock. Over the next 12-18 months, further rating

downgrades of the UK banks and building societies by the three main rating agencies cannot be discounted.

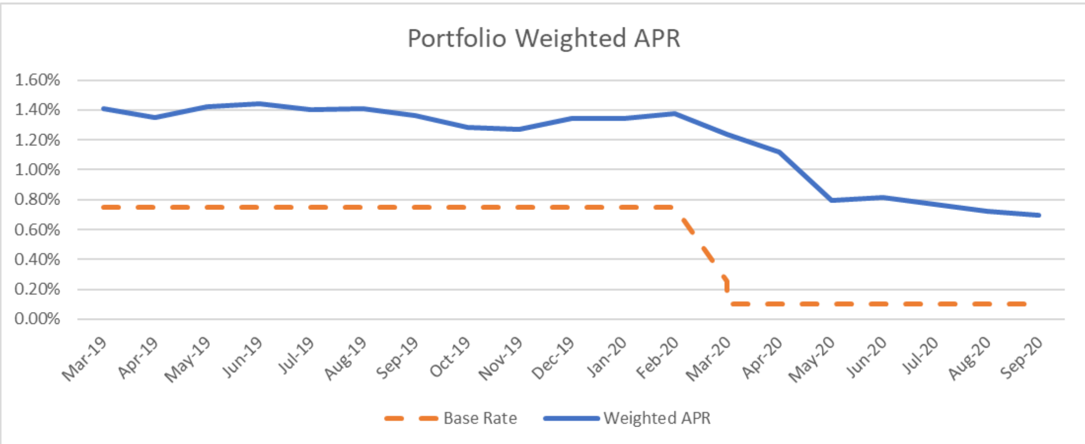
16. If ratings changes do occur, then these could potentially have an impact not only in relation to the suggested lending durations advised by Link but could also further limit the investment options open to the council.

Action Taken During Quarter 2 to September 2020

17. The balance of the investment portfolio increased from £239.2m to £273.3m. Within the portfolio, £115m of investment loans matured at an average rate of 0.66% (excluding Private Debt), and £149.9m of new loans were placed, at an average rate of 0.34%. We also received a capital receipt for the partners private debt investment totalling £0.9m.

18. The average rate achieved on new loans continues to fall short of the average rate of loans maturing. This was expected due to the reduction in base rates and the trend is likely to continue, as the markets do not foresee an increase in rates any time soon. As a result, the portfolio weighted annual percentage rate (APR) reduced from 0.81% in Q1 20-21 to 0.69% in Q2 20-21.

19. The chart below shows the weighted APR achieved by the treasury portfolio compared to the Bank of England base rate:



20. The loan portfolio at the end of September was invested with the counterparties shown in the list below, shown by original investment date:

	£m	**Maturity Date**
Instant Access		
Money Market Funds	44.9	October 2020
6 Months		
Australia & New Zealand Bank	10.0	August 2020
Santander	5.0	November 2020
National Westminster Bank Plc	20.0	November 2020
Close Brothers	10.0	November 2020
National Westminster Bank Plc	10.0	December 2020

HSBC	30.0	January 2021
Nationwide Building Society	10.0	January 2021
Santander	20.0	March 2021
Close Brothers	15.0	March 2021
12 Months		
Lloyds (Bank of Scotland)	20.0	November 2020
National Westminster Bank Plc	10.0	December 2020
HSBC	10.0	March 2021
National Westminster Bank Plc	10.0	August 2021
Lloyds (Bank of Scotland)	20.0	September 2021
Beyond 12 Months		
Partners Group (Private Debt)	18.4	Estimated 2024
Danske Bank	10.0	September 2027
Total Portfolio Balance at 30 September 2020	**273.3**	

21. The impact of the Covid19 pandemic has reduced the number of lending options open to the council. Whereas the economic crisis of 2008 was characterised by a lack of liquidity in financial markets. The opposite is true of the current crises, regulatory requirements for increased capitalisation, coupled with unprecedented fiscal and monetary stimulus from central governments, mean many of the institutions the council has previously used as a counterparty are not currently looking for funding. Further to this, ratings actions have reduced the list of acceptable counterparties available.

22. To illustrate how this issue is affecting the council’s treasury operations the institutions where we have reached lending capacity have been highlighted in the table above (paragraph 20). The committee should also note that since 30th September we have also reached capacity with Australia and New Zealand Bank.

23. In order to maintain a low risk approach that is mindful of the rates earned it is important to consider all options available in the annual investment strategy. Other than lending to banks the current options open to the council are to increase exposure to Money Market Funds (MMFs), lend to the Debt Management Office (DMO), and to resume lending to other local authorities.

24. Since the Bank of England lowered base rate to 0.10% in March, yields on MMFs have rapidly fallen. The council is currently receiving between 0.01% and 0.05% on capital invested in MMFs and reports suggest that some funds have hit a zero yield. In most cases fund managers have lowered fees to keep yields positive and whilst we anticipate this to continue, negative yields in the future cannot be ruled out. The council primarily uses MMFs to store its working capital (the day to day funds required to pay for services) and it is anticipated that this will continue to be the best way to use this option in the short term.

25. The DMO provides the Debt Management Account Deposit Facility (DMADF) to local authorities and other eligible institutions. Deposits placed represent a direct claim on HM Government, so are very secure. The low risk nature of these deposits mean that the yields are often significantly below those that can be achieved in the wider market; hence

the council rarely uses this facility. Currently the DMADF offers only fixed term deposits and all deposits under 6 months are paying a negative yield – so rather than receiving interest we would effectively be charged a fee for the deposit.

26. Link continue to advocate the use of lending to other local authorities as a secure way to spread counterparty risk and underpin a balanced portfolio. Local authorities are considered a secure counterparty for a number of reasons but primarily; a historic default rate of zero, the fact they cannot technically become insolvent, and that in the event that a default did occur courts can order council tax to be collected to repay outstanding loans.

27. Further credence can be given to the security of the local authority market by analysing the recent bond issues by Lancashire County Council and The London Borough of Sutton. During these issues the ratings agencies undertook robust analysis of local authority finances and the organisations in question were able to secure a rating equal to the UK sovereign rating. The rates paid by these organisations was below the equivalent Public Works Loan Board rate.

28. Financial risk is not the only consideration for the council when selecting a counterparty and lending to other local authorities does carry reputational risk. If the council placed a loan with another authority, who were subsequently revealed to be in financial difficulty, then, as previous experience indicates, this could create a negative external view of our operations despite the minimal risk of default. There are steps that officers can, and would, implement to mitigate this risk. Such as; analysing CIPFA's resilience index, reviewing the authorities accounts and scanning news articles (not all of which will be accurate). The Committee should note that much of the information that would be available to officers is historic in nature and primarily devised for other purposes. Unfortunately, there is no way to fully mitigate this reputational risk.

29. According to the Ministry for Housing Communities and Local Government (MHCLG) borrowing between local authorities was £13.5bn for the quarter to June 2020, a 15% increase on the same period last year. Reports suggest that the local to local market has cooled in the last quarter and there is no guarantee that the council would immediately find suitable counterparties for its capital. Previous experience does indicate the market is likely to pick up in the final half of the year and in particular the last quarter as authorities seek to ensure they have the requisite cash flow to see them through year end.

<u>Loans to Counterparties that breached authorised lending list</u>

30. There were no loans active during the period that breached the authorised counterparty list at the time that the loan was made.

31. On 20th October 2020, following a ratings downgrade from Moody's, Link asset services reduced the suggested lending duration of Lloyds (Bank of Scotland) from 12 months to 6 months. As at 30 September the council had £40m of exposure to Lloyds and £20m of this will not mature until September 2021 meaning this is now outside of the authorised lending duration.

Resource Implications

32. The interest earned on revenue balances and the interest paid on external debt will impact directly onto the resources available to the Council. For 2019/20 the interest generated by Treasury Management activities raised £2.5m. For 2020/21 the expected level of interest is expected to be significantly less than this at approx. £1.1m compared to a budget of £2.8m.

Recommendations

33. The Committee is asked to note this report.

Background papers

34. None

Circulation under the Local Issues Alert Procedure

35. None

Equality and Human Rights Implications

36. There are no discernible equality and human rights implications

Appendices

37. Appendix A – Economic Overview (September 2020)

38. Appendix B – Update on UK Sovereign Rating

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