Appendix D

Treasury Management Outturn Report 2020/21

Introduction

In February 2012 the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports.

The Authority's treasury management strategy for 2020/21 was approved at a meeting on 28th January 2020. The Authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk remains central to the Authority's treasury management strategy.

Treasury risk management at the Authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the Authority's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 28th January 2020.

External Context

Economic background: The coronavirus pandemic dominated 2020/21, leading to almost the entire planet being in some form of lockdown during the year. The start of the financial year saw many central banks cutting interest rates as lockdowns caused economic activity to grind to a halt. The Bank of England cut Bank Rate to 0.1% and the UK government provided a range of fiscal stimulus measures, the size of which has not been seen in peacetime.

Some good news came in December 2020 as two COVID-19 vaccines were given approval by the UK Medicines and Healthcare products Regulatory Agency (MHRA). The UK vaccine rollout started in earnest; over 31 million people had received their first dose by 31st March.

A Brexit trade deal was agreed with only days to spare before the 11pm 31st December 2020 deadline having been agreed with the European Union on Christmas Eve.

The Bank of England (BoE) held Bank Rate at 0.1% throughout the year but extended its Quantitative Easing programme by £150 billion to £895 billion at its November 2020 meeting. In its March 2021 interest rate announcement, the BoE noted that while GDP would remain low in the near-term due to COVID-19 lockdown restrictions, the easing of these measures means growth is expected to recover strongly later in the year. Inflation is forecast to increase in the near-term and while the economic outlook has improved there are downside risks to the forecast, including from unemployment which is still predicted to rise when the furlough scheme is eventually withdrawn.

Government initiatives supported the economy and the Chancellor announced in the 2021 Budget a further extension to the furlough (Coronavirus Job Retention) scheme until September 2021. Access to support grants was also widened, enabling more self-employed people to be eligible for government help. Since March 2020, the government schemes have help protect more than 11 million jobs.

Despite the furlough scheme, unemployment still rose. Labour market data showed that in the three months to January 2021 the unemployment rate was 5.0%, in contrast to 3.9% recorded for the same period 12 months ago. Wages rose 4.8% for total pay in nominal terms (4.2% for regular pay) and was up 3.9% in real terms (3.4% for regular pay). Unemployment is still expected to increase once the various government job support schemes come to an end.

Inflation has remained low over the 12 month period. Latest figures showed the annual headline rate of UK Consumer Price Inflation (CPI) fell to 0.4% year/year in February, below expectations (0.8%) and still well below the Bank of England's 2% target. The ONS' preferred measure of CPIH which includes owner-occupied housing was 0.7% year/year (1.0% expected).

After contracting sharply in Q2 (Apr-Jun) 2020 by 19.8% q/q, growth in Q3 and Q4 bounced back by 15.5% and 1.3% respectively. The easing of some lockdown measures in the last quarter of the calendar year enabled construction output to continue, albeit at a much slower pace than the 41.7% rise in the prior quarter. When released, figures for Q1 (Jan-Mar) 2021 are expected to show a decline given the national lockdown.

After collapsing at an annualised rate of 31.4% in Q2, the US economy rebounded by 33.4% in Q3 and then a further 4.1% in Q4. The US recovery has been fuelled by three major pandemic relief stimulus packages totalling over $5 trillion. The Federal Reserve cut its main interest rate to between 0% and 0.25% in March 2020 in response to the pandemic and it has remained at the same level since. Joe Biden became the 46th US president after defeating Donald Trump.

The European Central Bank maintained its base rate at 0% and deposit rate at -0.5% but in December 2020 increased the size of its asset purchase scheme to €1.85 trillion and extended it until March 2022.

Financial markets: Monetary and fiscal stimulus helped provide support for equity markets which rose over the period, with the Dow Jones beating its pre-crisis peak on the back of outperformance by a small number of technology stocks. The FTSE indices performed reasonably well during the period April to November, before being buoyed in December by both the vaccine approval and Brexit deal, which helped give a boost to both the more internationally focused FTSE 100 and the more UK-focused FTSE 250, however they remain lower than their pre-pandemic levels.

Ultra-low interest rates prevailed throughout most of the period, with yields generally falling between April and December 2020. From early in 2021 the improved economic outlook due to the new various stimulus packages (particularly in the US), together with the approval and successful rollout of vaccines, caused government bonds to sell off sharply on the back of expected higher inflation and increased uncertainty, pushing yields higher more quickly than had been anticipated.

The 5-year UK benchmark gilt yield began the financial year at 0.18% before declining to -0.03% at the end of 2020 and then rising strongly to 0.39% by the end of the financial year. Over the same period the 10-year gilt yield fell from 0.31% to 0.19% before rising to 0.84%. The 20-year declined slightly from 0.70% to 0.68% before increasing to 1.36%.

1-month, 3-month and 12-month SONIA bid rates averaged 0.01%, 0.10% and 0.23% respectively over the financial year.

The yield on 2-year US treasuries was 0.16% at the end of the period, up from 0.12% at the beginning of January but down from 0.21% at the start of the financial year. For 10-year treasuries the end of period yield was 1.75%, up from both the beginning of 2021 (0.91%) and the start of the financial year (0.58%).

German bund yields continue to remain negative across most maturities.

Credit review: After spiking in March 2020, credit default swap spreads declined over the remaining period of the year to broadly pre-pandemic levels. The gap in spreads between UK ringfenced and non-ringfenced entities remained, albeit Santander UK is still an outlier compared to the other ringfenced/retail banks. At the end of the period Santander UK was trading the highest at 57bps and Standard Chartered the lowest at 32bps. The other ringfenced banks were trading around 33 and 34bps while Nationwide Building Society was 43bps.

Credit rating actions to the period ending September 2020 have been covered in previous outturn reports. Subsequent credit developments include Moody's downgrading the UK sovereign rating to Aa3 with a stable outlook which then impacted a number of other UK institutions, banks and local government. In the last quarter of the financial year S&P upgraded Clydesdale Bank to A- and revised Barclay's outlook to stable (from negative) while Moody's downgraded HSBC's Baseline Credit Assessment to baa3 whilst affirming the long-term rating at A1.

The vaccine approval and subsequent rollout programme are both credit positive for the financial services sector in general, but there remains much uncertainty around the extent of the losses banks and building societies will suffer due to the economic slowdown which has resulted due to pandemic-related lockdowns and restrictions. The institutions and durations on the Authority's counterparty list recommended by treasury management advisors Arlingclose remain under constant review, but at the end of the period no changes had been made to the names on the list or the recommended maximum duration of 35 days.

<u>Local Context</u>

On 31st March 2020, the Authority had net borrowing of £767k arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31.3.21 Actual £m
General Fund CFR	55.25
Less other debt liabilities	0.0
Total CFR	**55.25**
External borrowing	39.60
Internal borrowing	**15.65**
Less: Usable reserves	-36.70
Less: Working capital	0.98
Net Borrowing	**20.07**

Lower official interest rates have lowered the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The Authority pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

The treasury management position at 31st March 2021 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.20 Balance £m	Movement £m	31.3.21 Balance £m	31.3.21 Rate %
Long-term borrowing	18.83	2.57	21.40	2.01%
Short-term borrowing	26.00	-8.00	18.00	0.35%
Total borrowing	**44.83**	**-5.43**	**39.40**	**1.54%**
Long-term investments	10.88	0.57	8.45	4.67%
Short-term investments	26.00	-21.00	5.00	1.49%
Cash and cash equivalents	7.19	-2.19	5.00	0.07%
Total investments	**44.07**	**-25.62**	**18.45**	**2.46%**
Net borrowing	**0.76**	**20.19**	**20.95**	

Borrowing Update

In November 2020 the PWLB published its response to the consultation on 'Future Lending Terms'. From 26th November the margin on PWLB loans above gilt yields was reduced from 1.8% to 0.8% providing that the borrowing authority can confirm that it is not planning to purchase 'investment assets primarily for yield' in the current or next two financial years. Authorities that are purchasing or intending to purchase investment assets primarily for yield will not be able to access the PWLB except to refinance existing loans or externalise internal borrowing. As part of the borrowing process authorities will now be required to submit more detailed capital expenditure plans with confirmation of the purpose of capital expenditure from the Section 151 Officer. The PWLB can now also restrict local authorities from borrowing in unusual or large amounts.

Acceptable use of PWLB borrowing includes service delivery, housing, regeneration, preventative action, refinancing and treasury management. Misuse of PWL B borrowing could result in the PWLB requesting that Authority unwinds problematic transactions, suspending access to the PWLB and repayment of loans with penalties.

Competitive market alternatives may be available for authorities with or without access to the PWLB. However, the financial strength of the individual authority and borrowing purpose will be scrutinised by commercial lenders.

The Authority is not planning to purchase any investment assets primarily for yield within the next three years and so is able to take advantage of the reduction in the PWLB borrowing rate.

Municipal Bonds Agency (MBA): The MBA revised its standard loan terms and framework agreement. Guarantees for the debt of other borrowers are now proportional and limited and a requirement to make contribution loans in the event of a default by a borrower has been introduced. The agency has issued 5-year floating rate and 40-year fixed rate bonds in 2020, in both instances Lancashire County Council is the sole borrower and guarantor. A planned third bond issuance by Warrington Borough Council was withdrawn in early December after the reduction in PWLB borrowing rates.

If the Authority intends future borrowing through the MBA, it will first ensure that it has thoroughly scrutinised the legal terms and conditions of the arrangement and is satisfied with them.

UK Infrastructure Bank: In his March 2021 budget the Chancellor confirmed that a UK Infrastructure Bank will be set up with £4bn in lending earmarked for local authorities from the summer of 2021. Loans will be available at gilt yield plus 0.60%, 0.20% lower than the PWLB certainty rate. A bidding process to access these loans is likely with a preference to projects likely to help the government meet its Net Zero emissions target. However other "high value and complex economic infrastructure projects" may also be considered.

Borrowing strategy

At 31st March 2021 the Authority held £39.4m of loans, a decrease of £5.44m since 31st March 2020, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 31st March are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.20 Balance £m	Net Movement £m	31.3.21 Balance £m
Public Works Loan Board	18.84	2.56	21.40
Banks (LOBO)	0.00	0.00	0.00
Banks (fixed-term)	0.00	0.00	0.00
Local authorities (long-term)	0.00	0.00	0.00
Local authorities (short-term)	26.00	-8.00	18.00
Total borrowing	**44.84**	**-5.44**	**39.40**

The Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective.

The Authority has an increasing CFR due to the capital programme and an estimated borrowing requirement as determined by the Liability Benchmark which also takes into account usable reserves and working capital. Having considered the appropriate duration and structure of the Authority's borrowing need based on realistic projections, the Authority decided to take some advantage of the fall in external borrowing rates and borrowed £3.0m of medium-term repayment loans (EIP) whilst allowing £8.0m of short term fixed rate loans to mature without replacement. This new loan structure provides some longer-term certainty and stability to the debt portfolio and creates a more rounded debt portfolio.

The Authority's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short- and long-term borrowing was maintained.

Long-dated Loans borrowed	**Amount £m**	**Rate %**	**Period (Years)**
PWLB Maturity Loan 1	11.00	2.35	40
PWLB Maturity Loan 2	3.00	2.47	40
PWLB EIP Loan 1	5.00	1.05	15
PWLB EIP Loan 2	3.00	1.80	15
Total borrowing	22.00	2.00	

PWLB funding margins have lurched quite substantially and there remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields + 0.80%. The Authority will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.

<u>Treasury Investment Activity</u>

Throughout 2020/21 the Authority received central government funding to support small and medium businesses during the coronavirus pandemic through grant schemes. £29.75m was received, temporarily invested in short-dated, liquid instruments such as call accounts and Money Market Funds. £26.32m was disbursed by the end of March.

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances ranged between £45.18 and £18.993 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.20 Balance £m	Net Movement £m	31.3.21 Balance £m	31.3.21 Income Return %
Banks & building societies (unsecured)	6.187	-4.187	2.0	0.09%
Government (incl. local authorities)	20.0	-18.0	2.0	0.22%
Money Market Funds	7.0	-4.0	3.0	0.01%
Registered Providers	3.0	0.0	3.0	1.70%
Other Pooled Funds	8.993	0.0	8.993	4.67%
Total investments	**45.180**	**-26.187**	**18.993**	**2.46%**

Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

Continued downward pressure on short-dated cash rate brought net returns on sterling low volatility net asset value money market funds (LVNAV MMFs) close to zero even after some managers have temporarily lowered their fees. At this stage net negative returns are not the central case of most MMF managers over the short-term, and fee waivers should maintain positive net yields, but the possibility cannot be ruled out.

Deposit rates with the Debt Management Account Deposit Facility (DMADF) have continued to fall and are now largely around zero.

The net return on Money Market Funds net of fees, which had fallen after Bank Rate was cut to 0.1% in March, are now at or very close to zero; fund management companies have temporarily lowered or waived fees to avoid negative net returns.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2020	4.03	AA-	31%	86	1.44%
31.03.2021	5.4	A+	50%	93	2.46%
Similar LAs	4.63	A+	65%	40	1.38%
All LAs	4.63	A+	63%	14	0.90%

Externally Managed Pooled Funds: £8.5m of the Authority's investments are invested in externally managed strategic pooled equity, multi-asset and property funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds generated a total return of £941k, comprising a £367k income return which is used to support services in year, and £574k of capital growth.

The Authority is invested in equity, multi-asset and property funds. During the initial phase of the pandemic in March 2020, the sharp falls corporate bond and equity markets had a negative impact on the value of the Council's pooled fund holdings and was reflected in the 31st March 2020 fund valuations with every fund registering negative capital returns over a 12-month period. Since March 2020 there here has been improvement in market sentiment which is reflected in an increase in capital values of these equity and multi-asset income funds in the Authority's portfolio. The recovery in UK equities has lagged those of US and European markets.

Similar to many other property funds, dealing (i.e. buying or selling units) in the CCLA Local Authorities' Property Fund was suspended by the fund in March 2020 and lifted in September. There was also a change to redemption terms for the CCLA Local Authorities Property Fund; from September 2020 investors are required to give at least 90 calendar days' notice for redemptions.

Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's medium- to long-term investment objectives are regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three- to five-year period total returns will exceed cash interest rates.

Following the cut in Bank rate from 0.75% to 0.10% in March 2020, the Authority had expected to receive significantly lower income from its cash and short-dated money market investments, including money market funds in 2020/21, as rates on cash investments are close to zero percent. Income from most of the Authority's externally managed funds will also be lower than in 2019/20 and earlier years. Whilst the arrival and approval of vaccines against COVID-19 and the removal of Brexit uncertainty that had weighed on UK equities were encouraging developments, dividend and income distribution was dependent on company earnings in a very challenging and uncertain trading environment as well as enforced cuts or deferral required by regulatory authorities.

Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. This is replicated in the Investment Guidance issued by Ministry of Housing, Communities and Local Government's (MHCLG) and Welsh Government, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

The Authority also held £47m of such investments in directly owned property as shown in the table below:

Property	Purchase date	Purchase Price	Sector
Challenge House, Tewkesbury	Dec-16	£8,730,000	Office
Challenge House, Tewkesbury	Dec-16	£5,820,000	Industrial
Retail units, Clevedon	Jul-06	£2,199,250	Retail
The Chase, Hertford	Nov-17	£3,700,000	Office
SPL House, Ellesmere Port	Nov-17	£3,490,000	Industrial
Wickes, Trowbridge	Dec-17	£5,542,000	Retail
Edmund House, Leamington	Aug-18	£3,610,000	Office
M&S, Walton on the Naze	Oct-18	£4,335,000	Retail
Vaughan Park, Tipton	May-20	£9,365,000	Industrial
Volvo, Crawley	Dec-20	£9,400,000	Alternatives
Total		**£56,191,250**	

These investments generated £2.713k of investment income for the Authority after taking account of direct costs, representing a rate of return of 4.83%.

Treasury Performance

The Authority measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in table 6 below.

Table 6: Performance

	Actual £	Budget £	Over/ Under £	Actual %	Benchmark %	Over/ under
Treasury Investments	552,712	501,300	51,412	1.50%	0.07%	1.63%
Borrowing	552,461	513,000	-39,461	1.34%	N/A	N/A
GRAND TOTAL	**-250**	**-11,700**	**11,950**	**N/A**	**N/A**	**N/A**

Compliance

The Chief Finance Officer reports that all treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the Authority’s approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below.

Table 7: Debt Limits

	2020/21 Maximum	31.3.21 Actual	2020/21 Operational Boundary	2020/21 Authorised Limit	Complied?
Borrowing	£44.84m	£39.40m	£55.0m	£60.0m	Yes
Total debt	**£44.84m**	**£39.40m**	**£55.0m**	**£55.0m**	Yes

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Table 8: Investment Limits

	Maximum	30.9.21 Actual	2020/21 Limit	Complied? Yes/No
Any single organisation, except the UK Government	**£2.0m**	**£2.0m**	**£2.0m**	Yes
Any group of organisations under the same ownership	**£2.0m**	**£2.0m**	**£2.0m**	Yes
Any group of pooled funds under the same management	**£3.93m**	**£3.93**	**£6.0m**	Yes
Negotiable instruments held in a broker's nominee account	**£0.0m**	**£0.0m**	**£4.0m**	Yes
Limit per non-UK country	**£2.0m**	**£0.0m**	**£3.0m**	Yes
Registered providers and registered social landlords	**£3.0m**	**£3.0m**	**£6.0m**	Yes
Unsecured investments with building societies	**£0.0m**	**£0.0m**	**£2.0m**	Yes
Loans to unrated corporates	**£0.0m**	**£0.0m**	**£1.0m**	Yes
Money Market Funds	£10.0m	£3.0m	**50% of total portfolio balance**	Yes

Treasury Management Indicators

The Authority measures and manages its exposures to treasury management risks using the following indicators.

Security: The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	31.3.21 Actual	2020/21 Target	Complied?
Portfolio average credit rating	A+	A	Yes

Maturity Structure of Borrowing: This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	31.3.21 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	45.69%	100%	0%	Yes
12 months and within 24 months	0.0%	100%	0%	Yes
24 months and within 5 years	0.0%	100%	0%	Yes
5 years and within 10 years	0.0%	100%	0%	Yes
10 years and above	54.31%	100%	0%	Yes

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than a year: The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2020/21	2021/22	2022/23
Actual principal invested beyond year end	£3.0m	£0.0m	£0.0m
Limit on principal invested beyond year end	£6.0m	£5.0m	£4.0m
Complied?	Yes	Yes	Yes

<u>Other</u>

CIPFA consultations: In February 2021 CIPFA launched two consultations on changes to its Prudential Code and Treasury Management Code of Practice. These follow the Public Accounts Committee's recommendation that the prudential framework should be further tightened following continued borrowing by some authorities for investment purposes. These are principles-based consultations and will be followed by more specific proposals later in the year.

In the Prudential Code the key area being addressed is the statement that "local authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed". Other proposed changes include the sustainability of capital expenditure in accordance with an authority's corporate objectives, i.e. recognising climate, diversity and innovation, commercial investment being proportionate to budgets, expanding the capital strategy section on commercial activities, replacing the "gross debt and the CFR" with the liability benchmark as a graphical prudential indicator.

Proposed changes to the Treasury Management Code include requiring job specifications and "knowledge and skills" schedules for treasury management roles to be included in the Treasury Management Practices (TMP) document and formally reviewed, a specific treasury management committee for MiFID II professional clients and a new TMP 13 on Environmental, Social and Governance Risk Management.

IFRS 16: The implementation of the new IFRS 16 Leases accounting standard has been delayed for a further year until 2022/23.