
Mid-Year Review of Treasury Management Activities 2021/22

Overview Select Committee

Date of meeting: 16th December 2021

Lead director: Colin Sharpe, Deputy Director of Finance

Useful information

- Ward(s) affected: All (Corporate Issue)
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- Report version number: 1

1. **Purpose of Report**

- 1.1 This report reviews how the Council conducted its borrowing and investments during the first six months of 2021/22.

2. **Summary**

- 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 already shown in the budget report and accounts.
- 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 are earmarked to repay debt but (because of Government rules which make it prohibitively expensive) we have been unable to use them 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 2021/22 has seen the continuance of the covid pandemic, though with a significant recovery in GDP which has been better than originally predicted. The Bank of England has to the date of writing this report kept base rate rates at just 0.1%, although most commentators are now expecting at least a small increase to 0.25% in the next few months to counter the rise in inflation. Earlier in the year there had been open speculation that the Bank of England was considering the use of negative interest rates, but the risk of this has reduced. Whilst the pandemic continues, the outlook for the economy can be described as uncertain.
- 2.6 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. This is further discussed below.
- 2.7 As a result of falling interest rates and concerns about the economy (even before the covid crisis occurred) we took advantage of favourable 2 year loan rates with other local authorities offered at the end of the 2019/2020 financial year, and lent £65 million at rates of between 1.5% and 1.7%. This generated just over £1 million p.a. for 2 years and has secured the treasury budget position despite the significant falls in interest rates. However, these loans will come to an end later this year, so if rates do not improve by 2022 future budgets will be more challenging.

2.8 It should be noted that the Office of Budgetary Responsibility (OBR) now expects as its central estimate for inflation to rise to 4.4% in the spring. It also expects the Bank of England to raise interest rates in the next few months and its extreme scenario has interest rates going up to 3.5%. We don't expect that rates to rise that far, but the risk now seems to be on the upside.

2.9 The position of UK banks has continued to improve with them having solid balance sheets, so although we currently have no unsecured deposits with them, we may consider using them in the future.

3. **Recommendations**

3.1 Members of the Overview Select Committee are recommended to note the report and make comments to the Deputy Director of Finance or the Chief Operating Officer 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 (PWLB).

4.3 The government has introduced rules that bar authorities that acquire capital assets "primarily for yield" from borrowing from the PWLB, though this does not preclude the acquisition of assets that do produce a yield but the purpose of acquisition is mainly for another purpose such as regeneration. It should be noted though that the Council has no plans to borrow from the PWLB in 2021/22 and it is unlikely that the Council will need to borrow over the medium term except perhaps over a very short period to manage cashflow.

4.4 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).

4.5 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).

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

- (a) Whilst the Government no longer supports capital spending with borrowing allocations, we are still required to set aside money in the budget each year to repay debt. Because

of the punitive rules described above, we are not usually able to repay any 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. We expect reserves to fall over the next few years.

Treasury Management Policy and Monitoring

- 4.7 The activities to which this report relates are governed by the Treasury Strategy for 2021/22 which was approved by the Council on 17th February 2021. This establishes an outline plan for borrowing and investment. The strategy was 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.
- 4.8 A twice-yearly report is submitted to your Committee reviewing the treasury activity undertaken in the year. This report is the mid-year report for 2021/22.

Loans and Investments at Key Dates

- 4.9 Table 1 below shows the loans (money borrowed by the Council) and investments (money invested by the Council) as at 31/03/2021 and 30/09/2021. The rates shown are the averages paid and received during 2021/22.
- 4.10 No new loans have been borrowed and no debt restructuring has taken place.
- 4.11 Investments have increased by £78m from £275m to £353m. It is normal for cashflow to be positive in the early part of the year with cash flow out of the authority tending to be weighted to the second half of the year, especially with various grants related to the coronavirus pandemic being received. It is expected that cashflow will be negative during the second half of the financial year.

Table 1- Loans & Investments

	Position at 31/03/2021 Principal £M	Position at 30/09/2021 Principal £M	Average Rate
Long Term Fixed Rate Loans			
Public Works Loan Board (PWLB)	134	134	4.2%
Market	25	25	4.4%
Variable Rate Loans			
Bank Loans	20	20	4.1%
Short Term (less than 6 months) Loans			
Local Authority Loans	Nil	Nil	n/a
Gross Debt	179	179	4.2%
Treasury Investments			
Banks and Build Soc	0	5	
Other Local Authorities	198	175	
Government Debt			
Management Office	0	73	
Money Market Funds	69	92	
Property Funds	8	8	
Total Treasury Investments	275	353	0.6%
NET INVESTMENTS	96	174	

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). Any changes in capital value will not affect our revenue budget. Our strategy for property funds as well as providing an element of diversification is to hold them for the long-term, so that short-term fluctuations in capital value become less important.

4.13 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. The Council has made no new investments since 31st March 2021.

5. **Credit Worthiness of Investments & Interest Rate Outlook**

5.1 2020/21 experienced an unprecedented reduction in GDP throughout the world due to the pandemic, though there has since been a recovery in the UK which has recaptured most though not all of the previous decline. Within the Eurozone many of the economic and financial tensions that followed the crisis of 2008 have eased, but significant underlying issues remain. Tensions between the USA and trading partners remain a source of uncertainty. The full impact of the UK's exit from the EU on the economy remains to be seen.

- 5.2 The central expectation of the Council's treasury advisors, Arlingclose, is now for the Bank Rate to increase slowly from its level of 0.1% to 0.5% by March 2023, which is lower than some other market commentators. The risk of the Bank of England introducing negative interest rates like Switzerland, which did seem possible last year now seems to have greatly diminished. It is possible that inflationary pressures will force the Bank of England to increase interest rates much further, but with the economy in a fragile state, much higher rates could lead to the Bank having to reverse such increases.
- 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. The view of Fitch, the credit rating agency, is that major UK banks are well capitalised.
- 5.4 Apart from Covid, these developments were reflected in the Council's approach to managing credit risk in its Treasury Strategy for 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 5.5 below).
- 5.5 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 to ensure a high level of credit worthiness in the underlying investments, 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. Some of our money needs to be immediate access (like individuals will usually keep some money in a current account). Rates are, however, generally slightly better than alternatives such as the Government's Debt Management Office
- 5.6 The Treasury Strategy 2021/22 permits investment in property funds. Investments of £8m have previously been made in two funds, the Lothbury Property Trust and the Threadneedle Property Unit Trust. No further investments in property funds have been made to date in 2021/22.

6. **Implementation of Borrowing & Investment Strategy**

- 6.1 The strategy approved by Council for 2021/22 envisaged using cash balances instead of borrowing, and this strategy has been adhered to.
- 6.2 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 payable is generally high and premature debt redemption is usually not financially viable.
- 6.3 We hold £20m of debt which is described as variable rate loans in table 1. These are technically "LOBOs" which are fixed rate but on which the lender may 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 would be pleased to receive a request for a rate rise as we would then take the opportunity to repay. To all intents and purposes, they are simply fixed rate loans with an unknown maturity date though with a backstop that is more than 30 years. We will explore any viable options to repay these which present themselves.

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 loans have been borrowed and no loans have been repaid.
- 7.2 The Council benchmarks its investments and the latest data for the investment portfolio is as at 30th September 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 30th September 2021.

Table 2 – Key Performance Data

Investment	Leicester City Council Revenue return	All Authorities’ Revenue return
Internally managed	0.63%	0.06%
External Longer-term investments income only	3.15%	4.27%
External investments capital gain/ (loss)	7.38	9.42
Total Income return	0.68%	0.78%
Total return including capital gains (losses)	0.85%	2.35%

- 7.5 The average rate of interest on internally managed investments for participating authorities at 30th September is just 0.06% whilst the Council’s own rate is higher at 0.63%. This reflects the longer term loans to other local authorities secured at the end of the 2019/20 financial year which has insulated the Council at least partly from the subsequent fall in interest rates.
- 7.6 The average rate of return on longer term investments (excluding capital gains and losses) is 4.27% for participating authorities at 30th September whilst the Council’s own rate is 3.15%. Including capital gains and losses, both the Council and other authorities are showing a gain which reverses capital losses from last year. This category will cover a wide range of investments and there an unavoidable element of “comparing apples with pears”. As at 30th September the Council’s own investments comprised only £8m of units in property unit trusts. These carry less risk than some other investment types and the lower risk sometimes equates to a lower investment return compared to more adventurous funds. Our internally managed investments considerably exceed the value of these investments.

7.7 Higher investment returns are always available if higher credit risk is accepted. However, the trade-off between risk and reward was considered when investment strategies were set for 2021/22 and in the current economic climate continues to be a most important consideration. The “return of the principal” is more important than the “return on the principal”: our primary concern is to ensure that the funds invested will be repaid on time and in full. This remains our approach during the current financial year.

7.8 The benchmarking data also indicated that other authorities, on average, held more longer-term investments (such as property funds and diversified asset funds) which have resulted in greater overall returns for the average authority during the last 6 months. However, the greater returns from longer term investments does come at the risk of greater losses which many funds experienced last year.

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.

10. Financial, legal, equalities, climate emergency and other implications

10.1 Financial Implications

This report is solely concerned with financial issues.

10.2 Legal implications

Kamal Adatia, Legal Services, has been consulted as Legal Advisor and there are no legal issues.

10.3 Equalities implications

None

10.4 Climate Emergency implications

n/a

11. Background Papers

- 11.1 The Council's Treasury Management Strategy - "Treasury Strategy 2021/22" (Council 17th February 2021).
The Council's Treasury Policy Document – "Framework for Treasury Decisions" – Council 19th February 2020.

12. Consultation

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

13. Author

- 13.1 Nick Booth, Treasury Manager, ext. 37 4063.