Overview Select Committee

Review of Treasury Management Activities 2020/21

Overview Select Committee: 27th May 2021

Lead director: Colin Sharpe, Deputy Director of Finance

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1. Summary

1.1 This report reviews how the Council conducted its borrowing and investments during 2020/21.

1.2 2020/21 saw unprecedented disruption throughout the world due to the emergence of coronavirus with lockdowns for many parts of the economy and huge injections of cash from the government and the Bank of England required to prevent parts of the economy from collapsing. However, towards the end of the year, there has been increased optimism (though tentative) regarding recovery with the roll out of various vaccines in the UK and throughout the world.

1.3 However, the outlook regarding coronavirus although encouraging is not yet assured. Experts don't expect the virus to be completely eradicated; and until the whole world has access to vaccines, it will remain a serious concern.

1.4 After the emergence of coronavirus, the focus of treasury management changed initially to ensuring the ready availability of cash rather than maximising income. Nevertheless, income generated has exceeded budget despite record low interest rates mainly because the Council entered into a number of 2 year loans with other local authorities at the end of 2019/20 at good rates. Income has also held up due to high levels of grant income on which interest was earned.

1.5 We continue to monitor the impact of the "bail in" requirements whereby major depositors could be forced to inject funds into banks which are running into trouble, introduced earlier in the year. This is further discussed below.

2. Background

2.1 Treasury management is the process by which our borrowing is managed, and our cash balances are invested. Whilst there are links to the budget, the sums in this report do not form part of the budget. Cash balances reported here cannot be spent, except to the extent shown in the budget report and revenue outturn report (elsewhere on your agenda).

2.2 The Council has incurred debt to pay for past capital expenditure

2.3 The Council also has cash balances. These are needed for day to day expenditure (e.g. to pay wages when they are due). A substantial proportion can only be used to repay debt but (because of Government rules) it is prohibitively expensive to repay debt. Thus, they are held in investments.

2.4 The report commences with an overview of treasury management, including loans and investments at key dates. It then reviews the credit worthiness of investments and implementation of our strategy, provides outcomes on key performance measures and concludes by reviewing compliance against limits set by the Council.

2.5 Reports reviewing treasury management activities are submitted twice a year. The previous report was presented to your committee on 3rd December 2020.

3. **Recommendations**

3.1 Members of the Overview Select Committee are recommended to note the report and make comments to the Director of Finance and the Executive as they wish.

4. **Overview of Treasury Management**

Main elements of Treasury Management

4.1 There are two main elements to treasury management. The first is managing our borrowings which have been taken out to finance capital expenditure. Most capital schemes are now financed by grant, and only a limited number of schemes are financed by borrowing (generally those which pay for themselves). In the past the Government expected us to borrow but allowed for the cost of borrowing in our grant settlement, and we still have a lot of debt which was taken to meet this capital expenditure.

4.2 Historic debt can sometimes be restructured to save money (i.e. repaying one loan and replacing it with another) and this is always given active consideration. In recent years, Government rule changes have normally made it prohibitively expensive to repay loans borrowed from the Public Works Loans Board.

4.3 The revenue budget approved by the Council for each financial year includes provision for the interest payable on this borrowing. It also includes a provision for repaying the borrowing over a number of years (broadly speaking over the economic life of the assets acquired).

4.4 The second element is cash management which involves managing the Council's investments to ensure the optimum amount of money is in the bank account on a day-to-day basis – so that there is enough money in the account to cover the payments made on the day but no more (cash held in the bank account earns negligible interest). The focus of this activity changed dramatically during March. The concept of liquidity – being able to get our money when we need it – is fundamental to cash management.

4.5 The Council has substantial investments but this is not "spare cash". There are four reasons for the level of investments:-

(a) Whilst the Government no longer supports capital spending with borrowing allocations, we are still required to raise money in the budget each year to repay debt. Because of the punitive rules described above, we are not usually able to repay any long-term debt, and therefore have to invest the cash;

(b) We have working balances arising from our day to day business (e.g. council tax received before we have to pay wages, and capital grants received in advance of capital spending);

(c) We have reserves, which are held in cash until we need to spend them.

(d) This year, investments have been bolstered by sums received for the pandemic prior to need to spend.

Treasury Management Policy and Monitoring

4.6 The activities to which this report relates were governed by the Treasury Strategy for 2020/21 which was approved by the Council on 19th February 2020. This establishes an outline plan for borrowing and investment. The strategy for 2021/22 was approved by the Council on 17th February 2021 and governs the treasury strategy from that point. The Treasury Strategy is drawn up in the light of the Council's expected borrowing requirements, its expected cash balances, the outlook for interest rates and the credit worthiness of the banks with whom the Council might invest its cash balances.

4.7 A twice-yearly report is submitted to your Committee reviewing the treasury activity undertaken in the year. This report is the final report for 2020/21

Loans and Investments at Key Dates

4.8 Table 1 below shows the loans (money borrowed by the Council) and investments (money invested by the Council) as at 01/10/2020 and at 31/03/2021. The rates shown are the averages paid and received during 2020/21.

4.9 The level of gross debt (total loans borrowed) has remained unchanged. No new long-term loans have been borrowed and no debt restructuring has taken place in the second half of the year.

4.10 Investments have decreased by £57m from £332m to £275m. This change is within the range of what is normal (for example if grant income has been spent) and reflects the usual pattern of balances declining towards the end of the financial year.

4.11 There was a deliberate shift since the second half of the 2019/20 financial year to increase investments held by other local authorities and reduce investments held by banks. This was in part to take advantage of some good rates offered by local authorities for fixed periods up to 2 years and in part to reduce expose to individual banks. At the end of the 2020/21 financial year, the only exposure we had to any bank was to Barclays who act as our bankers.

Table 1- Loans & Investments

	Position at 01/10/2020 Principal £M	**Position at 31/03/2021 Principal £M**	**Average Rate**
Long Term Fixed Rate Loans Public Works Loan Board (PWLB) Bank Loans	 134 25	 134 25	 4.2% 4.5%
LOBO Loans Bank Loans	 20	 20	 4.5%
Short Term (less than 6 months) Loans Local Authority Loans	NIL	NIL	N/A _
Gross Debt	**179**	**179**	**4.3%**
Treasury Investments Banks and Build Soc Other Local Authorities Money Market Funds Property Funds	 0 200 124 8	 0 198 69 8	
Total Treasury Investments	**332**	**275**	**0.9%**
NET INVESTMENTS	**153**	**96**	

4.12 The investments include £8m in property unit trusts. These are unit trusts which invest in property (as opposed to more traditional unit trusts that invest in shares). At present political and economic uncertainties are impacting on the property markets and if we had surrendered the units to the fund managers at 31st March 2020 then we would have made an estimated loss of at least 5% on the principal sum. This is not reflected in the table above because our strategy is to hold the investments long term; it should also be noted that any loss will not be a cost to our revenue account.

4.13 The dividends received on the units in the year totalled £291,000 which have held up remarkably well during the covid lockdown.

4.14 The treasury strategy permits investments in property funds up to a total value of £30M but no further such investments have been made during the last year with the uncertainty around Brexit and coronavirus. However, we shall continue to review this position.

4.15 The Council's (Non-Treasury) Investment Strategy also allows the authority to spend capital or make loans to a third party where it is intended to (at least partly) achieve a return. Since 30th September, the Council has made no further loans to third parties. The Council has now incurred expenditure totalling £15.5m on the Haymarket Shopping Centre and Pioneer Park. These schemes are nearly complete and expected to open in the summer and thus not receiving any income yet. A summary of loans and investments made under the Investment Strategy is shown in table 2 below.

Table 2- Loans & Investments under the Investment Strategy

Investment	Total Capital Expenditure or loans outstanding £m	Percentage Return 2020/2021
Loans		
Ethically Sourced Products	£1.3m	4%
Leicestershire County Cricket Club	£2.4m	5%
Other Investments		
Haymarket Centre Redevelopment	£10.26m	0%
Pioneer Park	£5.26m	0%
Total All Loans & Investments	£19.22m	

4.16 The repayments of loans to Ethically Sourced Products and Leicestershire County Cricket Club are up to date.

4.17 Also governed by the Investment Strategy is the Council's investment property portfolio. The performance of the Corporate Estate at the time of writing was expected to be reported separately to scrutiny committee.

4.18 The total amount of treasury investments made during 2020/21 was significantly higher than originally expected mainly because of various additional government grants received during the covid crisis. However, these grants are short-term and fewer investments are anticipated in 2021/22.

5. Credit Worthiness of Investments & Interest Rate Outlook

5.1 Coronavirus has eclipsed other factors affecting the world economy such as tensions between the USA and trading partners and even the impact of the UK's exit from the EU. The pandemic did not see the sort of meltdown in the financial system that was feared in the financial crisis of 2008.

5.2 The core expectations of the Council's treasury advisors, Arlingclose, prior to the advent of the pandemic was for Bank Rate to remain at 0.75% in 2020, reflecting sluggish growth. The bank rate has since been reduced to 0.1%, where Arlingclose expect it to remain. Although negative base interest rates have been seen in parts of Europe, these are on balance not seen as likely in the UK.

5.3 The governments of the largest world economies, including the UK, have implemented measures to make banks less likely to fail but also to reduce the impact on the financial system and on tax payers if they do fail. The measures for dealing with a failing bank see investors who have lent or deposited money (which includes us) taking significant losses before there is any tax payer support ("bail in"). Our assessment of risk is based both on the risk that banks fail (as measured by credit ratings) and also on the level of losses that we might face should the banks require capital support to prevent failure.

5.4 These developments are reflected in the Council's approach to managing credit risk in its treasury strategies for 2020/21 and 2021/22. It has adopted a cautious stance over the whole period covered by this report and has only directly lent to strong UK banks, other local authorities and the UK Government. Other lending has been part of pooled funds (see 5.7 below).

5.5 The position is continually under review. One factor is that other regulatory developments are continuing to require or push banks towards greater financial robustness. One change has been that banks are now required to "ring fence" bank deposits from other riskier activities.

5.6 At the start of the coronavirus outbreak, we sought to reduce our exposure to bank deposits, partly to reduce risk, and partly to increase liquidity. In practice, the Government took steps to assist authorities' cashflow principally by paying grants early. The monies withdrawn from banks have mostly been placed in money market funds and are readily accessible but pay little interest. This switch has reduced income, but that was more than outweighed by the extra income we received from other Local Authorities in 2020-21.

5.7 The Council has an indirect exposure to non-UK banks through its investment in money market funds. Money market funds are like "unit trusts" but rather than investing in company shares these funds invest in interest bearing investments such as bank deposits. When we open such funds, they are vetted to ensure that they have strong investment and risk management processes, and we receive advice from our treasury advisor, Arlingclose. Investing in this way helps manage credit risk by having a high level of diversification amongst the underlying banks and institutions to whom money is lent. Interest rates on these funds are low, because we have immediate access to the funds.

5.8 The Treasury Strategy for 2020/21 permits investment in property funds. Investments of £8m are held in two funds, the Lothbury Property Trust and the Threadneedle Property Unit Trust.

6. <u>Implementation of Borrowing & Investment Strategy</u>

6.1 The strategy approved by Council for 2020/21 envisaged using cash balances instead of borrowing. This strategy has been adhered to.

6.2 Total investment income during 2020/21 was £2.85 million. This was significantly better than originally budgeted due to entering into a number of investments with other local authorities at preferential interest rates, and because cashflow proved to be greater than anticipated due to a large number of grants from the government for the coronavirus pandemic.

6.3 Given that the Council continues to have a high level of investments, active consideration is given to the possible early redemption of a limited amount of debt. This, however, is not straightforward as debt repayment usually involves the payment of a premium. The level of such premia is generally high and premature debt redemption is usually not financially viable. Recently, we have also had to ensure a high level of investments in liquid funds.

6.4 As at 31/03/2021 we held £20m of "LOBO" loans. These are fixed rate, but permit the lender to ask for a rate rise. We have the option to repay if they do. Members may be aware of some criticism of LOBOs nationally, principally in respect of authorities which have complex mechanisms for calculating interest rates (we do not). We do not expect the lender to ask us for a rate rise, though we would be pleased to receive a request as we would then take the opportunity to repay. To all intents and purposes, they are simply fixed rate loans.

6.5 At the end of December 2020, there was considerable uncertainty as to whether or not there would be a no deal Brexit. Although there was little risk to the security of the Council's investments, there was a concern regarding the liquidity of foreign domiciled Money Market Funds. Accordingly, the Council greatly reduced its holdings in foreign domiciled funds and increased them in UK domiciled funds and with the Debt Management Office in December and January until the uncertainty abated. This resulted in slightly lower returns, but ensuring liquidity was more important at the time.

7. Key Performance Measures

7.1 The most important performance measures are the rate of interest on the Council's borrowings, the timing of borrowing decisions, the timing of decisions to prematurely repay debt and the return on investments. No new long-term loans have been borrowed and no further loans have been prematurely repaid.

7.2 The Council benchmarks its investments and the latest data for the investment portfolio as at 31st March 2021.

7.3 Treasury investments comprise internally managed investments, and longer maturity externally managed funds.

7.4 The following table compares our performance against that of participating authorities. This information is available for internally managed investments (including money market funds) and externally managed funds. It is a "snapshot" of investments held at 31st March 2020 (table 2 above shows the average for the year).

Table 2 – Key Performance Data

Investment	Leicester City Council Revenue return	All Authorities' Revenue return(1)
Internally managed	0.80%	0.15%
Longer term investments	1.89%	3.85%
Total	**0.83%**	**0.90%**

1. per Arlingclose

7.5 The average rate of interest on all investments for participating authorities at 31st March 2021 is 0.9% whilst the Council's own rate is 0.83%. This is mainly explained by differences on income from longer term investments. It should also be noted that the average for all authorities is skewed by a few that have generated average income of around 4% p.a. Whilst 4% is quite an impressive income return, it could only be achieved by taking greater risk of capital losses.

7.6 The Council has a lower proportion of longer-term investments than the average authority. Whilst this will reduce income returns, it also reduces our risk from capital losses which is particularly important following recent events.

7.7 As at 31st March the Council's own investments comprised units in property unit trusts. These carry less risk than some other investment types and the lower risk equates to a lower investment return. In addition, we selected property fund managers that invested in good quality properties with reliable tenants and such funds have a lower rate of return than more adventurous property funds or (for example) funds that invest in the shares of companies.

7.8 Higher investment returns are always available if higher risk is accepted. Risk can take the form of credit risk (money due is not paid) or market risk (the value of investments fall). However, the trade-off between risk and reward was considered when investment strategies were set for 2020/21 and in the current economic climate continues to be a most important consideration.

7.9 In practice, there is no such thing as a representative "average" authority. The benchmarking data shows a division between the authorities that use longer term and more risky assets (about half of all authorities) and those adopting a more cautious approach. We fall between the two as we have only a small proportion of longer-term assets.

8. **Use of Treasury Advisors**

8.1 The Council are advised by Arlingclose Ltd. They advise on all aspects of treasury management but their main focus is on providing advice on the following matters:

- the creditworthiness of banks
- the most cost effective ways of borrowing
- appropriate responses to Government initiatives
- technical and accounting matters.

9. **Compliance with the Council's Treasury Strategy**

9.1 As required by the statutory borrowing framework, the Council is required to set a number of prudential limits and indicators. These limits are set annually and can be found within the budget and treasury strategy.

9.2 For the operational implementation of the Council's treasury management strategy the most important limits and indicators that need to be monitored throughout the year are:

- The authorised limit – the maximum amount of borrowing that the Council permits itself to have outstanding at any one time
- The operational limit – a lower limit to trigger management action if borrowing is higher than expected.
- The maximum proportion of debt that is fixed rate.
- The maximum proportion of debt that is variable rate.
- Limits on the proportion of debt maturing in a number of specified time bands
- Limits on sums to be invested for more than 364 days

9.3 These limits are monitored and have been complied with. However, over the end of December to early January the Council did breach its limit on one individual Money Market Fund (Federated) by investing £30 million rather than £20 million as outlined in the Treasury Strategy. This £20m limit is not set in law but is self-imposed by the Council. The breach occurred because there was uncertainty at the end of December regarding Brexit and therefore it was felt prudent to put more in Federated as this was UK domiciled. This breach was exceptional and followed advice from our Treasury Advisors that it was safe to do so.

10. **Financial and Legal Implications**

10.1 This report is solely concerned with financial issues. Kamal Adatia, Legal Services, has been consulted as Legal Advisor and there are no legal issues.

11. **Other Issues**

OTHER IMPLICATIONS	YES/NO	Paragraph References Within Supporting information
Equal Opportunities	No	
Policy	No	
Sustainable and Environmental	No	
Crime and Disorder	No	
Human Rights Act	No	
Elderly/People on Low Income	No	
Corporate Parenting	No	
Health Inequalities Impact	No	

12. **Background Papers**

12.1 The Council's Treasury Management Strategy - "Treasury Strategy 2019/20" (Council 20th February 2019) and Treasury Management Strategy 2020/2021" (Council 19th February 2020 and The Council's Treasury Policy Document – "Framework for Treasury Decisions" – Council 20th February 2019 and Council 19th February 2020.

13. **Consultation**

13.1 Arlingclose Ltd (the Council's Treasury Management advisers).

14. **Author**

14.1 The author of this report is Nick Booth, Treasury Manager, on extension 37 4063.

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