Treasury Management Performance Report 2020/21

Introduction

In February 2011 the council 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 council to approve treasury management semi-annual and annual reports.

The council's treasury management strategy for 2020/21 was approved at the audit committee meeting on 15 March 2020. The council 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 council's treasury management strategy.

Treasury risk management at the council 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 council 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 council'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 council's Capital Strategy, complying with CIPFA's requirement, was approved by full council on 24 February 2021.

External Context (provided by Arlingclose Limited)

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 held the 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 31 March.

A Brexit trade deal was agreed with only days to spare before the 11pm 31 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 (April-June) 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 (January-March) 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 council'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.

Local Context

On 31 March 2021, the council had net borrowing of £174.4 million 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

	31.03.2021 Actual £m
Total CFR	409.0
Less Other Debt Liabilities *	(100.0)
Borrowing CFR	**309.0**
External Borrowing	**(242.7)**
Internal borrowing	**66.3**
Less Usable Reserves	(128.1)
Less Working Capital	(6.5)
Net Investments	**(68.3)**

* finance leases, PFI liabilities and transferred debt that form part of the council's total debt

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 council 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 31 March 2021 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.03.2020 Balance £m	Movement £m	31.03.2021 Balance £m	31.03.2021 Rate %
Long-term borrowing	209.3	(11.6)	197.7	3.19%
Short-term borrowing	70.0	(25.0)	45.0	0.43%
Total borrowing	**279.3**	**(36.6)**	**242.7**	**2.77%**
Short term Investments	67.0	1.3	68.3	0.14%
Total investments	**67.0**	**1.3**	**68.3**	**0.14%**
Net borrowing	**212.3**	**(37.9)**	**174.4**	**3.80%**

Borrowing Update

In November 2020 the PWLB published its response to the consultation on 'Future Lending Terms'. From 26 November the margin on PWLB loans above gilt yields was reduced from 1.8% to 0.8% providing that the borrowing council 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 PWLB borrowing could result in the PWLB requesting that the offending council 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 council and borrowing purpose will be scrutinised by commercial lenders.

The council 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 council 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 31 March 2021 the council held £242.7 million of loans, (a decrease of £36.6 million), as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 31 March are summarised in Table 3 below.

Table 3: Borrowing Position

	31.03.20 Balance £m	Net Movement £m	31.03.21 Balance £m	31.03.21 Weighted Average Rate %	31.03.2021 Weighted Average Maturity (years)
Public Works Loan Board	204.3	(11.6)	192.7	3.28%	15.61
Banks (LOBO)	5.0	-	5.0	4.27%	20.67
Banks (fixed term)	-	-	-		
Local authorities (long-term)	-	-	-		
Local authorities (short-term)	70.0	(25.0)	45.0	0.43%	0.43
Total borrowing	**279.3**	**(36.6)**	**242.7**	**2.77%**	**12.90**

The council'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 council's long-term plans change being a secondary objective.

In keeping with these objectives, no new borrowing was undertaken, while £6 million of PWLB loans and £25 million of local authority short-term loans were allowed to mature without replacement. This strategy enabled the council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

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 council will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.

The council continues to hold £5m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the council has the option to either accept the new rate or to repay the loan at no additional cost. The bank did not exercise their option during the year.

Towards the end of the year, Arlingclose, the council's treasury advisor determined that there was an opportunity to restructure this loan. The risks and benefits, including restructuring savings, are in the process of being assessed.

Other Debt Activity

During the 2020/21 financial year the council did not raise any additional capital finance for Highway Improvements via Private Finance Initiative. Total debt, other than borrowing, stood at £129.9 million on 31 March 2021, taking total debt to £372.6 million

Treasury Investment Activity

In April 2020, the council received central government funding to support small and medium businesses during the coronavirus pandemic through grant schemes. £62.7 million was received, temporarily invested in short-dated, liquid instruments such as call accounts and Money Market Funds. £51.2 million was disbursed by the end of March, with the balance of £11.5 million being repaid to central government in May 2021.

Between November 2020 and March 2021, further allocations of central government funding to support business were receive totalling £37.7 million, of which £27.7 million was disbursed before year end. Since year end, a further £1.6 million in respect of these allocations has been disbursed. It is expected that the undistributed balance will be repaid to central government during the second half of 2021-22 once reconciliation activity is completed.

The council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the council's investment balances ranged between £68.3 and £139 million due to timing differences between income and expenditure. During the year the council maintained balances of up to £10 million in the council's current bank account, in addition to the amounts invested.

The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.03.2020 Balance £m	Net Movement £m	31.03.2021 Balance £m	31.03.2021 Income Return %	31.03.2021 Weighted Average Maturity days
Banks & Building societies (unsecured)	10.0	-	10.0	0.12%	1
Covered bonds (secured)	-	-	-		
Govt (incl local authorities)	45.0	(7.0)	38.0	0.19%	93
Isle of Wight Council Pension Fund	8.0	(2.5)	5.5	0.16%	281
Corporate nonds and loans	-	-	-		
Money Market Funds	4.0	10.8	14.8	0.02%	1
Other Pooled Funds	-	-	-		
Total Investments	**67.0**	**1.3**	**68.3**	**0.14%**	**75**

Both the CIPFA Code and government guidance require the council 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 council'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 Money Market Fund 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.

Given the increasing risk and low returns from short-term unsecured bank investments, the council has continued in the more secure investment of lending to other local as shown in table 4 above. As a result, investment risk was diversified. The 2020/21 average return of 0.14% is higher than the official Bank of England rate of 0.10%.

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	3.65	AA-	22%	147	0.79%
30.06.2020	3.81	AA-	29%	44	0.38%
30.09.2020	4.08	AA-	56%	60	0.24%
31.12.2020	4.74	AA-	50%	74	0.16%
31.03.2021	4.71	A+	36%	75	0.14%
Similar LAs	**4.66**	**A+**	**62%**	**32**	**0.12%**
All LAs	**4.63**	**A+**	**56%**	**14**	**0.15%**

Following the cut in Bank rate from 0.75% to 0.10% in March 2020, the council 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 council'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 council as well as other non-financial assets which the council 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 council also held £40.3 million of such investments in

- directly owned property £35.1 million
- shared ownership housing £4.0 million
- loans to local businesses £1.2 million

A full list of the council's non-treasury investments is available in the Isle of Wight Council Statement of Accounts 2020/21

These investments generated £0.9 million of investment income for the council after taking account of direct costs, representing a rate of return of 2.72%

Treasury Performance

The council 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 £m	Budget £m	Over / Under £m	Actual %	Benchmark %	Over / Under %
Total Investment Income	0.3	0.2	0.1	0.27%	0.15%	0.12%
Total Cost of Borrowing	(7.4)	(8.3)	0.9	2.83%	-	-
GRAND TOTAL	(7.1)	(8.1)	1.0	n/a	n/a	n/a

Compliance

The Director of Finance and Section 151 Officer reports that all treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the council's approved Treasury Management Strategy.

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

Table 7: Debt Limits

	2020/21 Maximum	31.3.2021 Actual	2020/21 Operational Boundary	2020/21 Authorised Limit	Complied?
Borrowing	284.3	242.7	352.0	440.0	✓
PFI and Finance Leases	101.7	100.0	120.0	150.0	✓
Total Debt	**386.0**	**342.7**	**472.0**	**590.0**	✓

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

	2020/21 Maximum	31.03.2021 Actual	2020/21 Limit	Complied?
Any single organisation, except the UK Government [1]	12.5	10.0	12.0	x
Any group of organisations under the same ownership	12.0	-	12.0	✓
Money Market Funds [2]	58.0	14.8	50.0	x

1. The limit was breached due to the receipt of several grants from the government relating to the Covid-19 government packages. The breach was identified in advance and agreement was obtained from the Director of Finance and Section151 Officer. The limit was exceeded on one occasion for three days.
2. The overall total of the amount collectively held in all money market funds was greater than the approved limits due to the level of grants received from the government in response to the Covid-19 pandemic. The limits were exceeded on three separate occasions during the year, for a total of 21 days.

Treasury Management Indicators

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

Security: The council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score 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.

	31.03.21 Actual	2020/21 Target	Complied ?
Portfolio average credit score	4.71	4.63	x

The council measures the security of its investments using data provided by Arlingclose. The target figure is the average credit score of all Arlingclose clients that take part in the benchmarking exercise.

Although the portfolio average credit score for the year was slightly higher than the target in numeric terms, the average credit rating of the council's investments was A+ for both actual and target.

Liquidity: The council maintains detailed cash flow forecasts with a view to keeping minimum surplus cash balances. It addresses liquidity issues by restricting a significant proportion of its investment opportunities to short term and instant access deposits.

	31.03.2021 Actual £m	2020/21 Target £m	Complied?
Total cash available within 3 months	44.3	18.5	✓

Interest Rate Exposures: This indicator is set to control the council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interests was:

Interest Rate Risk Indicator	31.03.21 Actual £m	2020/21 Limit £m	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	-0.2	-0.3	✓
Upper limit on one-year revenue impact of a 1% fall in interest rates	0.2	0.3	✓

The impact of a change in interest rates is calculated on the assumption that maturing loans and investment will be replaced at current rates.

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

	31.03.2021 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	21%	50%	0%	✓
12 months and within 24 months	3%	30%	0%	✓
24 months and within 5 years	7%	30%	0%	✓
5 years and within 10 years	19%	75%	0%	✓
10 years and above	51%	95%	0%	✓

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 council'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 £m	**2021/22 £m**	**2022/23 £m**
Actual principal invested beyond year end	-	-	-
Limit on principal invested beyond year end	35	40	45
Complied?	✓	✓	✓

Other

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 council'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.