Committee: Cabinet

Date: 12 July 2021

Wards:

Subject: London Borough of Merton Treasury Management Strategy - Annual Review 2020/21

Lead officer: Caroline Holland

Lead member: Cllr. Tobin Byers

Contact officer: Roger Kershaw

Recommendations:

A. This report provides Members with an update on the Council's Treasury management activity during 2020-21 and details any areas of difference from the Treasury management strategy approved in March 2020.

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1 PURPOSE OF REPORT AND EXECUTIVE SUMMARY

1.1. The Council undertakes Treasury Management Activities in accordance with the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management, which requires that the Council receives an annual strategy report by 31 March for the year ahead and an annual review report of the previous year by 30 September. This report is the review of Treasury Management activities during 2020/21.

2 DETAILS

2.1 The 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 2020/21. 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 2020/21 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council March 2020)
- a mid-year (minimum) treasury update report – to the Director of Corporate Resources in addition to the monthly treasury management updates.
- an annual review following the end of the year describing the activity compared to the strategy (this report)

2.2 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.

2.3 THE COUNCIL'S CAPITAL EXPENDITURE AND FINANCING

2.3.1 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

- Financed through borrowing if insufficient alternative financing is available.

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

	2020/21 Actual £'000	2021/22 Estimate £'000	2022/23 Estimate £'000
Capital expenditure.	16,930	36,580	19,169
Financed in Year	16,930	26,516	11,426
Unfinanced Capital Expenditure	0	10,064	7,743

2.4 THE COUNCIL'S OVERALL BORROWING NEED

2.4.1 The Council's underlying need to borrow to finance capital expenditure is determined by the Capital Financing Requirement (CFR). Based on the CFR requirements the Council was 20% under borrowed as at 31 March 2021 and it will increase if the council will not make any new borrowing.

2.4.2 **Gross borrowing and 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 (2019/20), plus the estimates of any additional capital financing requirement for the current (2020/21) and next two financial years. This essentially means that the council is not borrowing to support revenue expenditure.

Capital Financing Requirement(CFR)	2020/21 Actual £'000	2020/21 Estimate £'000	2021/22 Estimate £'000
Total CFR	167,460	171,044	180,373

2.4.3 **The authorised limit –** this 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 2020/21 the Council has maintained gross borrowing within its authorised limit.

2.4.4 **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.

2.5 THE COUNCIL'S OVERALL TREASURY POSITION AS AT 31 MARCH 2021

2.5.1 At the beginning and the end of 2020/21 the Council's treasury (excluding borrowing by PFI and finance leases) position was as follows:

	Balance as at 31 March 2020	Balance as at 31 March 2021
Capital Financing Requirement	173,583	167,461
External Borrowing plus Leasing	143,085	139,817
Leasing	30,075	28,807
External Borrowing	113,010	111,010
Over/Under Borrowing	(30,498)	(27,644)

	Investment		Debt	
	31-Mar-20	31-Mar-21	31-Mar-20	31-Mar-21
Average interest Rate (%)	0.82	0.18	5.58	5.56
Average period	349 days	174 days	34 Yrs	33 yrs
Total interest (£000)	1,368	840	6,316	6,307
Balance as at 31 March (£000)	80,000	55,000	113,010	111,010

*Cash held in Money Market funds not included above.

2.5.2 In 2020-21 the interest income dropped significantly compared to 2019-20. This is mainly due to the two interest cuts by the bank of England and Merton, as a precaution decided to keep most of its cash as liquid to meet any pandemic demand since March 2021.

2.5.3 By carefully picking the counterparties and the investments in 2020-21 the investment income generated from the treasury investments was £840k.this is £132k above the budgeted interest income of £708K.

2.5.4 Due to the uncertainty posed by the pandemic the Council decided to hold sufficient amounts of cash as liquid since the beginning of the financial year. To have maximum liquidity and to earn as much as income possible funds were placed in Money Market Funds. The MMF gave an average of 0.02% interest compared to 0.15% in the previous years. This is mainly due the two base rate cuts by the Bank of England.

2.5.5 The Council approved the addition of two extra MMFs in November 2020 and this gave us the opportunity to spread our cash balance and still maintain liquidity.

2.5.6 The Council can use external borrowing to fund long-term capital expenditure. Please note that the Council has not borrowed since 2007. The current debt portfolio maturity structure is shown overleaf;

Maturity structure of the debt portfolio.	2020/21 Actual £'000	2020/21 Actual %
Under 12 months	2,000	1.80
12 months and within 24 months	310	0.28
24 months and within 5 years	26,200	23.60
5 years and within 10 years	4,500	4.05
10 years and within 15 years	12,500	11.27
15 years and over	65,500	59.00
Total Debt	**111,010**	**100**

2.6 BORROWING OUTTURN FOR 2020/21

2.6.1 An analysis of movements at nominal values on loans during the year is shown below:

	Balance at 31/03/20 £000's	Loans raised £000's	Loans repaid £000's	Balance at 31/03/20 £000's
PWLB	52,010	0	0	52,010
Temporary Loans	0	0	0	0
Other loans	61,000	0	2,000	59,000
Total Debt	113,010	0	2,000	111,010

2.6.2 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.

2.7 INVESTMENT OUTTURN FOR 2020/21

2.7.1 The Council's investment policy is governed by MHCLG and CIPFA guidance. The annual Treasury Management strategy is created based on these guidance and 2020-21 strategy was approved by the Council in March 2020

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.).

2.7.2 The Council manages its investments in-house (with advice from Link Asset Services) with the overall objective to balance risk with return and the overriding consideration being given to the security of the available funds.

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

2.7.4 The table below shows the investment breakdown and the movement in 2020-21

	Investment at 31/03/20 £000's	Amount Invested in year £000's	Investments realised in year £000's	Balance at 31/03/21 £000's
Fixed Rate Investments	70,000	40,000	(65,000)	45,000
Money Market Fund	500			60,000
CCLA Investment	10,000			10,000
Total Investments	80,500	40,000	(65,000)	115,000

2.7.5 All investments within the investment portfolio have a maturity date within 1 year.

2.7.6 The table below gives details of the fixed deposits as at 31st March 2021.

Counter party	Date of investment	Maturity	Value	rate%
GOLDMAN SACHS	26/02/2021	26/08/2021	- 5,000,000.00	0.235
SANTANDER	26/02/2021	24/08/2021	- 10,000,000.00	0.3
LLOYDS BANK PLC	05/11/2020	05/08/2021	- 5,000,000.00	0.15
GOLDMAN SACHS	29/01/2021	29/07/2021	- 5,000,000.00	0.13
CLOSE BROTHERS	26/03/2021	27/09/2021	- 5,000,000.00	0.25
CLOSE BROTHERS	29/03/2021	29/09/2021	- 5,000,000.00	0.25
LLOYDS BANK PLC	20/01/2021	20/01/2022	- 5,000,000.00	0.1
NATWEST	20/01/2021	20/01/2022	- 5,000,000.00	0.08

2.7.7 The council takes regular advice from our treasury consultant LINK and the investments are placed based on the recommendation we receive from LINK. The recommendation includes approved counterparties with limits in investment value and duration. Please find below Merton approved list as at 31 March 2021.

Y	Pi1	Pi2	P	B	O	R	G	N/C
1	1.25	1.5	2	3	4	5	6	7
Up to 5yrs	Up to 5yrs	Up to 5yrs	Up to 2yrs	Up to 1yr	Up to 1yr	Up to 6mths	Up to 100days	No Colour

	Colour (and long term rating where applicable)	Money Limit	Time Limit
Banks	**yellow**	**£35m**	**5yrs**
Banks	**purple**	**£25m**	**2 yrs**
Banks	**orange**	**£25m**	**1 yr**
Banks – part nationalised	**blue**	**£25m**	**1 yr**
Banks	**red**	**£10m**	**6 mths**
Banks	**green**	**£5m**	**100 days**
Banks	**No colour**	**Not to be used**	

Other institutions limit	**-**	**£5m**	**1yrs**
Government (DMADF)		**unlimited**	**6 months**
Local authorities	**Yellow**	**£35m**	**5yrs**
	Fund rating	**Money Limit**	**Time Limit**
Money market funds (maximum 5 Funds, £20m per Fund)	**AAA**	**£100m**	**Instant**
Ultra-Short Dated Bond funds with a credit score of 1.25	**Dark pink / AAA**	**£25m**	**Instant**
Ultra-Short Dated Bond funds with a credit score of 1.5	**Light pink / AAA**	**£10m**	**Instant**

2.8. Investment strategy and control of interest rate risk

2.8.1 Investment returns which had been low during 2019/20, plunged during 2020/21 to near zero or even into negative territory. Most local authority lending managed to avoid negative rates and one feature of the year was the growth of inter local authority lending.

2.8.2 The expectation for interest rates within the treasury management strategy for 2020/21 was that Bank Rate would continue at the start of the year at 0.75 % before rising to end 2022/23 at 1.25%. This forecast was invalidated by the Covid-19 pandemic bursting onto the scene in March 2020 which caused the Monetary Policy Committee to cut Bank Rate in March, first to 0.25% and then to 0.10%, in order to counter the hugely negative impact of the national lockdown on large swathes of the economy.

2.8.3 The Bank of England and the Government also introduced new programmes of supplying the banking system and the economy with massive amounts of cheap credit so that banks could help cash-starved businesses to survive the lockdown. The Government also supplied huge amounts of finance to local authorities to pass on to businesses. This meant that for most of the year there was much more liquidity in financial markets than there was demand to borrow, with the consequent effect that investment earnings rates plummeted.

2.8.4 While the Council has taken a cautious approach to investing, it is also fully appreciative of changes to regulatory requirements for financial institutions in terms of additional capital and liquidity that came about in the aftermath of the financial crisis. The council always follow the recommendation from its Treasury consultant LINK

2.8.5 These requirements have provided a far stronger basis for financial institutions, with annual stress tests by regulators evidencing how institutions are now far more able to cope with extreme stressed market and economic conditions.

2.8.6 Investment balances have been kept to a minimum through the agreed strategy of using reserves and balances to support internal borrowing, rather than borrowing externally from the financial markets. External borrowing would have incurred an additional cost, due to the differential between borrowing and investment rates as illustrated in the charts shown above and below. Such an approach has also provided benefits in terms of reducing the counterparty risk exposure, by having fewer investments placed in the financial markets.

Link Asset Services Interest Rate View	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 Month LIBID	0.45	0.40	0.35	0.30	0.30	0.30	0.30	0.30
6 Month LIBID	0.60	0.55	0.50	0.45	0.40	0.40	0.40	0.40
12 Month LIBID	0.75	0.70	0.65	0.60	0.55	0.55	0.55	0.55
5yr PWLB Rate	1.90	1.90	1.90	2.00	2.00	2.00	2.10	2.10
10yr PWLB Rate	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30
25yr PWLB Rate	2.50	2.50	2.50	2.60	2.60	2.60	2.70	2.70
50yr PWLB Rate	2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50

2.9 Borrowing strategy and control of interest rate risk

2.9.1 During 2020-21, the Council maintained an under-borrowed position (17%). This meant 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 very low and minimising counterparty risk on placing investments also needed to be considered.

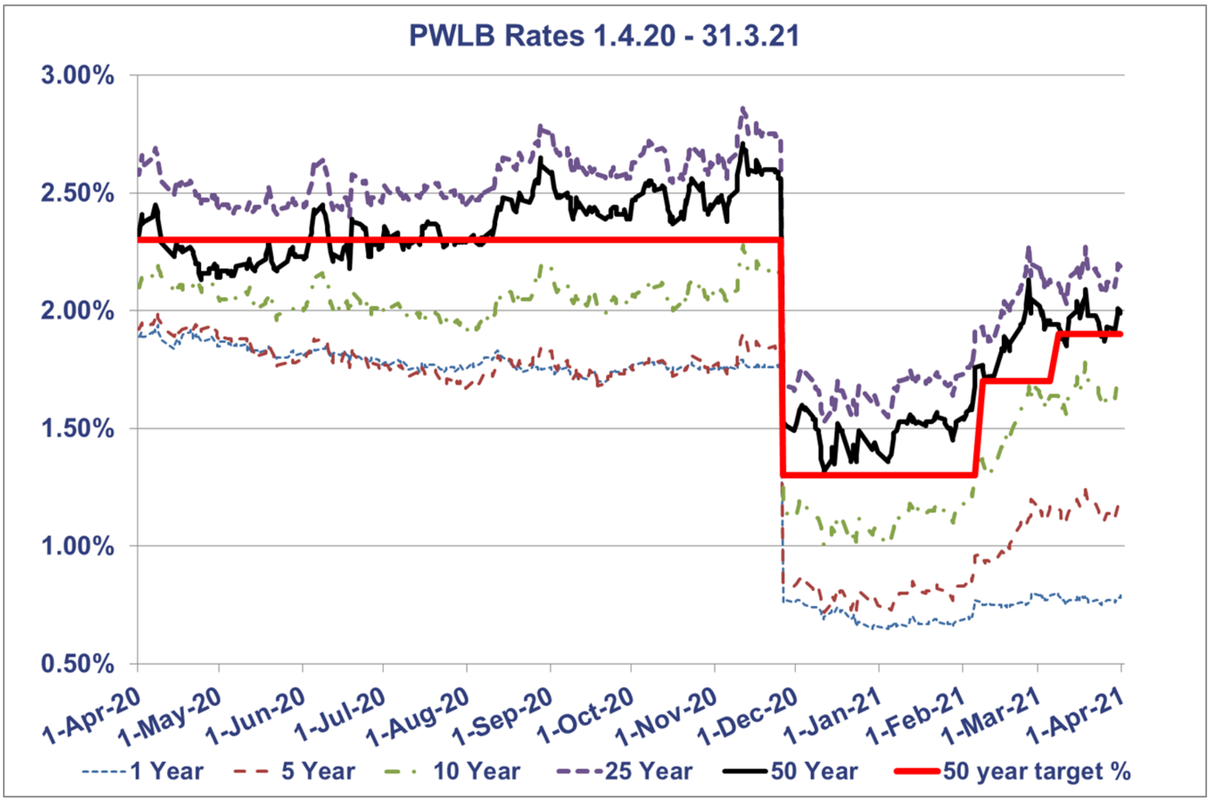
2.9.2 The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this was kept under review to avoid incurring higher borrowing costs in the future when this authority may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.

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

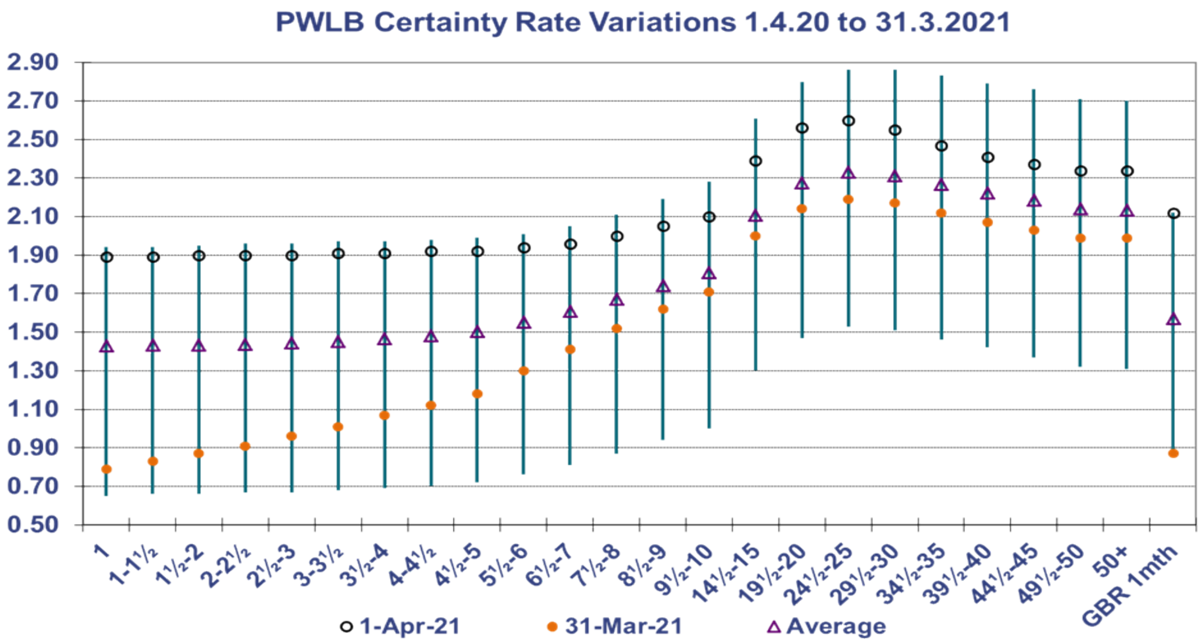
- if it had been felt that there was a significant risk of a sharp FALL in long and short term rates, (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings would have been postponed, and potential rescheduling from fixed rate funding 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 2020/21 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period.



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.65%	0.72%	1.00%	1.53%	1.32%
Date	04/01/2021	11/12/2020	11/12/2020	11/12/2020	11/12/2020
High	1.94%	1.99%	2.28%	2.86%	2.71%
Date	08/04/2020	08/04/2020	11/11/2020	11/11/2020	11/11/2020
Average	1.43%	1.50%	1.81%	2.33%	2.14%
Spread	1.29%	1.27%	1.28%	1.33%	1.39%

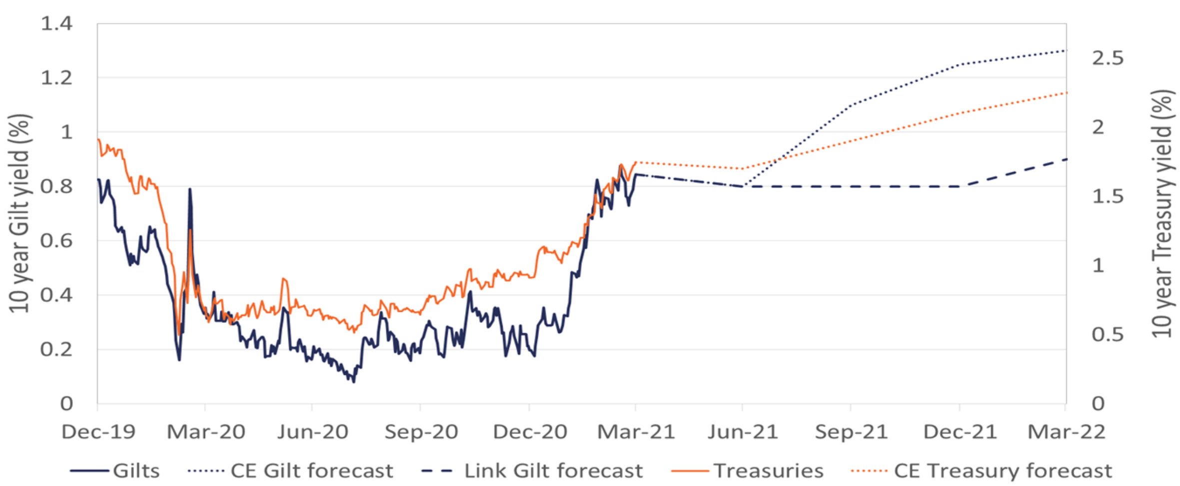


2.9.4 PWLB rates are based on, and are determined by, gilt (UK Government bonds) yields through H.M.Treasury determining a specified margin to add to gilt yields. The main influences on gilt yields are Bank Rate, inflation expectations and movements in US treasury yields.

2.9.5 Inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation and 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.

2.9.6 We have seen over the last two years, many bond yields up to 10 years in the Eurozone turn negative on expectations that the EU would struggle to get growth rates and inflation up from low levels. 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.

Graph of UK gilt yields v. US treasury yields



2.9.7 Gilt yields fell sharply from the start of 2020 and then spiked up during a financial markets melt down in March caused by the pandemic hitting western countries; this was rapidly countered by central banks flooding the markets with liquidity. While US treasury yields do exert influence on UK gilt yields so that the two often move in tandem, they have diverged during the first three quarters of 2020/21 but then converged in the final quarter.

2.9.8 Expectations of economic recovery started earlier in the US than the UK but once the UK vaccination programme started making rapid progress in the new year of 2021, gilt yields and gilt yields and PWLB rates started rising sharply as confidence in economic recovery rebounded. Financial markets also expected Bank Rate to rise quicker than in the forecast tables in this report.

2.9.9 At the close of the day on 31 March 2021, all gilt yields from 1 to 5 years were between 0.19 – 0.58% while the 10-year and 25-year yields were at 1.11% and 1.59%.

2.9.10 HM Treasury imposed **two changes of margins over gilt yields for 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. A consultation was then held with local authorities and **on 25th November 2020, the Chancellor announced the conclusion to the review of margins over gilt yields for PWLB rates;** the standard and certainty margins were reduced by 1% but a prohibition was introduced to deny access to borrowing from the PWLB for any local authority which had purchase of assets for yield in its three year capital programme. The new margins over gilt yields are as follows: -.

- **PWLB Standard Rate** is gilt plus 100 basis points (G+100bps)
- **PWLB Certainty Rate** is gilt plus 80 basis points (G+80bps)
- **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)

2.9.11 There is likely to be only a gentle rise in gilt yields and PWLB rates over the next three years as Bank Rate is not forecast to rise from 0.10% by March 2024 as the Bank of England has clearly stated that it will not raise rates until inflation is sustainably above its target of 2%; this sets a high bar for Bank Rate to start rising.

3 ALTERNATIVE OPTIONS

3.1. N/A

4 CONSULTATION UNDERTAKEN OR PROPOSED

4.1. Regular advise from the Treasury management consultant

5 TIMETABLE

5.1. N/A

6 FINANCIAL, RESOURCE AND PROPERTY IMPLICATIONS

6.1. Financial implication are covered in the main report

7 LEGAL AND STATUTORY IMPLICATIONS

7.1. All relevant implication are included in the report.

8 HUMAN RIGHTS, EQUALITIES AND COMMUNITY COHESION IMPLICATIONS

8.1. N/A

9 CRIME AND DISORDER IMPLICATIONS

9.1. N/A

10 RISK MANAGEMENT AND HEALTH AND SAFETY IMPLICATIONS

10.1. N/A

11 APPENDICES – THE FOLLOWING DOCUMENTS ARE TO BE PUBLISHED WITH THIS REPORT AND FORM PART OF THE REPORT

- None

12 BACKGROUND PAPERS

12.1. Regular market updates from various sources

12.2. Treasury Management Strategy 2020-21

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