Committee: Cabinet

Date: 18 July 2022

Subject: London Borough of Merton Treasury Management Strategy - Annual Review 2021/22

Lead officer: Caroline Holland, Director Corporate Services

Lead member: Councillor Billy Christie, Cabinet Member for Finance and Corporate Services

Contact officer: Nemashe Sivayogan, Treasury and Pensions Manager

Recommendations:

A. This is an update on the Merton Treasury management activity during 2021-22 and details any activities in accordance with the Treasury management strategy approved in March 2021.

B. That Cabinet note the report together with compliance with the CIPFA code.

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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 2021/22.

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 2021/22. 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 2021/22 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 2021)
- a mid-year (minimum) treasury update report – to the finance director. And 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

- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

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.

	2021/22 Actual £'000	2022/23 Estimate £'000	2023/24 Estimate £'000
Capital expenditure.	21,776	30,203	21,971
Financed in Year	21,776	18,730	10,176
Unfinanced Capital Expenditure	0	11,473	11,795

2.4 THE COUNCIL'S OVERALL BORROWING NEED

2.4.1 The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR). As at the December balance sheet projection the council was 17% under borrowed. This will increase if the council does not undertake 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 (2020/21), plus the actuals of any additional capital financing requirement for the current (2021/22) and next two financial years. This essentially means that the council is not borrowing to support revenue expenditure.

Capital Financing Requirement(CFR)	2021/22 Actual £'000	2022/23 Estimate £'000	2023/24 Estimate £'000
Total CFR	160,945	175,452	177,304

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 2021/22 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 2022

2.5.1 At the beginning and the end of 2021/22 the Council's treasury (excluding borrowing by PFI and finance leases) position was as follows:

	Balance as at 31 March 2021	Balance as at 31 March 2022
CFR including PFI & lease	167,460	160,945
CFR excluding PFI & lease	138,653	133,811
External Borrowing	111,010	109,010
Over/(Under) Borrowing	(28,807)	(36,009)

	Investment		Debt	
	31-Mar-21	31-Mar-22	31-Mar-21	31-Mar-22
Average interest Rate (%)	0.18	0.64	5.56	5.54
Average period	174 days	179 days	33 Yrs	32 Yrs
Total interest (£000)	840	530	6,307	6,079
Balance as at 31 March (£000)	55,000	70,000	111,010	109,010

*Cash held in Money Market funds not included above.

2.5.2 In 2021-22 interest rates started to recover after the effects of the pandemic. This was further boosted by the Bank of England increasing interest rates from December 2021. There have been further interest rate rises since then which in turn has seen returns on deposits increase rapidly.

2.5.3 By carefully picking the counterparties and the investments in 2021-22 the investment income generated from the treasury investments is £530k. This is £143k above the budgeted figure of £387k.

2.5.4 The council has slowly and prudently started to deposit funds into counterparties again in 2021-22 as we move out of the pandemic. However, being risk adverse and prudent. the council is only investing in main UK banks and has decided not to deposit funds into Local Authorities. Money Market Funds have started to pick up and current rates are around the 0.50% mark. These funds are a good option for immediate liquid cash whist giving a reasonable related return.

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

2.5.6 The Council uses external borrowing to fund its long-term capital expenditures. The Council has taken no new loans since 2007. The current debt portfolio maturity structure is shown below. In the year the council paid back a £2m LOBO loan and reduced its long-term borrowing to £109m

Maturity structure of the debt portfolio.	2020/21 Actual £'000	2020/21 Actual %
Under 12 months	310	0.28
12 months and within 24 months	0	0
24 months and within 5 years	26,200	24.03
5 years and within 10 years	5,500	5.05
10 years and within 15 years	11,500	10.55
15 years and over	65,500	60.09
Total Debt	**109,010**	**100**

2.6 BORROWING OUTTURN FOR 2021/22

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

	Balance at 31/03/2021 £000's	Loans raised £000's	Loans repaid £000's	Balance at 31/03/2022 £000's
PWLB	52,010		-	52,010
Temporary Loans		-	-	
Other loans	59,000	-	2,000	57,000
Total Debt	111,010		2,000	109,010

2.6.2 The Council has not borrowed more than its requirement or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed.

2.7 INVESTMENT OUTTURN FOR 2021/22

2.7.1 The Council's investment policy is governed by DULHC guidance, which was been implemented in the annual investment strategy approved by the Council on the 3rd March 2021

This policy set 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. The Council had no liquidity difficulties.

2.7.4 the table below shoes the investment breakdown and the movement in 2021/22

	Investment at 31/03/21 £000's	Amount Invested in year £000's	Investments realised in year £000's	Balance at 31/03/22 £000's
Fixed Rate Investments	45,000	25,000	(10,000)	60,000
Money Market Fund	60,000		(10,000)	50,000
CCLA Investment	10,000			10,000
Total Investments	115,000	25,000	(20,000)	120,000

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 made during the year.

Counter party	Date of investment	Maturity	Value	rate%
Close Brothers Bank	29/03/2022	29/09/2022	5,000,000	1.20
National Westminster Bank	20/01/2022	20/01/2023	5,000,000	0.86
Goldman Sachs	01/02/2022	01/08/2022	5,000,000	0.82
Goldman Sachs	28/02/2022	31/08/2022	5,000,000	1.10
Santander	31/03/2022	31/03/2023	10,000,000	0.55
Close Brothers Bank	28/03/2022	28/09/2022	5,000,000	1.20
National Westminster Bank	20/10/2021	20/10/2022	5,000,000	0.28
National Westminster Bank	16/07/2021	19/04/2022	5,000,000	0.13
National Westminster Bank	02/11/2021	03/05/2022	5,000,000	0.43
NATIONWIDE B.S	10/11/2021	10/11/2022	5,000,000	0.15
National Westminster Bank	26/01/2022	26/01/2023	5,000,000	0.94

2.8. Investment strategy and control of interest rate risk

Investment returns remained close to zero for much of 2021/22. Most local authority lending managed to avoid negative rates and one feature of the year was the continued growth of inter local authority lending. The expectation for interest rates within the treasury management strategy for 2021/22 was that Bank Rate would remain at 0.1% until it was clear to the Bank of England that the emergency level of rates introduced at the start of the Covid-19 pandemic were no longer necessitated.

The Bank of England and the Government also maintained various monetary and fiscal measures, supplying the banking system and the economy with massive amounts of cheap credit so that banks could help cash-starved businesses to survive the various lockdowns/negative impact on their cashflow. 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 remained low until towards the turn of the year when inflation concerns indicated central banks, not just the Bank of England, would need to lift interest rates to combat the second-round effects of growing levels of inflation (CPI was 6.2% in February).

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. 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.

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 counterparty risk exposure, by having fewer investments placed in the financial markets.

Link Group Interest Rate View 7.2.22													
	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
BANK RATE	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
3 month av. earnings	0.80	1.00	1.00	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20
6 month av. earnings	1.00	1.10	1.20	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30
12 month av. earnings	1.40	1.50	1.60	1.70	1.70	1.60	1.60	1.50	1.40	1.40	1.40	1.40	1.40
5 yr PWLB	2.20	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30
10 yr PWLB	2.30	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40
25 yr PWLB	2.40	2.50	2.50	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60
50 yr PWLB	2.20	2.30	2.30	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40

2.9 Borrowing strategy and control of interest rate risk

During 2021/22, the Council maintained an under-borrowed position. 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.

A cost of carry remained during the year on any new long-term borrowing that was not immediately used to finance capital expenditure, as it would have caused a temporary increase in cash balances; this would have incurred a revenue cost – the difference between (higher) borrowing costs and (lower) investment returns.

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.

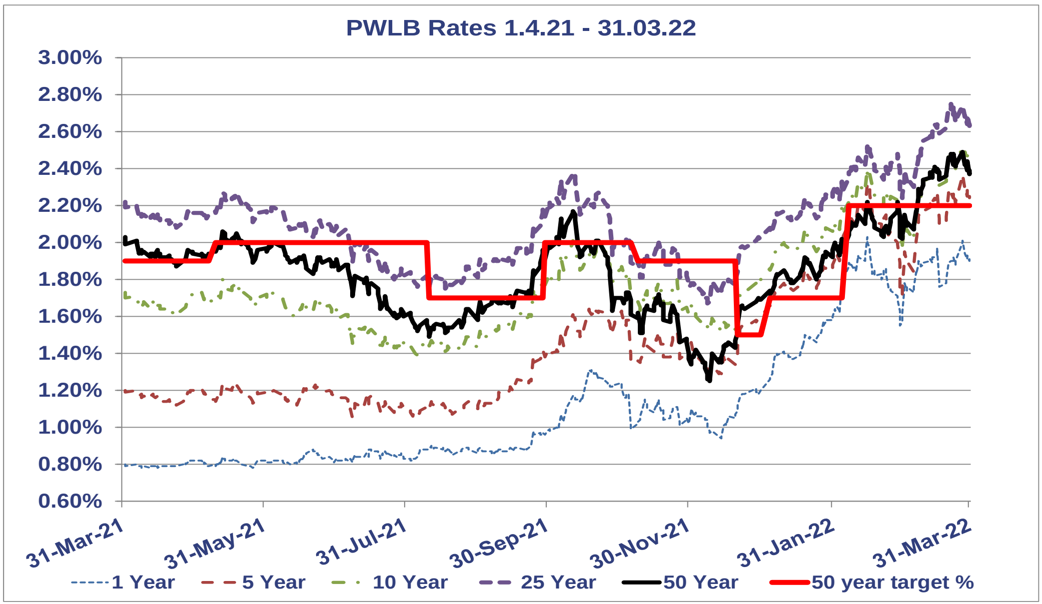
Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. The Director of Corporate Services therefore monitored interest rates in financial markets and adopted a pragmatic strategy based upon the following principles to manage interest rate risks. The council continued to invest in deposits for a maximum term of one year to avoid any long-term fluctuations in interest rates. The Council continues to adopt their advisor, LINK's methodology in that the council would only place deposits in counterparties that are on their approved credit rating list.

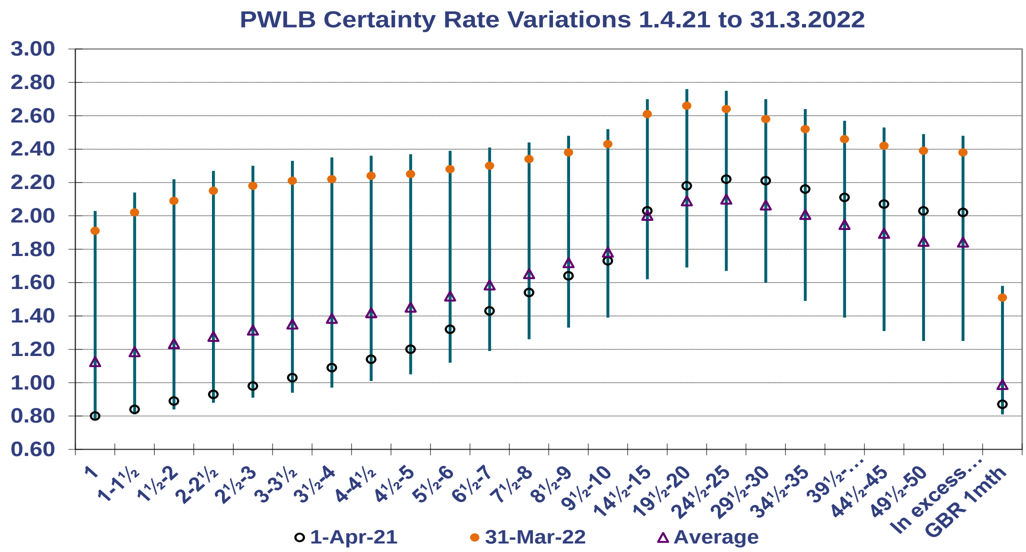
if it had been felt that there was a significant risk of a sharp FALL in long- and short-term rates, (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings would have been postponed, and potential rescheduling from fixed rate funding 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 2021/22 and the two subsequent financial years until the turn of the year, when inflation concerns increased significantly. Internal, variable or short-term rates, were expected to be the cheaper form of borrowing until well in to the second half of 2021/22.

2.10 PWLB RATES 2021/22



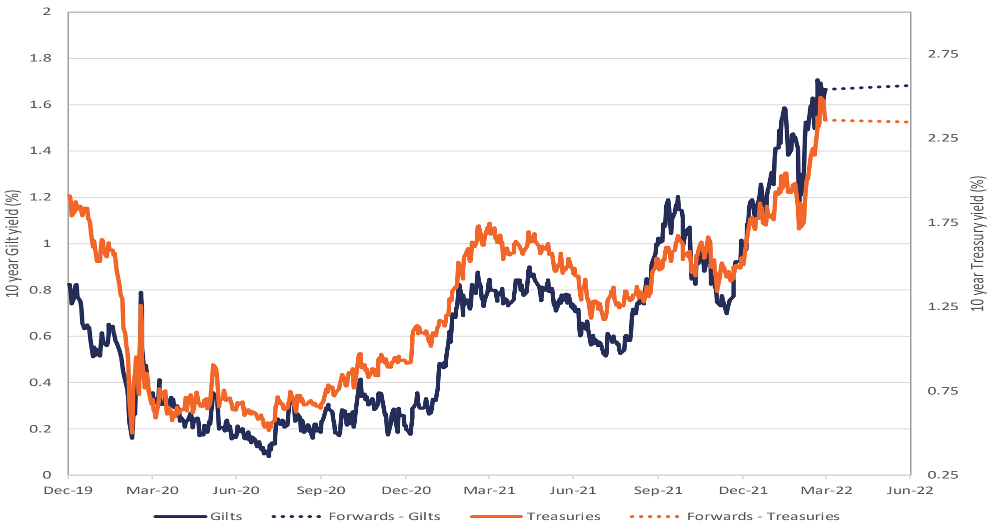


2.11 HIGH/LOW/AVERAGE PWLB RATES FOR 2021/22

	1 Year	5 Year	10 Year	25 Year	50 Year
01/04/2021	0.80%	1.20%	1.73%	2.22%	2.03%
31/03/2022	1.91%	2.25%	2.43%	2.64%	2.39%
Low	0.78%	1.05%	1.39%	1.67%	1.25%
Low date	08/04/2021	08/07/2021	05/08/2021	08/12/2021	09/12/2021
High	2.03%	2.37%	2.52%	2.75%	2.49%
High date	15/02/2022	28/03/2022	28/03/2022	23/03/2022	28/03/2022
Average	1.13%	1.45%	1.78%	2.10%	1.85%
Spread	1.25%	1.32%	1.13%	1.08%	1.24%

PWLB rates are based on 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. 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. 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. Recently, yields have risen since the turn of the year on the back of global inflation concerns.

2.12 Graph of UK gilt yields v. US treasury yields



Gilt yields fell sharply from the spring of 2021 through to September and then spiked back up before falling again through December. However, by January sentiment had well and truly changed, as markets became focussed on the embedded nature of inflation, spurred on by a broader opening of economies post the pandemic, and rising commodity and food prices resulting from the Russian invasion of Ukraine.

At the close of the day on 31 March 2022, all gilt yields from 1 to 5 years were between 1.11% – 1.45% while the 10-year and 25-year yields were at 1.63% and 1.84%.

Regarding PWLB borrowing rates, the various margins attributed to their pricing 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)

2.13 There is likely to be a further rise in short dated gilt yields and PWLB rates over the next three years as Bank Rate is forecast to rise from 0.75% in March 2022 to currently 1.25% and may rise higher later this year, with upside risk likely if the economy proves resilient in the light of the cost-of-living squeeze. Medium to long dated yields are driven primarily by inflation concerns but the Bank of England is also embarking on a process of Quantitative Tightening when Bank Rate hits 1%, whereby the Bank's £895bn stock of gilt and corporate bonds will be sold back into the market over several years. The impact this policy will have on the market pricing of gilts, while issuance is markedly increasing, is an unknown at the time of writing.

3. ALTERNATIVE OPTIONS

4. CONSULTATION UNDERTAKEN OR PROPOSED

4.1 Regular advise from the Treasury management consultant

5. TIMETABLE

N/A

6. FINANCIAL, RESOURCE AND PROPERTY IMPLICATIONS

6.1.1 Financial implications are covered in the main report. Treasury management, in particular the management of debt, is becoming an increasingly important area for the Council. Members need to be aware of the financial risks and potential benefits of the Strategy.

7. LEGAL AND STATUTORY IMPLICATIONS

7.1.1 The statutory and regulatory requirement requiring a Treasury Management Strategy and review are contained above in this report and there are no further implications arising out of this report.

8. HUMAN RIGHTS, EQUALITIES AND COMMUNITY COHESION IMPLICATIONS

N/A

9. CRIME AND DISORDER IMPLICATIONS

N/A

10. RISK MANAGEMENT AND HEALTH AND SAFETY IMPLICATIONS

N/A

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

None

12. BACKGROUND PAPERS

1. Regular market updates from various sources
2. Treasury Management Strategy 2021-22