Committee: Cabinet

Date: 07 September 2020

Wards: All

Subject: 2019/20 Treasury Management Strategy Annual Review and update on counter party limits

Lead officer: Caroline Holland

Lead member: Cllr. Mark Allison

Contact officer: Roger Kershaw

Recommendations:

A. To note the annual review onto the London Borough of Merton's 2019-20 Treasury Management strategy.

B. To recommend to Council to approve the updated and increased Money Market Funds limits.

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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 contains a review of Treasury Management activities during 2019/20.

1.2 Due to the current low interest rate environment and the need for liquid cash we aim to open more Money Market Funds with increased individual fund limits. This will enable the Council to hold funds more liquid and in the meantime earn interest income when the long term and short term deposit rates are looking very low.

2 DETAILS

2.1 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 2019/20 the reporting requirements were that the Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 18/02/2019)
- a mid-year treasury update report – to the Director of Corporate Resources (November 2019)
- an annual review following the end of the year of Treasury management activity compared to the strategy (this report)

2.2 The regulatory environment places responsibility on Members for the review and scrutiny of treasury management Strategy 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 has engaged external advisors LINK Asset Services who provide advice and research on our deposits and debt structure to ensure we maximize returns, minimize debt interest and primarily ensure the security of our cash deposits.

2.4 THE COUNCIL'S CAPITAL EXPENDITURE AND FINANCING

2.4.1 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, which can be internal or external.

2.4.2 The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure for 2019/20.

	2019/20 Original Forecast	**2019/20 Actual £'000**
Capital expenditure	40,711	23,161
Financed in Year	25,004	23,161
Unfinanced Capital Expenditure	15,707	0

2.5 THE COUNCIL'S OVERALL BORROWING NEED

2.5.1 The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR).

2.5.2 **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 (2018/19), plus the estimates of any additional capital financing requirement for the current year in review (2019/20) and the next two financial years. This ensures that the council is not borrowing to support revenue expenditure.

Capital Financing Requirement £000	2019/20 Estimate	2019/20 Actual
Total CFR	**185,854**	**173,003**

2.5.3 **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. During 2019/20 the Council has maintained gross borrowing at £113m, which is well within its authorised limit. £215,854k

2.5.4 **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. During 2019/20 the council stayed well within the Operational Boundary- £185,854k

2.5.5 The council's preferred option to use excess cash balances available to delay the need to borrow thus avoiding paying interest on debt. The council last borrowed in 2007 and as at 31 March 2020 under borrowed by £29.918k (21%) There are no plans to take any long term borrowing but the council will take positions in advance if there is a need to borrow.

2.6 THE COUNCIL'S OVERALL TREASURY POSITION AS AT 31 MARCH 2020

2.6.1 The Council's treasury Management activity during 2019/20 (excluding borrowing by PFI and finance leases) was as follows:

	Balance as at 31 March 2019	Balance as at 31 March 2020
CFR	- 180,207	- 173,003
Other Long term Liabilities (PFI)	31,306	30,075
External Borrowing	113,010	113,010
Over/(Under) Borrowing	- 35,891	- 29,918

Deposits	31-Mar-19	31-Mar-20
Average interest Rate (%)	0.86	0.82
Average period	290 days	349 days
Total interest income (£000)	1,123	1,368
Balance as at 31 March (£000)	60,000	80,000

Debt	31-Mar-19	31-Mar-20
Average interest Rate (%)	5.58	5.58
Average period	34 Yrs	34 Yrs
Total interest (£000)	6,326	6,326
Balance as at 31 March (£000)	113,010	113,010

2.6.2 The maturity structure of the debt portfolio was as follows:

Maturity structure of fixed rate borrowing during 2019/2020	2019/20 Actual £'000	2019/20 Actual %
Under 12 months	2,000	1.8
12 months and within 24 months	2,000	1.8
24 months and within 5 years	27,010	23.9
5 years and within 10 years	4,500	4.0
10 years and within 15 years	1,000	0.9
15 years and over	76,500	67.7
Total Debt	**113,010**	**100**

2.7 INVESTMENT STRATEGY AND CONTROL OF INTEREST RATE RISK

2.7.1 Investment returns remained low during 2019/20. The expectation for interest rates within the treasury management strategy for 2019/20 was that the Bank Rate would stay at 0.75% during 2019/20 as it was not expected that the MPC would be able to deliver on an increase in Bank Rate until the Brexit issue was finally settled. But due to Covid 19 the interest rate was cut down to 0.1% in two attempts within a week in March. This was to help the economy and in support of the reliefs announced by the chancellor.

2.7.2 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 .Such an approach has also provided benefits in terms of reducing the counterparty risk exposure, by having fewer investments placed in the financial markets.

2.8 BORROWING STRATEGY AND CONTROL OF INTEREST RATE RISK

2.8.1 During 2019/20 the Council maintained an under-borrowed position. This meant that the capital borrowing need, the capital financing requirement (CFR), 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 low and minimizing counterparty risk on placing investments also needed to be considered.

2.8.2 The Council's last long term borrowing was made in March 2007. The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. The Council was under borrowed by £30m as at 31 March 2020 and the three years under borrowing average is £35m. This has helped to make a saving of £581k per annum (based on 20yrs PWLB interest rate, Please see table below .

Saving Made on Internal Borrowing	
3 years under borrowing average	£35,000,000
20 years PWLB rate (maturity)	2.66%
Annual interest cost	£931,000
Average interest rate on deposit	1.00%
Annual interest income	£350,000
Annual saving made on internal borrowing	***£581,000***

2.8.3 However, the under borrowing 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 BORROWING OUTTURN FOR 2019/20

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

	Balance at 31/03/19 £000's	Loans raised £000's	Loans repaid £000	Balance at 31/03/20 £000's
PWLB	52,010	0	0	52,010
Temporary	0	0	0	0
Other loans	61,000	0	0	61,000
Total Debt	113,010			113,010

2.9.2 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.

Year	2015/16	2016/17	2017/18	2018/19	2019/20
Average Interest Rate on Debt	5.14	5.31	5.58	5.58	5.58

2.10 INVESTMENT OUTTURN FOR 2019/20

2.10.1 The Council's investment policy is governed by MHCLG guidance, which was been implemented in the annual investment strategy approved by the Council on 18 February 2019

2.10.2 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.).

2.10.3 The Council manages its deposits 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.

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

2.10.5 The table below reflects the investment strategy undertaken by the Council.

	Average Deposit	Rate of Return	Benchmark Return *
Internally Managed	5,000	1.20	0.54

* the benchmark return is the average 7-day London Interbank Bid (LIBID) rate sourced from Link Asset Services

2.10.6 Deposits at 31 March 2020 stood at £ 80m (£60m at 31 March 2019).

	Balance at 31/03/2019 £000's	Amount Invested in year £000's	Realised in year £000's	Balance at 31/03/2020 £000's
Fixed Rate Deposits	60,000	90,000	- 70,000	80,000
Money Market Funds	28,000	123,000	- 150,500	500
Total Investments	88,000	213,000	-220,500	80,500

3. MONEY MARKET FUND – INCREASE IN THE INVESTMENT LEVEL.

3.1 The Bank of England cut interest rates twice within a week in March 2020 in an emergency move as it tried to support the UK economy in the face of the coronavirus pandemic.

3.2 From a rate of 0.75% the BOE announced a 0.5% cut to 0.25% and a package of measures to help businesses and individuals cope with the economic damage caused by the virus. It is the second cut in interest rates in just over a week, bringing them down to 0.1% from 0.25%. Interest rates are now at the lowest ever level in the Bank's 325-year history**.**

3.3 Due to increasing uncertainty in the economic climate due to Covid-19 affecting markets the interest rates are staying low and continue to stay lower. In comparison to last year where the Council would typically see a return of 1.25% we are now seeing levels of within the range between 0.10% and 0.40%.

3.2 The Council is risk averse and in terms of deposits the priority is always security, liquidity and then yield. Therefore after careful consideration, liaising closely and taking advice from our treasury consultants (LINK asset services) the Council has taken the position not to place any deposits into fixed term instruments for the time being.

3.3 In an attempt to gain returns in a very tough climate the Council took actions in two areas. Firstly we have negotiated with our bank to pay interest on our current account at a rate of 0.05%. Although low in the current market this is comparable to Money Market Fund returns and is certainly higher than the current DMO rate of 0.01%.

3.4 Secondly the proposal is to increase our deposit limit and the number of Money Market funds to deposit in as set out in our current Treasury Management Strategy approved by full Council on 4 March 2020. Currently we are invested across four different MMF at an aggregated maximum limit of £35m as below.

Fund	value £m
Aberdeen Standard Liquidity Fund	10m
Deutsche Managed Sterling Fund	10m
Insight Investment FIG	5m
Invesco Sterling Liquidity Portfolio	10m
	£35m

3.5 The proposal is to increase our existing maximum deposit in an individual MMF rom £10m to £20m per fund, and to open a fifth MMF. The new fund will be selected from the Treasury management consultant recommended list taking in to account security, Liquidity and yield of the Fund. This will provide an outlet for our excess cash that is currently held in the bank account to maximise returns while still being liquid as funds can be withdrawn, if needed, on a daily basis.

3.5 On our approved counter party list (table below), MMF's are classed as triple A and are considered highly secure by our advisors as well as being instantly callable. Due to the continuing uncertainty with the economy, low interest rates, lost income and the potential need for immediate cash it is not advisable to lock funds in fixed term deposits during the Covid crisis. If there is need for cash and our balances were low the temporary borrowing cost will be much higher than the interest earned on the short term deposits. Hence the reason MMF's look the most suitable vehicle until we have some certainty on future interest rates and income.

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	AAA	£35m	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

4. UPDATE ON 2020-21 TREASURY MANAGEMENT INVESTMENT STRATEGY AND FORECAST

4.1 Due to uncertainty in the economy created by the global pandemic, the interest rate forecast looks lower for longer. Based on the current projection the Council is expected to receive less investment income in the year compared to the past two years.
The investment made in the CCLA property fund (£10m) is expected to stay steady in its distribution and will be a main contributor to this year's interest income.

4.2 In the mid-year review due in November 2020 we should be able to provide more detail to the Director of Corporate Services as we hope we will have better understanding of the interest rate and the economy.

4.3 Please refer to Appendix 1 for the latest update from our Treasury investment consultant LINK on Markets and interest rate forecast.

5.0 ALTERNATIVE OPTIONS

5.1 As usual can place the excess cash in term deposits based on the cash flow forecast. However this will reduce our access to funds especially when we have very high uncertainty of our future cash flows/income as a result of the COVID pandemic. This may be an option in six to twelve months but not currently.

6 CONSULTATION UNDERTAKEN OR PROPOSED

6.1. Consulted with the Treasury management consultant on the Treasury Management Annual review and placing funds/increasing the limits in the MMF. The officers and the consultant are in constant discussions due to the uncertainties in the cash flow and the interest rates.

7 TIMETABLE

Increase the current investment level and opening of the new MMF will be immediately to get value for our money while maintain liquidity.

8 FINANCIAL, RESOURCE AND PROPERTY IMPLICATIONS

8.1. Interest income earned on the MMF will help to meet the budgeted interest income and holding fund liquid will prevent un-planned borrowing and will reduce interest expenses.

9 LEGAL AND STATUTORY IMPLICATIONS

9.1. None

10 HUMAN RIGHTS, EQUALITIES AND COMMUNITY COHESION IMPLICATIONS

10.1. None

11 CRIME AND DISORDER IMPLICATIONS

11.1. None

12 RISK MANAGEMENT AND HEALTH AND SAFETY IMPLICATIONS

12.1. None

13 APPENDICES –

13.1 Money and interest rate forecast from Link

14 BACKGROUND PAPERS

14.1 The Council's cash flow forecast

Appendix 1

Update on 2020-21 Treasury Management investment Strategy and forecast

LINK ASSET SERVICES' FORECASTS

Link Group Interest Rate View	6.7.20											
	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Bank Rate View	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 Month LIBID	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-	-	-	-
6 Month LIBID	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	-	-	-	-
12 Month LIBID	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	-	-	-	-
5yr PWLB Rate	1.90	1.90	1.90	2.00	2.00	2.00	2.00	2.00	2.10	2.10	2.10	2.10
10yr PWLB Rate	2.10	2.10	2.10	2.20	2.20	2.20	2.20	2.20	2.30	2.30	2.30	2.30
25yr PWLB Rate	2.50	2.50	2.50	2.60	2.60	2.60	2.60	2.60	2.70	2.70	2.70	2.70
50yr PWLB Rate	2.30	2.30	2.30	2.40	2.40	2.40	2.40	2.40	2.50	2.50	2.50	2.50

The world has changed considerably since we undertook our last interest rate forecasts and newsflash on 31 January. We are now in a completely different environment where interest rate forecasting is much more problematic and tentative than it is in normal circumstances. The scale of both Government and Central Bank intervention that we have recently seen is historic in its magnitude. What you find in this newsflash, therefore, is a set of forecasts that reflect the latest known situation with regard to coronavirus, and its likely impact on economies around the world given the unprecedented lock-downs now being put in place by many governments.

The new set of forecasts will be subject to change if materially new information/policies come to light. Pragmatically, we are also only going to give forecasts for two years ahead in view of the exceptional levels of uncertainty at the current time.

For now, we are making an assumption that the coronavirus will be "defeated" in the UK over a 6 to 12 months period, either through lock-downs and/or the invention and distribution to the general population of a vaccine. However, no one can be 100% confident that the virus will not return before a vaccine is available and widely used, and so there may be a requirement for further lock-downs despite all our best efforts. In addition,

- We can expect to see on-going market volatility, and therefore the potential for on- going Government and Central Bank intervention as required, for perhaps up to a year but also possibly longer;
- The MPC will aim for very loose monetary policy, primarily through the use of quantitative easing, in order to maintain low yields/funding costs to help support businesses and to also maintain appropriate levels of liquidity;
- We will, therefore, most likely have a very flat yield curve for at least a year before investors are sufficiently confident to push for higher yields in order to hold existing and additional debt incurred in putting measures in place to fight coronavirus.

- Bank Rate will stay at 0.1% for the next two years and any yield steepening will only arise after it is apparent that the end of the coronavirus epidemic is in sight;
- The measures recently introduced by Government to underpin the job security of both PAYE workers and the self-employed will be extended past 12 weeks if necessary;
- Inflation will stay below 2% and wage increases will be tepid in the face of economic uncertainty and a steady rise in unemployment;
- The economy is likely to take a considerable time to recover lost momentum;
- Brexit will still go ahead but the original timeframe may be impacted;
- There will be a recession in world growth in 2020; growth is unlikely to recover quickly.

Gilt yields and PWLB rates

The general situation is for volatility in bond yields to endure as investor fears and confidence ebb and flow between favouring relatively more "risky" assets i.e. equities, or the "safe haven" of government bonds. The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently.

Our forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU, (apart from the departure of the UK), within our forecasting time period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and China, North Korea and Iran, which have a major impact on international trade and world GDP growth.

Our revised forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

The table below is for PWLB Certainty Rates for non-HRA borrowing (currently gilts plus180bp points)

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