

<b>Committee:</b> Financial Investment Board Audit and Risk Management Committee	<b>Date:</b> 25 November 2020 13 January 2021
<b>Subject:</b> Mid-Year Treasury Management Review 2020/21	<b>Public</b>
<b>Report of:</b> The Chamberlain	<b>For Information</b>
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### Summary

The Treasury Management Strategy Statement and Annual Investment Strategy for 2020/21 was approved by the Financial Investment Board and the Finance Committee in February 2020 and by the Court of Common Council on 5 March 2020 and came into effect on 1 April 2020.

Under CIPFA’s Code of Practice on Treasury Management, which was adopted by the Court of Common Council on 3 March 2010, there is a requirement to provide a mid-year review. The main points to note are as follows:

- The strategy has been reviewed considering the significant economic developments related to Covid-19 that have taken place over the first half of the year.
- Despite the very low returns available on cash investments at present, the Corporation’s priorities remain as security and liquidity (ahead of yield). Given the current risk environment, officers do not recommend that the Corporation relaxes its risk appetite for the second half of the year.
- As at 30 September 2020, the City had cash balances totalling £1,121.6m. Most of the balances are held for payment to third parties or are restricted reserves. They also include the City’s Cash borrowing proceeds.
- No approved counterparty limits were breached during the first half of 2020/21 and the City has experienced no liquidity concerns.
- No external borrowing has been entered into by City Fund and it is not anticipated that City Fund will require any external borrowing during the remainder of the financial year.

### Recommendation

Members are asked to note the report.

## Main Report

### Introduction

1. The City of London Corporation (the City) is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the City's low risk appetite, providing adequate liquidity initially before considering investment return.
2. The second main function of the treasury management service is the funding of capital expenditure plans. Last year, the City issued debt on behalf of City's Cash via a private placement, which will support that entity's long term capital financing plans. The City has not undertaken and new borrowing in the first half of this year and does not at this stage anticipate any external borrowing in the remainder of 2020/21.
3. The City's treasury management activities are undertaken in accordance with the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017) which was adopted by the Court of Common Council on 3 March 2010.
4. The City defines its treasury management activities 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.*

### Economic Update

5. Covid-19 has understandably dominated the domestic economic agenda over the first half of the year. GDP fell sharply by 21.8% between December and June, which represents one of the largest falls in output amongst developed economies, although not unexpected given the prominence of consumer-facing services in the UK. A sharp, partial recovery took place between June and August as businesses re-opened following the lifting of social restrictions, although this still left the economy 11.7% smaller than in February. Recovering the remaining lost output is expected to take much longer and over the near term developments related to the virus will weigh on GDP.
6. The Bank of England's Monetary Policy Committee (MPC) acted to reduce rates twice in March, first from 0.75% to 0.25% and then again to 0.10%. At the same time the Bank increased its quantitative easing programme by £200bn to £645bn. These actions are intended to stimulate inflation and support the economy by reducing the cost of borrowing for households and businesses and encouraging spending. The MPC has since kept rates at 0.10% and has increased QE by a further £100bn in June and another £150bn in November.

7. Inflation as measured by CPI reached 0.5% at the end of September (far below the Bank's 2% target) reflecting the direct and indirect effects of Covid-19 on the economy. The Bank has indicated that inflation will rise above the 2% target in Q3 2022 as spare capacity starts to be used up. However in a slight change of tack, the MPC has stated that it does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably.
8. Gilt yields were on a declining trend before the emergence of Covid-19 and, after a brief spike in March, they have fallen further and remained at historic lows over the first half of 2020/21. This is in spite of the huge amount of additional government spending that has taken place this year and the new public debt that has been issued to finance that spend, which in ordinary circumstances would lead to an increase in gilt yields.
9. Considering the above, officers expect that interest rates will remain very low for the foreseeable future. The Corporation's treasury consultants, Link Asset Services, have provided an updated interest rate forecast which is attached as an Appendix.

### **Treasury Management Strategy Statement and Annual Investment Strategy Update**

10. The Treasury Management Strategy Statement and Annual Investment Strategy for 2020/21 was approved by the Financial Investment Board (11 February 2020), the Finance Committee (18 February 2020) and the Court of Common Council (5 March 2020).
11. As such the strategy was conceived before the emergence of Covid-19 as a global pandemic and this mid-year review provides a timely opportunity to reassess the strategy and its appropriateness in light of the economic developments outlined above.
12. Having considered the strategy, officers believe that it remains appropriate for the second half of 2020/21 and do not recommend any fundamental changes are made.

### **Investment Strategy**

13. The City held £1,121.6m of investments as at 30 September 2020 (£1,014.7m at 31 March 2020). Most of the balances are held for payment to third parties or are restricted reserves; they also include debt issued by City's Cash in 2019/20. The weighted average rate of return on the City's treasury management portfolio at the end of September was 0.85%.
14. In accordance with the CIPFA Treasury Management Code of Practice, the Corporation's investment priorities are:
  - Security of capital
  - Liquidity
  - Yield

15. The Corporation aims to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the Corporation's risk appetite. In the current economic climate, it is considered appropriate to retain sufficient capacity to cover planned and potentially unanticipated cash flow needs, but also to seek out value by placing deposits with high credit rated counterparties where possible. The current investment strategy remains appropriate for facilitating these aims by limiting lending to only high-quality borrowers whilst also not being so restrictive as to create an overconcentration of exposure to any single counterparty.
16. As shown by the interest rate forecasts in the Appendix, it is now very difficult to earn the sort of returns commonly seen in previous years as all investment rates are barely above zero now that Bank Rate is at 0.10%. Given this risk environment and the fact that increases in Bank Rates are unlikely to occur before the end of the current forecast horizon of 31st March 2023, investment returns are expected to remain low.
17. Although the returns on cash investments are at historic lows, the prime objective is to ensure cash is safe and available when needed. It is not recommended that the Corporation relaxes its creditworthiness criteria at this stage to protect income as this would contradict the primary obligation of keeping the Corporation's cash assets secure, before considering yield.
18. No approved counterparty limits were breached during the first half of 2020/21 and the City has experienced no liquidity concerns. The Treasury Management Strategy remains appropriate in enabling the City to pursue its prime objectives of security and liquidity, followed by yield.

#### Negative interest rates

19. As noted above, the Bank of England has loosened monetary policy in order to mitigate the economic impact of Covid-19. This has coincided with renewed speculation over whether the Bank will reduce interest rates even further to zero or below zero. Indeed, the Bank itself has undertaken preparations for a zero or negative interest rate environment and in October the Deputy Governor formally wrote to financial institutions requesting feedback on their readiness for negative policy rates.
20. However, when the MPC met in November it unanimously agreed to keep Bank Rate at 0.10% and voted to increase its quantitative easing programme by another £150bn to £895bn. This could imply that the Bank will seek to use asset purchases rather than interest rates as its preferred tool for stimulating the economy during the pandemic and this coheres with the view of the City's treasury consultants, Link, who currently contend that the MPC will keep interest rates at 0.10% for the foreseeable future. However, given that it remains possible that negative interest rates could be implemented, it is prudent for the Corporation to assess the potential ramifications for the cash portfolio.
21. It should be noted that for most of the past decade, the rate of inflation as measured by CPI has been at a level above the yield available on short term

cash investments. Therefore, treasury managers have already been navigating an environment whereby real interest rates have routinely been negative for some years. The prospect of negative nominal interest rates does not fundamentally change this situation and if the Bank reduces interest rates to zero or lower, it will reinforce the importance of ensuring cash is invested over appropriate time horizons to generate the best possible yield within appropriate parameters.

22. Officers have considered the potential impact of negative interest rates on the credit standing of banks. Even though banks are much more adequately capitalised today than compared to before the global recession in 2007-08, negative interest rates have the potential to further squeeze the interest rate margins on which their profitability depends. This could have an adverse impact on their credit standing with the main rating agencies. Officers have stress tested a scenario whereby Fitch downgrades its long-term credit rating for all financial institutions by one notch (e.g. from A to A-). Of the 36 domestic and global banks that are currently eligible under the 2020/21 Treasury Management Strategy, 5 would no longer meet the minimum credit requirement (that is to say their long term credit rating would move from "A" to "A-". However, none of these 5 banks are active counterparties for the Corporation and all of the banks with whom the Corporation routinely places deposits would still qualify under the stressed conditions. Therefore the current creditworthiness policy remains appropriate for restricting lending to only high quality counterparties whilst ensuring that there is sufficient capacity to diversify deposits amongst multiple banks.

## **Borrowing Strategy**

### City Fund

23. The City Fund has not acquired any external borrowing in the first half of the year and it is not anticipated that any external borrowing will be required in the remainder of 2020/21. Although the City Fund has a borrowing requirement forecast in the years ahead, entering into new external borrowing now would increase the Corporation's revenue pressures in the immediate term and, given that the outlook for interest rates is judge to be benign, officers recommend that no new borrowing is undertaken.

### City's Cash

24. No further borrowing activity has been undertaken by City's Cash, which issued £450m debt in 2019/20. The first tranche of £250m of this debt was received in September 2019. The remaining £200m of borrowing proceeds will be received in July 2021 and will be used to support the planned increase in capital expenditure arising over the course of the next few years. By deferring receipt of this borrowing until 2021, the City has avoided paying additional interest costs whilst at the same time securing fixed rate borrowing on competitive terms. Likewise, by arranging both tranches of borrowing (the initial £250m and the deferred £200m) at once, the City has avoided the administrative and financial burden of running a second private placement process in 2021.

## **Conclusion**

25. The City has effectively executed the 2020/21 Treasury Management Strategy during the first six months of the year. After considering the original strategy against the current treasury management environment, officers judge that the investment strategy remains appropriate for the second half of the year.

## **APPENDIX: Interest Rate Forecasts 2020 - 2024**

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**APPENDIX: Interest Rate Forecasts 2020 – 2024**

PWLB rates and forecast shown below have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012.

Link Group Interest Rate View		9.11.20													
	Dec-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	
<b>BANK RATE</b>	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	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	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	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	0.20	
5 yr PWLB	1.80	1.80	1.80	1.80	1.80	1.90	1.90	1.90	1.90	1.90	2.00	2.00	2.00	2.00	
10 yr PWLB	2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30	2.30	2.30	2.30	2.30	
25 yr PWLB	2.50	2.50	2.60	2.60	2.60	2.60	2.70	2.70	2.70	2.70	2.80	2.80	2.80	2.80	
50 yr PWLB	2.30	2.30	2.40	2.40	2.40	2.40	2.50	2.50	2.50	2.50	2.60	2.60	2.60	2.60	
<b>Bank Rate</b>															
Link	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	0.10	
Capital Economics	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	-	-	-	-	-	
<b>5yr PWLB Rate</b>															
Link	1.80	1.80	1.80	1.80	1.80	1.90	1.90	1.90	1.90	1.90	2.00	2.00	2.00	2.00	
Capital Economics	1.80	1.90	1.90	1.90	1.90	1.90	1.90	1.90	1.90	-	-	-	-	-	
<b>10yr PWLB Rate</b>															
Link	2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30	2.30	2.30	2.30	2.30	
Capital Economics	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	-	-	-	-	-	
<b>25yr PWLB Rate</b>															
Link	2.50	2.50	2.60	2.60	2.60	2.60	2.70	2.70	2.70	2.70	2.80	2.80	2.80	2.80	
Capital Economics	2.40	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	-	-	-	-	-	
<b>50yr PWLB Rate</b>															
Link	2.30	2.30	2.40	2.40	2.40	2.40	2.50	2.50	2.50	2.50	2.60	2.60	2.60	2.60	
Capital Economics	2.30	2.20	2.20	2.20	2.20	2.20	2.20	2.20	2.20	-	-	-	-	-	