APPENDIX A

TREASURY MANAGEMENT MID-YEAR REVIEW 2020/21

A1. SUMMARY OF TREASURY MANAGEMENT INDICTORS

The City Council originally approved the authorised limit (the maximum amount of borrowing permitted by the Council) and the operational boundary (the maximum amount of borrowing that is expected) on 11th February 2020. The Council's debt at 30th September was as follows:

Prudential Indicator	**Limit** £m	**Actual** £m
Authorised Limit - the maximum amount of borrowing permitted by the Council	883	786
Operational Boundary - the maximum amount of borrowing that is expected	868	786

The maturity structure of the Council's fixed rate borrowing was:

	Under 1 Year	**1 to 2 Years**	**3 to 5 Years**	**6 to 10 Years**	**11 to 20 Years**	**21 to 30 Years**	**31 to 40 Years**	**41 to 50 Years**
Minimum proportion of loans maturing	0%	0%	0%	0%	0%	0%	0%	0%
Maximum proportion of loans maturing	10%	10%	10%	20%	30%	30%	40%	40%
Actual proportion of loans maturing	1%	1%	4%	11%	18%	7%	31%	27%

The maturity structure of the Council's variable rate borrowing was:

	Under 1 Year	**1 to 2 Years**	**3 to 5 Years**	**6 to 10 Years**	**11 to 20 Years**	**21 to 30 Years**	**31 to 40 Years**	**41 to 50 Years**
Minimum proportion of loans maturing	0%	0%	0%	0%	0%	0%	0%	0%
Maximum proportion of loans maturing	10%	10%	10%	20%	30%	30%	30%	30%
Actual proportion of loans maturing	2%	2%	6%	11%	22%	24%	19%	14%

Surplus cash invested for periods longer than 365 days at 30th September 2020 was:

	Limit £m	**Quarter 2 Actual** £m
Maturing after 31/3/2021	117	80
Maturing after 31/3/2022	50	38
Maturing after 31/3/2023	50	20

A2. GOVERNANCE

The Treasury Management Policy approved by the City Council on 17th March 2020 provides the framework within which treasury management activities are undertaken.

There have been no breaches of these policies during 2020/21 up to the period ending 30th September 2020.

A3. BORROWING ACTIVITY

Gilt yields had already been on a generally falling trend up until the coronavirus crisis hit western economies during March. After gilt yields initially spiked upwards in March, we have seen yields fall sharply in response to major western central banks taking rapid policy action to deal with excessive stress in financial markets during March, and starting massive quantitative easing driven purchases of government bonds: these actions also acted to put downward pressure on government bond yields at a time when there has been a huge and quick expansion of government expenditure financed by issuing government bonds. Such unprecedented levels of issuance in "normal" times would have caused bond yields to rise sharply. At the close on 30th September, all gilt yields from 1 to 6 years were in negative territory, while even 25-year yields were only at 0.76% and the 50 year at 0.60%.

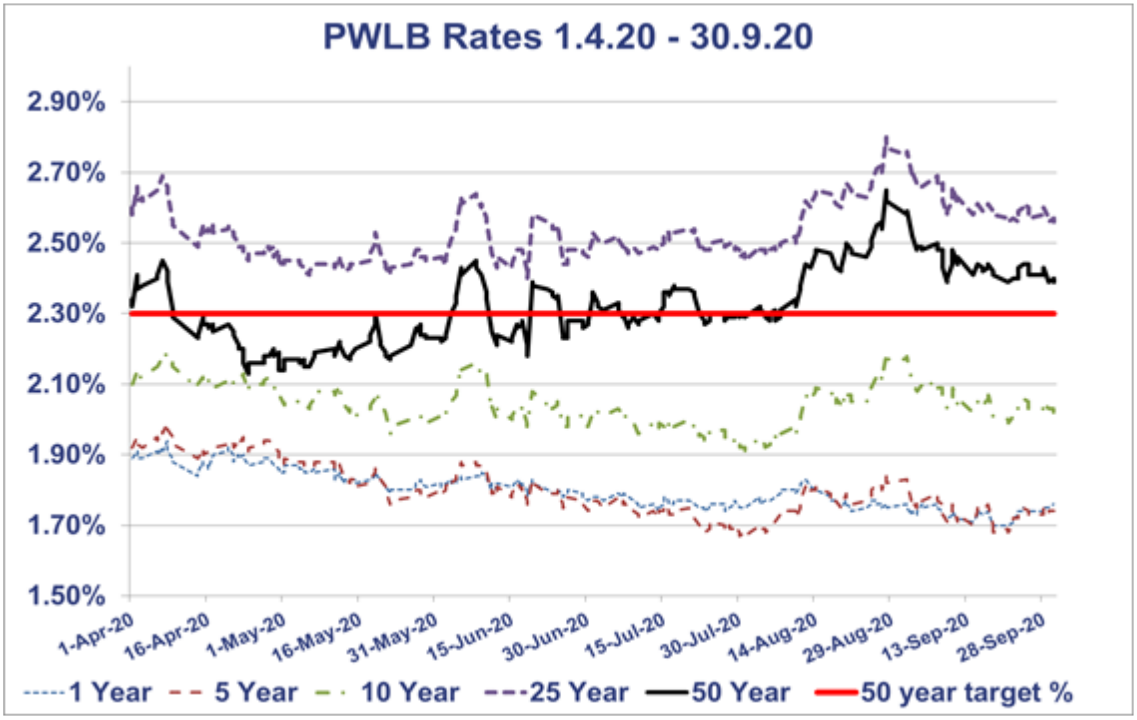
From the local authority borrowing perspective, HM Treasury imposed two changes of margins over gilt yields for Public Works Loans Board (PWLB) rates in 2019/20 without any prior warning. The first took place on 9th October 2019, adding an additional 1% margin over gilts to all PWLB period rates. That increase was then, at least partially, reversed for some forms of borrowing on 11th March 2020, but not for mainstream non-HRA capital schemes. At the same time the Government announced in the Budget a programme of increased infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins; the HM Treasury consultation was initially due to end on 4th June, but that date was subsequently put back to 31st July. To date, the outcomes of the consultation have yet to be announced but it is clear that HM Treasury will most likely no longer allow local authorities to borrow money from the PWLB to purchase commercial property if the primary aim is to generate an income stream (assets for yield). The definition of such commercial activity in the consultation is vague.

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)

The Council qualifies to borrow from the PWLB at the certainty rate for both General Fund and Housing Revenue Account purposes. It is possible that the non-HRA Certainty Rate will be subject to revision downwards after the conclusion of the HM Treasury consultation; however, the timing of such a change is currently an unknown, although it would be likely to be within the current financial year.

There has not been a great deal of volatility in PWLB rates since the start of the financial year, apart from a more significant spike up during the second half of August into early September. This is shown in the graph below.



There is likely to be little upward movement in PWLB rates over the next two years as it will take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down period. Inflation is also likely to be very low during this period.

£60m was borrowed from the PWLB at the HRA certainty rate in the first quarter of 2020/21 to fund the HRA capital programme. This was because PWLB rates were very low and because the Council may not be able to access funding from the PWLB in future because of its commercial activities. These loans were all for £20m and are repayable in 50 years at maturity. These loans have an average interest rate of 1.17%.

Whereas this authority has previously relied on the PWLB as its main source of funding, it now has to fundamentally reconsider alternative cheaper sources of borrowing at cheaper rates from the following:

- Local authorities (primarily shorter dated maturities)
- Financial institutions (primarily insurance companies and pension funds but also some banks, out of spot or forward dates)
- Municipal Bonds Agency (limited issuance at present but there is potential)

At the current time, this is a developmental area as the action taken by HM Treasury on PWLB rates has also taken the financial services industry by surprise. The market has yet to settle down and Members will be updated as this area evolves.

At the start of the year, the Council had £30m of short term loans to help fund the payment of 3 years' of employer's pension contributions in advance in return for a discount. These loans were repaid in the first quarter of 2020/21.

The Council's gross borrowing at 30th September 2020 of £786m is within the Council's Authorised Limit (the maximum amount of borrowing approved by City Council) of £883m and also within the Council's Operational Boundary (the limit beyond which borrowing is not expected to exceed) of £868m.

The Council plans for gross borrowing to have a reasonably even maturity profile. This is to ensure that the Council does not need to replace large amounts of maturing borrowing when interest rates could be unfavourable.

The actual maturity profile of the Council's borrowing is within the limits contained within the Council's Treasury Management Policy (see paragraph A1).

Early Redemption of Borrowing

Debt rescheduling opportunities have been limited in the current economic climate and following the various increases in the margins added to gilt yields which has impacted PWLB new borrowing rates since October 2010. During the quarter ended 30th September 2020 no debt rescheduling was undertaken.

With the exception of two loans all the Council's borrowings to finance capital expenditure are fixed rate and fixed term loans. This reduces interest rate risk and provides a high degree of budget certainty.

The Council's borrowing portfolio is kept under review to identify if and when it would be financially beneficial to repay any specific loans early. Repaying borrowing early invariably results in a premium (early repayment charges) by the PWLB that are sufficiently large to make early repayment of borrowing financially unattractive to the Council.

No debt rescheduling or early repayment of debt has been undertaken during the two quarters of 2020/21 as it has not been financially advantageous for the Council to do so.

A4. INVESTMENT ACTIVITY

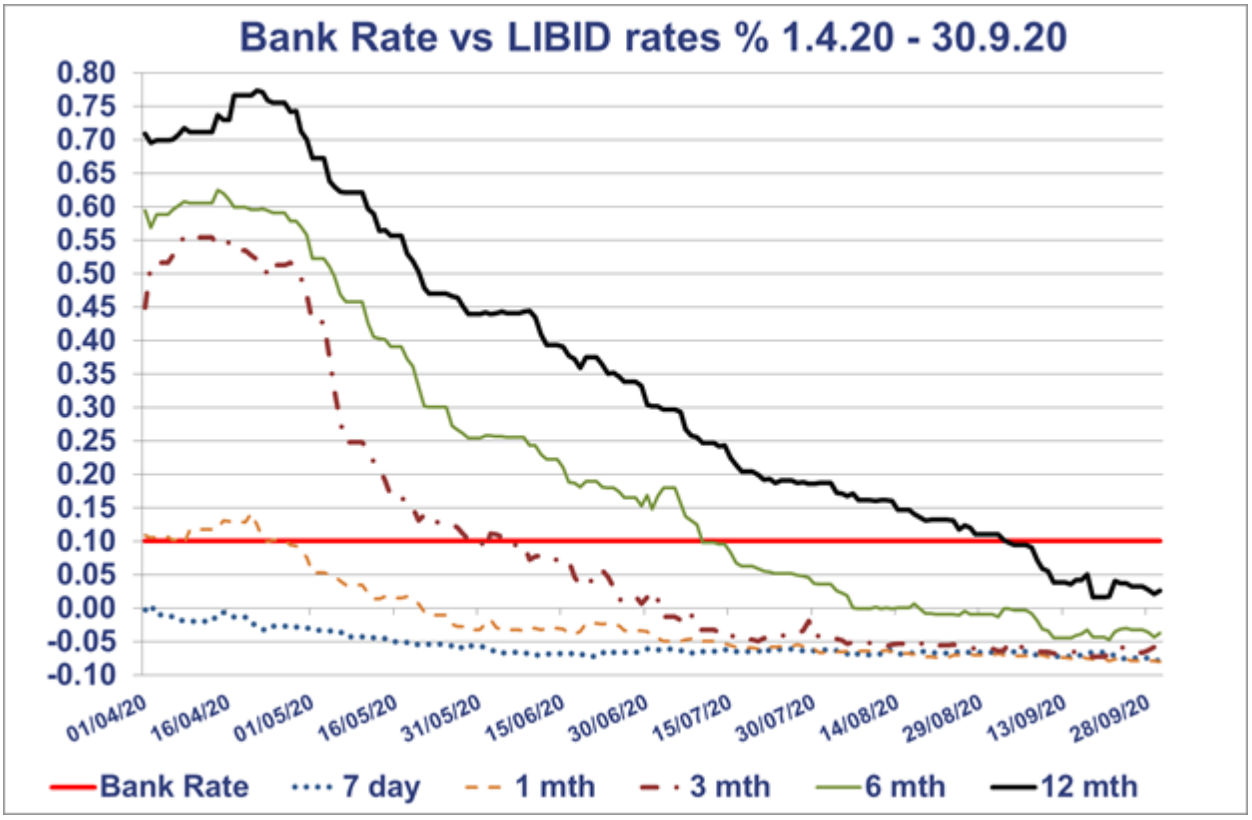
Although the credit rating agencies changed their outlook on many UK banks from stable to negative outlook during the quarter ended 30th June 2020, due to upcoming risks to banks' earnings and asset quality during the economic downturn caused by the pandemic, the majority of ratings were affirmed due to the continuing strong credit profiles of UK banks. However, during Q1 and Q2 2020, banks did make provisions for expected credit losses and the rating changes reflected these provisions. As we move into the next quarters ahead, more information will emerge on actual levels of credit losses. This has the potential to cause rating agencies to revisit their initial rating adjustments later in 2020. These adjustments could be negative or positive, although it should also be borne in mind that UK banks went into this pandemic with strong balance sheets. Indeed, the Financial Policy Committee (FPC) report on 6th August revised down their expected credit losses for the banking sector to "somewhat less than £80bn". They stated that, in their assessment, "banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the Monetary Policy Committee's (MPC) central projection". The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC's projection, with unemployment rising to above 15%.

All three rating agencies have reviewed banks around the world with similar results in many countries of most banks being placed on negative watch, but with a small number of actual downgrades.

It is possible to insure deposits with banks against the risk of the bank defaulting through a financial instrument known as a credit default swap (CDS). CDS prices are therefore market indicators of credit risk. The CDS prices for UK banks spiked upwards at the end of March / early April due to the liquidity crisis throughout financial markets. CDS prices have returned to average levels since then, although they are still elevated compared to end-February.

Uncertainty over Brexit caused the MPC to leave Bank Rate unchanged during 2019 and at its January 2020 meeting. However, since then the coronavirus outbreak has transformed the economic landscape: in March, the MPC took emergency action twice to cut Bank Rate first to 0.25%, and then to 0.10%.

Actual market investment rates (London Interbank Bid rate) are shown in the graph below.



It is now impossible to earn the level of interest rates commonly seen in previous decades as all investment rates are barely above zero now that Bank Rate is at 0.10%, while some entities, including more recently the Debt Management Account Deposit Facility (DMADF), are offering negative rates of return in some shorter time periods. Given this risk environment and the fact that increases in Bank Rate are unlikely to occur before 2023, investment returns are expected to remain low.

The Council's cash investment portfolio consists of the following.

	Portfolio at 31st March 2020	**Return in 2019/20**	**Portfolio at 30th June 2020**	**Annualised Return to 30th June 2020**	**Portfolio at 30th September 2020**	**Annualised Return to 30th September 2020**
Plain vanilla interest bearing deposits	£375.7	0.98%	£374.2m	0.98%	£415.0m	0.92%
Tradable structured interest bearing deposits where the interest rate or the maturity date is determined by certain criteria	£9.7m	2.05%	£10.2m	22.55%	£10.3m	13.88%
Externally managed corporate bonds	£7.4m	-1.16%	£8.0m	24.28%	£8.0m	18.92%
Total	**£392.8m**	**0.99%**	**£392.4m**	**2.02%**	**£433.3m**	**1.58%**

Plain Vanilla Interest Bearing Deposits

As previously reported in the Treasury Management Outturn Report for 2019/20, the return on plain vanilla interest bearing deposits in 2019/20 was reduced through the need to provide £0.6m to write off the investment in Victory Energy Services Limited (VESL). The underlying return on these deposits in 2019/20 before providing for the write off of the investment in VESL was 1.16%. Therefore the underlying return on these investments has fallen by 24 basis points in the first half of 2020/21. This trend is expected to continue as when the current investments mature, it is unlikely that it will be possible to replace them with new investments paying the previous rates.

Tradable Structured Interest Bearing Deposits

This now consists of a single collared floating rate note purchased in June 2018 with a nominal value of £10m maturing in June 2023. Interest is paid at the 3 month London Inter Bank Offer Rate (LIBOR) with a floor of 1.60% and a cap of 3.50%. Interest is currently being paid at 1.60%.

At the end of 2019/20 this investment had a market value of £9.7m because the financial markets had become illiquid.

However, liquidity has returned to the financial markets and the guaranteed return of at least 1.60% is very attractive against the current 3 month LIBOR rate of 0.06%. Consequently at 30th September 2020 this investment had a market value of £10.3m. The market value of this investment should be £10m when it matures in June 2023.

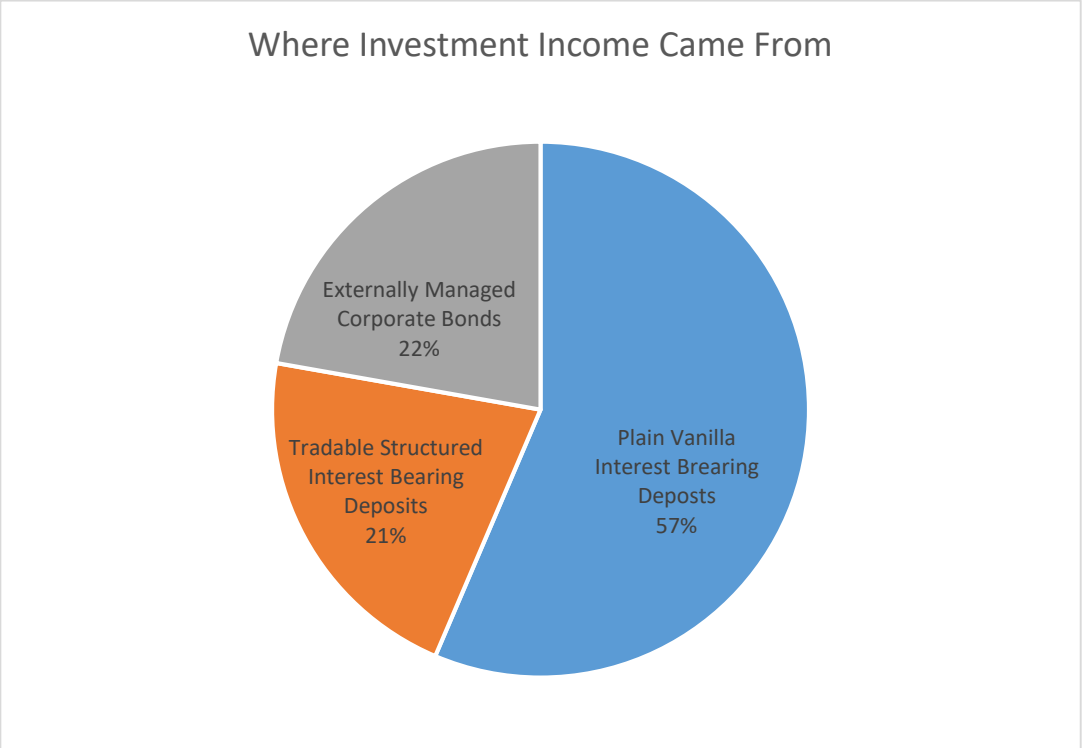
Externally Managed Corporate Bonds

The shortage of liquidity in the financial markets in March 2020 also caused the market value of corporate bonds to fall sharply. As a consequence of this the Council's externally managed corporate bonds made a negative return of 1.16% in 2019/20.

The corporate bond portfolio has been defensively managed and has no direct exposure to the energy, travel, hospitality, or non-food retail sectors. Now that liquidity has returned to the financial markets the value of the corporate bond portfolio has made a strong recovery.

Overall Return

The Council made an overall return of 1.56% on its cash investments in the first half of 2020/21. The chart below shows the source of the Council's cash investment income.



43% of the Council's investment income came from externally managed corporate bonds and tradable structured interest bearing deposits, despite these investments making up less than 5% of the investment portfolio. However, much of these gains result from a recovery in the market value of these investments and the level of returns experienced in the first quarter of 2020/21 is not being sustained.

Over the remainder of the year, the vast majority of the Council's investment returns will come from plain vanilla interest bearing deposits which make up over 95% of the investment portfolio. The returns on this type of investment are falling in line with market interest rates.

Given these factors, the return on the Council's investments over the remainder of the year is likely to be around 1%.

A5. COMBINED BORROWING AND INVESTMENT POSITION (NET DEBT)

The Councils net debt position at 30th September 2020 is summarised in the table below.

	Principal	**Average Interest Rate**	**Interest to 30th September 2020**
Borrowing (including finance leases & private finance initiative (PFI) schemes)	£786m	3.44%	£13.5m
Investments	(£433m)	(1.58%)	(£3.2m)
Net Debt	£353m		£10.3m

*Although the Council's investments were £433m at 30th September 2020, the average sum invested over this period was £404m.