Annex 1.3

Treasury Management

Borrowing and Investments

1. The table below shows the year's opening balance of borrowing and investments, current levels and those predicted for year-end. Forecast borrowing is currently based on month 9 capital monitoring and will be subject to review during the year.

Lower official interest rates have lowered the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The Authority continued its strategy of keeping borrowing and investments below their underlying levels in order to reduce risk and make a net saving.

2.

	31-Mar-20 Actual £M	31-Mar-20 Average %	31-Dec-20 Actual £M	31-Dec-20 Average %	31-Mar-21 Forecast £M	31-Mar-21 Forecast %
Long Term Borrowing						
Public Works Loan	257.87	2.88	237.35	2.69	277.70	2.72
LOBO Loans from Banks	9.00	4.89	9.00	4.86	9.00	4.87
	266.87	**2.95**	**246.35**	**2.72**	**286.70**	**2.79**
Short Term Borrowing						
Other Local Authorities	10.00	0.92	0.00	0.27	10.00	0.82
Other	0.36	0.92	0.36	0.27	0.36	0.82
Total External Borrowing	**277.23**	**2.85**	**246.71**	**2.72**	**297.06**	**2.74**
Other Long Term Liabilities						
PFI Schemes	54.00	9.01	52.48	8.82	50.96	9.16
Deferred Debt Charges (HCC)	13.83	2.66	13.64	2.61	13.46	2.15
Total Gross External Debt	**345.06**	**3.87**	**312.84**	**4.08**	**361.48**	**3.73**
Investments:						
Managed In-House						
Government & Local Authority	0.00	0.00	(10.00)	0.10		
Cash (Instant access)	(31.11)	0.34	(29.33)	0.01	(10.00)	0.03
Cash (Notice Account)	0.00	0.00	0.00	0.00	0.00	0.00
Long Term Bonds	(3.01)	5.30	(3.01)	5.30	(3.00)	5.30
Managed Externally						
Pooled Funds (CCLA) & Shares	(27.02)	4.35	(27.00)	3.52	(27.02)	3.00
Total Investments	**(61.15)**	**4.44**	**(69.34)**	**3.51**	**(40.02)**	**2.43**
Net Debt	**283.91**		**243.50**		**321.46**	

3. After taking into account maturing and new debt requirements in year and a reduction in investment balances, there is a current estimated increase in net borrowing of £37.55M for the year, this is less than previously reported as a number of schemes have been deferred.

4. The interest cost of financing the council's long term and short term loan debt is charged to the general fund revenue account and is detailed below together with a summary of performance to date.

<u>Borrowing</u>

5. The forecast cost of financing the council's loan debt is £15.06M of which £4.94M relates to the HRA, however this will be subject to movement as the need for further borrowing for the remainder of the year becomes more certain.

6.	In November 2020 the PWLB published its response to the consultation on 'Future Lending Terms'. From 26th November the margin on PWLB loans above gilt yields was reduced from 1.8% to 0.8% providing that the borrowing authority can confirm that it is not planning to purchase 'investment assets primarily for yield' in the current or next two financial years. Authorities that are purchasing or intending to purchase investment assets primarily for yield will not be able to access the PWLB except to refinance existing loans or externalise internal borrowing (only after a detailed application from the section 151 officer). As part of the borrowing process authorities will now be required to submit detailed capital expenditure plans with confirmation of the purpose of capital expenditure from the Section 151. The PWLB can now also restrict local authorities from borrowing in unusual or large amounts.
7.	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 Authority unwinds problematic transactions, suspending access to the PWLB and repayment of loans with penalties. Competitive market alternatives may be available for authorities with or without access to the PWLB. However, the financial strength of the individual authority and borrowing purpose will be scrutinised by commercial lenders.
8.	As a result of these changes the Authority is currently reviewing its capital programme and may consider the cancellation of planned purchases of assets primarily for yield so as to retain access to the PWLB, the figures presented in this report exclude the previously planned expenditure on the Property investment Fund.
9.	**Municipal Bonds Agency (MBA):** The MBA revised its standard loan terms and framework agreement. Guarantees for the debt of other borrowers are now proportional and limited and a requirement to make contribution loans in the event of a default by a borrower has been introduced. The agency has issued 5-year floating rate and 40-year fixed rate bonds in 2020, in both instances Lancashire County Council is the sole borrower and guarantor. A planned third bond issuance by Warrington Borough Council was withdrawn in early December after the reduction in PWLB borrowing rates. If the Authority intends future borrowing through the MBA, it will first ensure that it has thoroughly scrutinised the legal terms and conditions of the arrangement and is satisfied with them.
10.	Short term interest rates have remained low and are likely to do so for the remainder of the year and offer good value, which we will utilise to fund any further borrowing needs in the year, unless an opportunity arises to secure a long term loan at advantageous rates or to provide certainty for the portfolio. Although we currently do not have any short term debt, we anticipate borrowing from February onwards to replace maturing long term debt, expected reduction in reserves and to fund the forecast capital programme for the year, until a decision is taken with regards to long term borrowing. Any increase in short term borrowing costs will be offset by a reduction in long term costs. This is later than previously reported as cash flows have remained higher than expected.
	<u>Investment</u>
11.	The initial reaction to the COVID crisis in March meant that short term liquidity became difficult and Government sought to assist cash flow by providing up front funding as far as possible,

	both in terms of the grants to businesses administered by the Council on its behalf and the funding to the local authority itself (under the business rates retention scheme). As a result of this grant funding year end investment balances were higher than expected and have remained so during the year to date but are expected to fall to an estimated £40M by the end of the year, as we have a number of debt maturities and an ongoing capital programme, but this will be dependent on actual capital spend and movement in balances. Investment balances have ranged between £114M and £61M during the year and are currently £69M. Continued downward pressure on short-dated cash brought net returns on money market funds to zero even after some managers have temporarily lowered their fees. At this stage net negative returns are not the central case of most MMF managers over the short-term but the possibility cannot be ruled out. The overnight, 1- and 2-week deposit rates on Debt Management Account Deposit Facility (DMADF) deposits have dropped below zero percent on occasion and would only be used as a last resort to ensure security of funds. This supports our decision to only borrow for cash flow purposes at this stage as savings on borrowing costs more than offset the loss on short term investments. The impact of COVID-19 will continue during the year and will be reported at each quarter and as part of Treasury Reports to Governance Committee.
	<u>External Managed investments</u>
12.	The council has invested £27M in property funds as an alternative to buying property directly. As previously reported these funds offer the potential for enhanced returns over the longer term but may be more volatile in the shorter term and are managed by professional fund managers which allows the Authority to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date but are usually available for withdrawal after a notice period (90 days), their performance and continued suitability in meeting the Authority's investment objectives is regularly reviewed.
13.	Like many other property funds, dealing (i.e. buying or selling units) in the fund was suspended by the fund in March 2020. The lack of property transactions meant that it was not possible for valuers to be confident that their valuations correctly reflected prevailing conditions. To avoid material risk of disadvantage to buyers, sellers and holders of units in the property fund, the management company was obliged to suspend transactions until the required level of certainty is re-established. Since then conditions in the property market have stabilised and valuation clarity and certainty have improved, and the dealing suspension was lifted in September 2020.
14.	Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three to five-year period total returns will exceed cash interest rates. In light of their performance over the long-term and the Authority's latest cash flow forecasts, investment in these funds has been maintained.
15.	During 2019/20 this investment returned £1.2M at an average yield of 4.4% against the initial investment, however since the onset of the COVID-19 pandemic and the current global economic environment, the value of the fund fell to £26.47M at 31 March 2020 a reduction of £0.53M against the original investment.

This trend has continued into 2020/21 and the fund is currently valued at £25.37M, £1.63M lower than original investment. This notional “loss” will only be a cost to the Authority at the point the investment is sold as the Authority is using the alternative fair value through profit and loss (FVPL) accounting and can defer the funds’ fair value losses to the Pooled Investment Fund Adjustment Account until 2023/24, by which time it is anticipated that the global economic environment will have improved.

Future income is also expected to 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 has improved the economic forecast it will take time to recover from the impact of the pandemic.

The dividend for October to December has been boosted by a significant level of one-off receipts resulting in an enhanced payment of over £40k more than the previous two quarters.

The estimated return for the year is now expected to be about 95% of that for 2019/20, £1.1M at an average yield of 4.16% against the initial investment.

Financial Review and Outlook

16. A summary of the external factors, which sets the background for Treasury, as provided by the council’s treasury advisors, Arlingclose Ltd, is summarised below. The low for longer interest rate outlook theme that has been at the core of the recommended strategic advice for over a decade remains.

	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.15	0.15	0.15	0.15	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Downside risk	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50

17. The medium-term global economic outlook has improved with the distribution of vaccines, but the recent upsurge in coronavirus cases has worsened economic prospects over the short term. Restrictive measures and further lockdowns are likely to continue in the UK and Europe until the majority of the population is vaccinated by the second half of 2021. The recovery period will be strong thereafter, but potentially longer than previously envisaged.

18. Signs of a slowing UK economic recovery were already evident in UK monthly GDP and PMI data, even before the second lockdown and Tier 4 restrictions. Employment is falling despite an extension to support packages. The need to support economic recoveries and use up spare capacity will result in central banks maintaining low interest rates for the medium term.

19. Brexit will weigh on UK activity. The combined effect of Brexit and the after-effects of the pandemic will dampen growth relative to peers, maintain spare capacity and limit domestically generated inflation. The Bank of England will therefore maintain loose monetary conditions for the foreseeable future.

20. Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid longer-term inflation expectations.

There is a chance yields may follow a slightly different path in the medium term, depending on investor perceptions of growth and inflation, the deployment of vaccines and the impact of UK leaving the EU.

21.	Arlingclose expects Bank Rate to remain at the current 0.10% level. The central case for Bank Rate is no change, but further cuts to zero, or perhaps even into negative territory, cannot be completely ruled out. Downside risks remain, and indeed appear heightened, in the near term, as the government reacts to the escalation in infection rates and the Brexit transition period comes to an end.
22.	Gilt yields will remain low in the medium term. Shorter term gilt yields are currently negative and will remain around zero or below until either the Bank expressly rules out negative Bank Rate or growth/inflation prospects improve.
	Credit background
23.	After rising in late October/early November, credit default swap spreads declined over the remaining period of the calendar year to broadly pre-pandemic levels and the gap in spreads between UK ringfenced and non-ringfenced entities remained. At the end of the period Barclays Bank Plc was trading the highest at 57bps and Standard Chartered the lowest at 32bps. The ringfenced banks were trading between 33 and 36bps. During the period Moody's downgraded the UK sovereign rating to Aa3 with a Stable outlook which then impacted a number of other UK institutions, banks and local government. These included Cornwall Council and Guildford BC which were downgraded to Aa3.Transport for London, Aberdeen CC, Lancashire CC, Lloyds Bank and HSBC Bank downgraded to A1 and Warrington BC was downgraded to A2.
24.	While the approval of two coronavirus vaccines is a credit positive, 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 on Arlingclose's counterparty list and recommended duration 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.
25.	**Investment Performance**
26.	The council's advisors undertake quarterly investment benchmarking across its client base. As reported previously our portfolio was more diversified and at higher interest rates than the average as a result of moving into the bond programme earlier than most clients, but there is now more competition for bonds from both government bodies and other local authorities, so opportunities to replace maturing bonds are limited and we will see a fall in suitable instruments. With this in mind, and following discussions with our advisors, it was decided to move more into property funds, which are a longer term investment, and to short term investments for cash flow purposes.
27.	Our current investments in bonds is now £3M following maturities in 2019/20 and we maintained the property funds at £27M, with all other cash being placed in short term deposits as shown in paragraph 2.
28.	As detailed in paragraph 11 our cash balances have continued to be higher than usual. As a result, we had £39M in short term investment which is above our normal working balances. Our target is to reduce this to a £10M working balance to reduce borrowing and therefore net interest costs but this will be dependent on actual capital spend and movement in balances.

29.	Investments managed internally are currently averaging a return of 0.41% which is higher than the average of 0.16% whilst still maintaining the same average credit rating of A-. Total income return at 1.81% is also higher than the average for both unitary (0.78%) and LA's (0.77%). However due to a fall in the capital value of our external funds of -4.89% (an improvement from last quarter at -6.72%) our total investment return at -0.04% is lower than that for the average LA's (-0.00%) but better than the average unitary (-0.24%) across Arlingclose's client base, but as previously reported it is the income return at 4.12% on NAV (Net Asset Value) that is the driver to invest plus they are deemed less risky than buying individual properties and do not constitute capital spend.