Midlothian

Audit Committee
Tuesday 22 June 2021
Item No: 5.5

Annual Treasury Management Report 2020/21

Report by Gary Fairley, Chief Officer Corporate Solutions

Report for Decision

1 Recommendations

The Audit Committee is invited to consider this report before the final report is presented to Council. Committee should note that the proposed recommendation to Council is that it note the Annual Treasury Management Report 2020/21.

2 Purpose of Report/Executive Summary

The purpose of the report is to inform members of the Audit Committee of the Treasury Management activity undertaken in 2020/21 and the year-end position.

Date: 11 June 2021
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3 Background

The main points arising from treasury activity in 2020/21 were:

- The pooled internal loans fund rate for General Fund and HRA was 3.10% in 2020/21, which is again expected to be one of the lowest when benchmarked against all mainland Authorities in Scotland;

- Were the pooled internal loans fund rate to have equated to the Scottish weighted average of 3.70%, this would have generated loan charges in 2020/21 of £18.3 million. The Council's actual 2020/21 loan charges for General Services and HRA were £16.5 million, representing a cash saving (compared to the Scotland average) of £1.8 million in 2020/21;

- Total new long term borrowing taken in the year amounted to £15.000 million, this being a maturity loan from PWLB drawn on 28 April 2020 with a loan tenor of 46.5 years at an interest rate of 1.17% utilising the HRA discounted borrowing rate;

- Total long term borrowing maturing in the year amounted to £9.282 million, comprising the following:-
    - One £8.400 million Maturity Loan with PWLB matured on 14 December 2020 (original tenor 9 years at an interest rate of 2.98%);
    - £0.040 million of PWLB Annuities of various tenors and interest rates;
    - £0.641 million of Annuity and EIP, and £0.201 million of interest free loans.

- The average rate of interest paid on external debt was 3.31% in 2020/21, down from 3.44% in 2019/20 and reflecting the historically low interest rates secured on longer-term PWLB borrowing in 2020/21;

- Three deposits were placed with local authorities, which replaced existing/maturing deposits with financial institutions and which continues the approved strategy of cash backing the Council's reserves;

- The average rate of return on deposits was 0.97% in 2020/21, exceeding the benchmark of 0.65% for the seventeenth year in succession;

- Cash balances in instant access accounts throughout the year were significantly higher than normal and reflective of (a) the Scottish Government providing upfront funding to local authorities to support a range of grant schemes, in particular schemes to support local businesses; (b) advanced Revenue Support Grant payments and Early Years Capital Grant payments in 2020/21, and (c) the impact of Covid on the Council's cashflow due to rephasing of capital expenditure plans.

- No debt rescheduling was undertaken during 2020/21.

A detailed report "*Annual Treasury Management Review 2020/21*" on the activity during 2020/21 is attached as Appendix 2.

The Treasury Portfolio at the start and end of the financial year is shown in Tables 1 and 2 below.

Table 1: Loan Portfolio at 1 April 2020 and 31 March 2021

Loan Type	**Principal Outstanding 1 Apr 2020 £000's**	**Principal Outstanding 31 Mar 2021 £000's**	**Movement £000's**
PWLB Annuity	637	597	-40
PWLB Maturity	228,824	235,424	+6,600
LOBO	20,000	20,000	0
Forward Starting Loans	18,831	18,191	-640
Temporary Market Loans	0	0	0
Salix Loans	785	583	-202
Total Loans	**269,077**	**274,795**	**+5,718**

Table 2: Deposits at 1 April 2020 and 31 March 2021

Deposit Type	**Principal Outstanding 1 Apr 2020 £000's**	**Principal Outstanding 31 Mar 2021 £000's**	**Movement £000's**
Bank Call Accounts	11,476	26,470	+14,994
Money Market Funds	14,901	29,818	+14,916
Bank Notice Accounts	14,985	14,985	0
Bank Fixed Term Deposit Accounts	30,000	0	-30,000
Other Local Authorities	40,000	60,000	+20,000
Total Deposits	**111,363**	**131,273**	**+19,910**

4. Other Issues

The Code recommends that Treasury reports are presented to and scrutinised by Audit Committee in advance of being considered by Council.

The report is being presented to Audit Committee on 22 June 2021 and subsequently to Council, and will be updated to reflect any comments that the Audit Committee have.

5 Report Implications (Resource, Digital and Risk)

5.1 Resource

Treasury Management activity during the year, in accordance with the approved strategy, has once again been effective in minimising the cost of borrowing and maximising the return on deposits within the parameters set by the strategy for the year.

Although benefits from Treasury Management activity continue to accrue there are no direct financial implications or other resource issues arising from this report.

The loan charges associated with Capital Expenditure and Treasury Management activity during 2020/21 are reported in the Financial Monitoring 2020/21 – General Fund Revenue report elsewhere on today's agenda.

5.2 Digital

None.

5.3 Risk

As the Council follows the requirements of CIPFA Code of Practice and the Prudential Code this minimises the risks involved in Treasury Management activities place. For those risks that do exist there are robust and effective controls in place to further mitigate the level of risks. These include further written Treasury Management Practices, which define the responsibilities of all staff involved.

5.4 Ensuring Equalities (if required a separate IIA must be completed)

This report does not recommend any change to policy or practice and therefore does not require an Equalities Impact Assessment.

5.5 Additional Report Implications

See Appendix A

Appendices:-

Appendix 1: Loans Fund Rate Comparison with other Scottish Local Authorities
Appendix 2: Annual Treasury Management Review 2020/21
Appendix 3: Deposit Benchmarking Analysis 2020/21

APPENDIX A – Report Implications

A.1 Key Priorities within the Single Midlothian Plan

Not applicable

A.2 Key Drivers for Change

Key drivers addressed in this report:

- ☐ Holistic Working
- ☐ Hub and Spoke
- ☐ Modern
- ☒ Sustainable
- ☒ Transformational
- ☐ Preventative
- ☐ Asset-based
- ☒ Continuous Improvement
- ☐ One size fits one
- ☐ None of the above

A.3 Key Delivery Streams

Key delivery streams addressed in this report:

- ☐ One Council Working with you, for you
- ☒ Preventative and Sustainable
- ☐ Efficient and Modern
- ☐ Innovative and Ambitious
- ☐ None of the above

A.4 Delivering Best Value

The report does not directly impact on Delivering Best Value.

A.5 Involving Communities and Other Stakeholders

Although no external consultation has taken place, cognisance has been taken of professional advice obtained from Link Asset Services, the Council's appointed Treasury Consultants.

A.6 Impact on Performance and Outcomes

The strategies adopted are an integral part of the corporate aim to achieve Best Value as they seek to minimise the cost of borrowing by exercising prudent debt management and placement of deposits. This in turn helps to ensure that the Council's capital expenditure is sustainable in revenue terms.

A.7 Adopting a Preventative Approach

Not applicable.

A.8 Supporting Sustainable Development

Not applicable.

Appendix 1:-

Loans Fund Pooled Rate Comparison 2019/20

Loans Fund Rate	2019/20
All Scottish Councils	Pooled Rate
West Dunbartonshire	2.58%
Midlothian	2.95%
Aberdeenshire	3.00%
Perth & Kinross	3.07%
Dumfries & Galloway	3.16%
East Lothian	3.18%
North Lanarkshire	3.45%
Inverclyde	3.50%
Dundee City	3.57%
Argyll & Bute	3.57%
Aberdeen City	3.58%
East Renfrewshire	3.72%
Falkirk	3.77%
East Ayrshire	3.80%
Glasgow City	3.87%
West Lothian	3.87%
Highland	3.89%
Renfrewshire	3.93%
South Ayrshire	3.94%
South Lanarkshire	3.96%
Scottish Borders	4.05%
North Ayrshire	4.06%
East Dunbartonshire	4.06%
Stirling	4.16%
Moray	4.19%
Edinburgh City	4.37%
Angus	4.42%
Clackmannanshire	5.10%

The Pooled Loans Fund Rate combines the interest paid by the Council on money borrowed, with the interest earned by the Council on money invested, along with other charges such as internal interest allowed, premiums written off and treasury-related expenses to arrive at a weighted average “loans fund rate” figure for each authority, as noted in the final column above.

Appendix 2

Annual Treasury Management Review 2020/21

Midlothian Council
June 2021

Contents

This Council is required by regulations issued under the Local Government in Scotland Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2020/21. 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 2020/21 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 11/02/2020);
- a mid-year, (minimum), treasury update report (Council 15/12/2020);
- an annual review following the end of the year describing the activity compared to the strategy, (this report);

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy 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.

This Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Audit Committee before they are reported to the full Council.

1. The Council's Capital Expenditure and Financing 2020/21

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.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

Table 1: Capital Expenditure + Financing			
	2019/20 Actual £000	2020/21 Budget £000	2020/21 Actual £000
General Fund			
Capital Expenditure	30,977	63,765	25,570
Available Funding	26,062	41,790	15,612
Borrowing Required	**4,915**	**21,975**	**9,958**
HRA			
Capital Expenditure	24,936	81,128	15,632
Available Funding	11,951	5,489	9,241
Borrowing Required	**12,985**	**75,639**	**6,391**
General Fund and HRA			
Capital Expenditure	55,913	144,893	41,202
Available Funding	38,013	47,279	24,853
Borrowing Required	**17,900**	**97,614**	**16,349**

2. The Council's Overall Borrowing Need

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and what resources have been used to pay for the capital spend. It represents the 2020/21 unfinanced capital expenditure (see above table), plus prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

Reducing the CFR – the Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Scheduled Debt Amortisation (or loans repayment), to reduce the CFR. This is effectively a repayment of the borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the minimum loan repayment each year through an additional revenue charge.

The Council's CFR for the year is shown below, and represents a key prudential indicator.

Table 2: Council's Underlying Borrowing Requirement

CFR:	31-Mar-20 Actual	2020/21 Budget	31-Mar-21 Actual
	£000	£000	£000
Opening balance	**£ 274,582**	**£ 299,486**	**£ 283,384**
Add Borrowing Required	£ 17,900	£ 97,614	£ 17,900
Less scheduled debt amortisation	£ (9,098)	£ (9,182)	£ (8,170)
Closing balance	**£ 283,384**	**£ 387,918**	**£ 293,114**

Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

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 (2019/20) plus the estimates of any additional capital financing requirement for the current (2020/21) and next three financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2020/21. The table below highlights the Council's gross borrowing position against the CFR (excluding PFI schemes). The Council has complied with this prudential indicator.

Table 3: Council's Gross Borrowing Position			
	31-Mar-20 Actual	2020/21 Budget	31-Mar-21 Actual
	£000	£000	£000
Gross Borrowing	£ 269,077	£ 346,660	£ 274,795
CFR	£ 283,384	£ 387,918	£ 293,114

The authorised limit – this Council has kept within its authorised external borrowing limit as shown by the table below. Once this has been set, the Council does not have the power to borrow above this level.

The operational boundary – 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 is acceptable subject to the authorised limit not being breached.

Table 4: Gross Borrowing against Authorised Limit / Operational Boundary	
	2020/21
Authorised limit - borrowing	£551,806
Operational boundary - borrowing	£387,918
Maximum gross borrowing position	£293,495
Average gross borrowing position	£281,385

3. Treasury Position as at 31 March 2021

The Council's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting detailed in the Purpose section of this report, and through officer activity detailed in the Council's Treasury Management Practices. At the beginning and the end of 2020/21 the Council's treasury (excluding borrowing by PFI and finance leases) position was as follows:

Table 5: Treasury Position

	31 March 2020 Principal	Rate/ Return	Average Life (Yrs)	31 March 2021 Principal	Rate/ Return	Average Life (Yrs)
Debt						
Fixed Rate Debt						
PWLB	£ 229,462	3.43%	30.27	£ 236,021	3.30%	31.36
Market	£ 24,616	2.89%	30.70	£ 23,774	2.92%	30.09
Total Fixed Rate Debt	**£ 254,078**	**3.38%**	**30.31**	**£ 259,795**	**3.27%**	**31.24**
Variable Rate Debt						
PWLB	£ -	n/a	n/a	£ -	n/a	n/a
Market	£ 15,000	4.63%	31.71	£ 15,000	4.63%	31.71
Total Variable Rate Debt	**£ 15,000**	**4.63%**	**32.71**	**£ 15,000**	**4.63%**	**31.71**
Total debt/gross borrowing	**£ 269,078**	**3.47%**	**30.45**	**£ 274,795**	**3.34%**	**31.27**
CFR	**£ 283,384**			**£ 293,114**		
Over/ (under) borrowing	**£ (14,306)**			**£ (18,319)**		
Deposits						
Fixed Rate Deposits						
In House	£ 70,000	1.43%	1.71	£ 60,000	1.62%	1.41
With Managers	£ -	n/a	n/a	£ -	n/a	n/a
Total Fixed Rate Deposits	**£ 70,000**	**1.43%**	**1.71**	**£ 60,000**	**1.62%**	**1.41**
Variable Rate Deposits						
In House	£ 26,378	0.59%	0.18	£ 71,272	0.13%	0.11
With Managers	£ -	n/a	n/a	£ -	n/a	n/a
Total Variable Rate Deposits	**£ 26,378**	**0.59%**	**0.18**	**£ 71,272**	**0.13%**	**0.11**
Total Deposits	**£ 96,378**	**1.20%**	**1.29**	**£ 131,272**	**0.81%**	**0.70**

The maturity structure of the debt portfolio was as follows:

Table 6: Maturity Structure of Debt Portfolio					
	31-Mar-20		2020/21	31-Mar-21	
	Actual		Original Limits	Actual	
	£000	%	%	£000	%
Under 12 months	£ 9,230	3%	0% to 50%	£ 1,471	1%
12 months to 2 years	£ 1,490	1%	0% to 50%	£ 1,465	1%
2 years to 5 years	£ 3,720	1%	0% to 50%	£ 3,624	1%
5 years to 10 years	£ 14,560	5%	0% to 50%	£ 23,923	9%
10 years to 20 years	£ 63,229	23%	0% to 50%	£ 53,308	19%
20 years to 30 years	£ 14,265	5%	0% to 50%	£ 13,421	5%
30 years to 40 years	£ 90,534	34%	0% to 50%	£ 95,534	35%
40 years to 50 years	£ 67,049	25%	0% to 50%	£ 77,049	28%
50 years and above	£ 5,000	2%	0% to 50%	£ 5,000	2%
Total	**£ 269,077**	**100%**		**£ 274,795**	**100%**

The maturity structure of the Council's deposits was as follows:

Table 7: Maturity Structure of Deposit Portfolio		
	31-Mar-20	31-Mar-21
	£000	£000
Deposit		
Under 1 Year	£ 81,363	£ 71,272
Over 1 Year	£ 30,000	£ 60,000
Total	**£ 111,363**	**£ 131,272**

The exposure to fixed and variable interest rates on debt was as follows:-

Table 8: Fixed/Variable Interest Rate Exposure of Debt Portfolio					
	31-Mar-20		2020/21	31-Mar-21	
	Actual		Original Limits	Actual	
	£000	%	%	£000	%
Fixed Interest Rate Exposure	£254,077	94%	0% to 100%	£259,795	95%
Variable Interest Rate Exposure	£ 15,000	6%	0% to 30%	£ 15,000	5%
Total	**£269,077**	**100%**		**£274,795**	**100%**

4. The Strategy for 2020/21

During 2020/21, the Council maintained a partial under-borrowed position. This meant that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure to finance capital investment.

Interest rate forecasts expected only gradual rises in medium and longer term fixed borrowing rates during 2020/21 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period.

Link Asset Services Interest Rate View													
	Mar-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	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25	1.25	1.25	1.25
3 Month LIBID	0.70	0.70	0.80	0.80	0.90	1.00	1.00	1.10	1.20	1.30	1.30	1.30	1.30
6 Month LIBID	0.80	0.80	0.90	1.00	1.00	1.10	1.20	1.30	1.40	1.50	1.50	1.50	1.50
12 Month LIBID	0.90	0.90	1.00	1.10	1.20	1.30	1.40	1.50	1.60	1.70	1.70	1.70	1.70
5yr PWLB Rate	2.30	2.30	2.40	2.40	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.00	3.10
10yr PWLB Rate	2.50	2.50	2.60	2.60	2.70	2.80	2.90	3.00	3.10	3.10	3.20	3.20	3.30
25yr PWLB Rate	3.00	3.00	3.10	3.20	3.30	3.40	3.50	3.60	3.70	3.80	3.80	3.90	3.90
50yr PWLB Rate	2.90	2.90	3.00	3.10	3.20	3.30	3.40	3.50	3.60	3.70	3.70	3.80	3.80

Return on funds placed on deposit which had been low during 2019/20, plunged during 2020/21 to near zero or even into negative territory. Most local authority lending managed to avoid negative rates and one feature of the year was the growth of inter local authority lending.

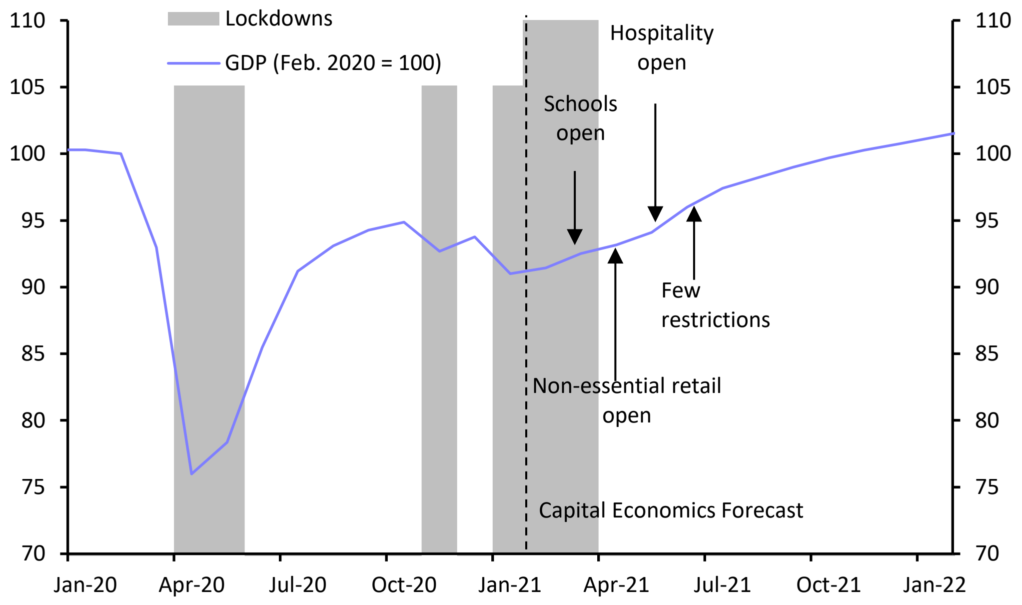
The expectation for interest rates within the treasury management strategy for 2020/21 was that Bank Rate would continue at the start of the year at 0.75 % before rising to end 2022/23 at 1.25%. This forecast was invalidated by the Covid-19 pandemic bursting onto the scene in March 2020 which caused the Monetary Policy Committee to cut Bank Rate in March, first to 0.25% and then to 0.10%, in order to counter the hugely negative impact of the national lockdown on large swathes of the economy.

The Bank of England and the Government also introduced new programmes of supplying the banking system and the economy with massive amounts of cheap credit so that banks could help cash-starved businesses to survive the lockdown. The Government also supplied huge amounts of finance to local authorities to pass on to businesses. This meant that for most of the year there was much more liquidity in financial markets than there was demand to borrow, with the consequent effect that investment earnings rates plummeted.

While the Council has taken a cautious approach to depositing funds, it is also fully appreciative of changes to regulatory requirements for financial institutions in terms of additional capital and liquidity that came about in the aftermath of the financial crisis. These requirements have provided a far stronger basis for financial institutions, with annual stress tests by regulators evidencing how institutions are now far more able to cope with extreme stressed market and economic conditions.

5. The Economy and Interest Rates

UK. Coronavirus. The financial year 2020/21 will go down in history as being the year of the pandemic. The first national lockdown in late March 2020 did huge damage to an economy that was unprepared for such an eventuality. This caused an economic downturn that exceeded the one caused by the financial crisis of 2008/09. A short second lockdown in November did relatively little damage but by the time of the third lockdown in January 2021, businesses and individuals had become more resilient in adapting to working in new ways during a three month lockdown so much less damage than was caused than in the first one. The advent of vaccines starting in November 2020, were a game changer. The way in which the UK and US have led the world in implementing a fast programme of vaccination which promises to lead to a return to something approaching normal life during the second half of 2021, has been instrumental in speeding economic recovery and the reopening of the economy. In addition, the household saving rate has been exceptionally high since the first lockdown in March 2020 and so there is plenty of pent-up demand and purchasing power stored up for services in the still-depressed sectors like restaurants, travel and hotels as soon as they reopen. It is therefore expected that the UK economy could recover its pre-pandemic level of economic activity during quarter 1 of 2022.



Both the **Government** and **the Bank of England** took rapid action in March 2020 at the height of the crisis to provide support to financial markets to ensure their proper functioning, and to support the economy and to protect jobs.

The **Monetary Policy Committee** cut Bank Rate from 0.75% to 0.25% and then to 0.10% in March 2020 and embarked on a £200bn programme of quantitative easing QE (purchase of gilts so as to reduce borrowing costs throughout the economy by lowering gilt yields). The MPC increased then QE by £100bn in June and by £150bn in November to a total of £895bn. While Bank Rate remained unchanged for the rest of the year, financial markets were concerned that the MPC could cut Bank Rate to a negative rate; this was firmly discounted at the February 2021 MPC meeting when it was established that commercial banks would be unable to implement negative rates for at least six months – by which time the economy was expected to be making a strong recovery and negative rates would no longer be needed.

Average inflation targeting. This was the major change adopted by the Bank of England in terms of implementing its inflation target of 2%. The key addition to the Bank's forward guidance in August was a new phrase in the policy statement, namely that "it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably". That seems designed to say, in effect, that even if inflation rises to 2% in a couple of years' time, do not expect any action from the MPC to raise Bank Rate – until they can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate. This sets a high bar for raising Bank Rate and no increase is expected by March 2024, and possibly for as long as five years. Inflation has been well under 2% during 2020/21; it is expected to briefly peak at just over 2% towards the end of 2021, but this is a temporary short lived factor and so not a concern to the MPC.

Government support. The Chancellor has implemented repeated rounds of support to businesses by way of cheap loans and other measures, and has protected jobs by paying for workers to be placed on furlough. This support has come at a huge cost in terms of the Government's budget deficit ballooning in 20/21 and 21/22 so that the Debt to GDP ratio reaches around 100%. The Budget on 3rd March 2021 increased fiscal support to the economy and employment during 2021 and 2022 followed by substantial tax rises in the following three years to help to pay the cost for the pandemic. This will help further to strengthen the economic recovery from the pandemic and to return the government's finances to a balanced budget on a current expenditure and income basis in 2025/26. This will stop the Debt to GDP ratio rising further from 100%. An area of concern, though, is that the government's debt is now twice as sensitive to interest rate rises as before the pandemic due to QE operations substituting fixed long-term debt for floating rate debt; there is, therefore, much incentive for the Government to promote Bank Rate staying low e.g. by using fiscal policy in conjunction with the monetary policy action by the Bank of England to keep inflation from rising too high, and / or by amending the Bank's policy mandate to allow for a higher target for inflation.

BREXIT. The final agreement on 24th December 2020 eliminated a significant downside risk for the UK economy. The initial agreement only covered trade so there is further work to be done on the services sector where temporary equivalence has been granted in both directions between the UK and EU; that now needs to be formalised on a permanent basis. There was much disruption to trade in January as form filling has proved to be a formidable barrier to trade. This appears to have eased somewhat since then but is an area that needs further work to ease difficulties, which are still acute in some areas.

USA. The US economy did not suffer as much damage as the UK economy due to the pandemic. The Democrats won the presidential election in November 2020 and have control of both Congress and the Senate, although power is more limited in the latter. This enabled the Democrats to pass a $1.9trn (8.8% of GDP) stimulus package in March on top of the $900bn fiscal stimulus deal passed by Congress in late December. These, together with the vaccine rollout proceeding swiftly to hit the target of giving a first jab to over half of the population within the President's first 100 days, will promote a rapid easing of restrictions and strong economic recovery during 2021. The Democrats are also planning to pass a $2trn fiscal stimulus package aimed at renewing infrastructure over the next decade. Although this package is longer-term, if passed, it would also help economic recovery in the near-term.

After Chair Jerome Powell spoke on the **Fed's adoption of a flexible average inflation target** in his Jackson Hole speech in late August 2020, the mid-September meeting of the Fed agreed a new inflation target - that "*it would likely be appropriate to maintain the current target range until labour market conditions were judged to be consistent with the Committee's assessments of maximum employment and inflation had risen to 2% and was on track to moderately exceed 2% for some time.*" This change was aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary "trap" like Japan. It is to be noted that inflation has actually been under-shooting the 2% target significantly for most of the last decade, (and this year), so financial markets took note that higher levels of inflation are likely to be in the pipeline; long-term bond yields duly rose after the meeting. There is now some expectation that where the Fed has led in changing its policy towards implementing its inflation and full employment mandate, other major central banks will follow, as indeed the Bank of England has done so already. The Fed expects strong economic growth during 2021 to have only a transitory impact on inflation, which explains why the majority of Fed officials project US interest rates to remain near-zero through to the end of 2023. The key message is still that policy will remain unusually accommodative – with near-zero rates and asset purchases – continuing for several more years. This is likely to result in keeping treasury yields at historically low levels. However, financial markets in 2021 have been concerned that the sheer amount of fiscal stimulus, on top of highly accommodative monetary policy, could be over-kill leading to a rapid elimination of spare capacity in the economy and generating higher inflation much quicker than the Fed expects. They have also been concerned as to how and when the Fed will eventually wind down its programme of monthly QE purchases of treasuries. These concerns have pushed treasury yields sharply up in the US in 2021 and is likely to have also exerted some upward pressure on gilt yields in the UK.

EU. Both the roll out and take up of vaccines has been disappointingly slow in the EU in 2021, at a time when many countries are experiencing a sharp rise in cases which are threatening to overwhelm hospitals in some major countries; this has led to renewed severe restrictions or lockdowns during March. This will inevitably put back economic recovery after the economy had staged a rapid rebound from the first lockdowns in Q3 of 2020 but contracted slightly in Q4 to end 2020 only 4.9% below its pre-pandemic level. Recovery will now be delayed until Q3 of 2021 and a return to pre-pandemic levels is expected in the second half of 2022.

Inflation was well under 2% during 2020/21. **The ECB** did not cut its main rate of -0.5% further into negative territory during 2020/21. It embarked on a major expansion of its QE operations (PEPP) in March 2020 and added further to that in its December 2020 meeting when it also greatly expanded its programme of providing cheap loans to banks. The total PEPP scheme of €1,850bn is providing protection to the sovereign bond yields of weaker countries like Italy. There is, therefore, **unlikely to be a euro crisis** while the ECB is able to maintain this level of support.

China. After a concerted effort to get on top of the virus outbreak in Q1 of 2020, economic recovery was strong in the rest of the year; this has enabled China to recover all of the contraction in Q1. Policy makers have both quashed the virus and implemented a programme of monetary and fiscal support that has been particularly effective at stimulating short-term growth.

Japan. Three rounds of government fiscal support in 2020 together with Japan's relative success in containing the virus without draconian measures so far, and the roll out of vaccines gathering momentum in 2021, should help to ensure a strong recovery in 2021 and to get back to pre-virus levels by Q3.

World growth. World growth was in recession in 2020. Inflation is unlikely to be a problem in most countries for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

Deglobalisation. Until recent years, world growth has been boosted by increasing globalisation i.e. countries specialising in producing goods and commodities in which they have an economic advantage and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has also depressed inflation. However, the rise of China as an economic superpower over the last 30 years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. In March 2021, western democracies implemented limited sanctions against a few officials in charge of government policy on the Uighurs in Xinjiang; this led to a much bigger retaliation by China and is likely to mean that the China / EU investment deal then being negotiated, will be torn up. After the pandemic exposed how frail extended supply lines were around the world, both factors are now likely to lead to a sharp retrenchment of economies into two blocs of western democracies v. autocracies. It is, therefore, likely that we are heading into a period where there will be a reversal of world globalisation and a decoupling of western countries from dependence on China to supply products and vice versa. This is likely to reduce world growth rates.

Central banks' monetary policy. During the pandemic, the governments of western countries have provided massive fiscal support to their economies which has resulted in a big increase in total government debt in each country. It is therefore very important that bond yields stay low while debt to GDP ratios slowly subside under the impact of economic growth. This provides governments with a good reason to amend the mandates given to central banks to allow higher average levels of inflation than we have generally seen over the last couple of decades. Both the Fed and Bank of England have already changed their policy towards implementing their existing mandates on inflation, (and full employment), to hitting an average level of inflation. Greater emphasis could also be placed on hitting subsidiary targets e.g. full employment before raising rates. Higher average rates of inflation would also help to erode the real value of government debt more quickly.

6. Borrowing Rates in 2020/21

PWLB rates are based on gilt (UK Government bonds) yields through H.M.Treasury determining a specified margin to add to gilt yields. The main influences on gilt yields are Bank Rate, inflation expectations and movements in US treasury yields. Inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation and the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers: this means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. This has pulled down the overall level of interest rates and bond yields in financial markets over the last 30 years. We have seen, over the last two years, many bond yields up to 10 years in the Eurozone turn negative on expectations that the EU would struggle to get growth rates and inflation up from low levels. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession.

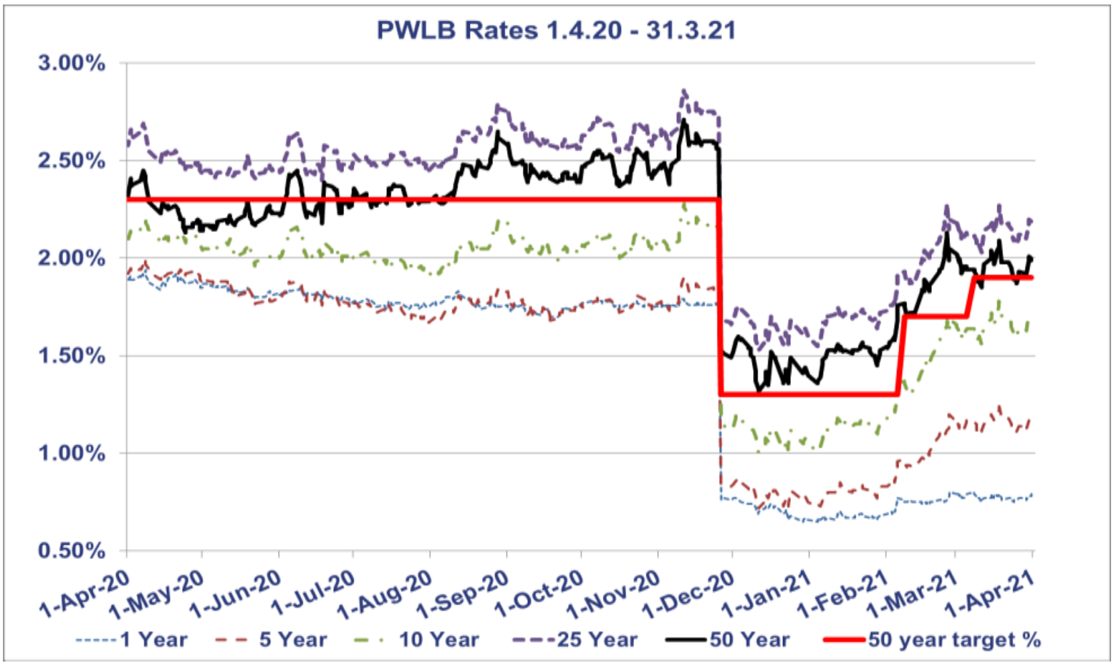
Gilt yields fell sharply from the start of 2020 and then spiked up during a financial markets melt down in March caused by the pandemic hitting western countries; this was rapidly countered by central banks flooding the markets with liquidity. While US treasury yields do exert influence on UK gilt yields so that the two often move in tandem, they have diverged during the first three quarters of 2020/21 but then converged in the final quarter. Expectations of economic recovery started earlier in the US than the UK but once the UK vaccination programme started making rapid progress in the new year of 2021, gilt yields and gilt yields and PWLB rates started rising sharply as confidence in economic recovery rebounded. Financial markets also expected Bank Rate to rise quicker than in the forecast tables in this report.

At the close of the day on 31 March 2021, all gilt yields from 1 to 5 years were between 0.19 – 0.58% while the 10-year and 25-year yields were at 1.11% and 1.59%.

HM Treasury imposed two changes of margins over gilt yields for PWLB rates in 2019/20 without any prior warning. The first took place on 9th October 2019, adding an additional 1% margin over gilts to all PWLB period rates. That increase was then, at least partially, reversed for some forms of borrowing on 11th March 2020, but not for mainstream non-HRA capital schemes. A consultation was then held with local authorities and on 25th November 2020, the Chancellor announced the conclusion to the review of margins over gilt yields for PWLB rates; the standard and certainty margins were reduced by 1% but a prohibition was introduced to deny access to borrowing from the PWLB for any local authority which had purchase of assets for yield in its three year capital programme. The new margins over gilt yields are as follows:-

- PWLB Standard Rate is gilt plus 100 basis points (G+100bps)
- PWLB Certainty Rate is gilt plus 80 basis points (G+80bps)
- PWLB HRA Standard Rate is gilt plus 100 basis points (G+100bps)
- PWLB HRA Certainty Rate is gilt plus 80bps (G+80bps)
- Local Infrastructure Rate is gilt plus 60bps (G+60bps)

There is likely to be only a gentle rise in gilt yields and PWLB rates over the next three years as Bank Rate is not forecast to rise from 0.10% by March 2024 as the Bank of England has clearly stated that it will not raise rates until inflation is sustainably above its target of 2%; this sets a high bar for Bank Rate to start rising.



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.65%	0.72%	1.00%	1.53%	1.32%
Low date	04/01/2021	11/12/2020	11/12/2020	11/12/2020	11/12/2020
High	1.94%	1.99%	2.28%	2.86%	2.71%
High date	08/04/2020	08/04/2020	11/11/2020	11/11/2020	11/11/2020
Average	1.43%	1.50%	1.81%	2.33%	2.14%
Spread	1.29%	1.27%	1.28%	1.33%	1.39%

7. Borrowing Outturn for 2020/21

New Treasury Borrowing:-

New loans were drawn to fund the net unfinanced capital expenditure and naturally maturing debt.

The loans drawn were:-

Table 9: New Loans Taken in Financial Year 2020/21						
Lender	**Date Taken**	**Principal £000's**	**Interest Rate**	**Fixed/ Variable**	**Maturity Date**	**Term (Yrs)**
PWLB Maturity	28 Apr 2020	£ 15,000	1.17%	Fixed	28 Oct 2066	46.50
Market	Various	£ 14,500	0.15%-0.25%	Variable interest rate	Various	0.08-0.11
Total		**£ 29,500**				

Maturing Debt:-

The following table gives details of treasury debt maturing during the year:-

Table 10: Maturing Debt in Financial Year 2020/21						
Lender	**Date Repaid**	**Principal £000's**	**Interest Rate**	**Fixed/ Variable**	**Date Originally Taken**	**Original Term (Yrs)**
PWLB	14 Dec 2020	£ 8,400	2.98%	Fixed	14 Dec 2011	8.00
Salix	Various	£ 201	0.00%	Fixed	Various	7-8 years
Deutsche Pfandbriefbank	Various	£ 357	2.63%	Fixed	29 Jun 2017	28.00
Deutsche Pfandbriefbank	Various	£ 283	2.73%	Fixed	15 Nov 2018	25.50
Market	Various	£ 14,500	0.15%-0.25%	Variable interest rate	Various	0.08-0.11
Total		**£ 23,741**				

Rescheduling:-

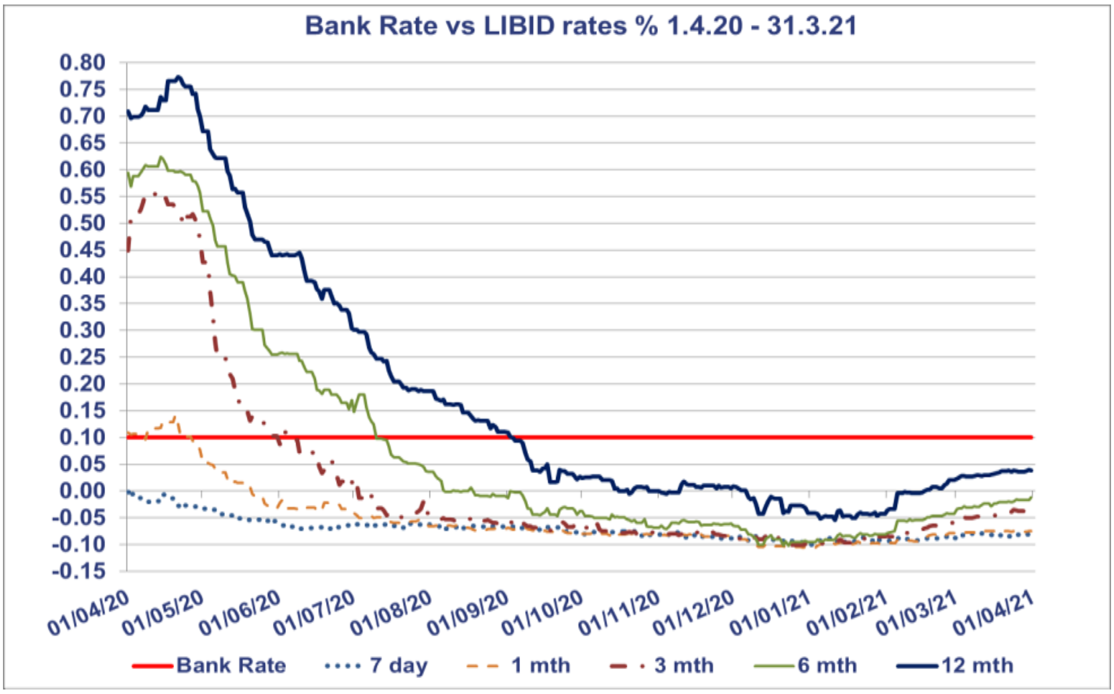
No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

Summary of debt transactions:-

The average interest rate payable on external debt decreased from 3.44% at the start of 2020/21 to 3.34% at the end of 2020/21. The average life of debt within the loan portfolio lengthened from 30.33 years to 31.16 years.

8. Deposit Rates in 2020/21

Money market fund rates started the year between 0.45%-0.78%, trending at base rate levels throughout the year, and mirroring the decreases in bank rate, with a slight lag due to the longer durational element of money market fund portfolios.



9. Funds on Deposit Outturn for 2020/21

Deposit Policy:-

The Council's policy for placing deposits is governed by Scottish Government Investment Regulations, which have been implemented in the annual investment strategy approved by the Council on 11 February 2020. This policy sets out the approach for choosing counterparties, and for financial institutions 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.).

The activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties. The position at 31 March 2021 was as follows:-

Table 11: Breakdown of Deposits by Counterparty at 31 March 2021

Counterparty	Deposit Start Date	Deposit End Date	Principal Outstanding 31 Mar 2021 £000's
Royal Bank of Scotland	Instant Access Call Account		26,470
MMF - Aberdeen Liquidity Fund	Instant Access Money Market Fund		14,908
MMF - Federated	Instant Access Money Market Fund		14,908
MMF - Legal & General	Instant Access Money Market Fund		2
Santander	180 Day Notice Account		14,985
Wokingham Borough Council	25-Mar-20	24-Mar-23	15,000
Medway Council	30-Mar-20	30-Mar-22	15,000
London Borough of Croydon Council	03-Apr-20	03-Oct-22	13,000
Stoke on Trent City Council	06-Apr-20	06-Apr-23	2,000
London Borough of Waltham Forest Council	30-Apr-20	29-Apr-22	15,000
Total Deposits			**131,273**

Deposits placed by the Council:-

The Council maintained an average balance of £133.2 million of internally managed funds. The internally managed funds earned an average rate of return of 0.97%. The comparable performance indicator is the average 12-month LIBID un-compounded rate, which was 0.65%.

10. Performance Measurement

One of the key requirements in the Code is the formal introduction of performance measurement relating to investments, debt and capital financing activities.

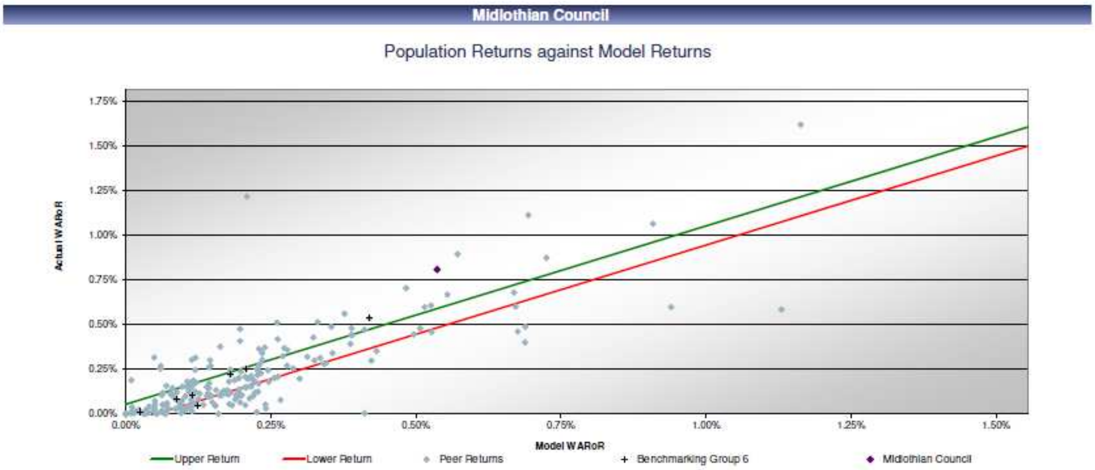
Loans Fund Rate

Combining the interest paid (earned) on external debt (deposits) with charges for premiums written off and internal interest allowed into an average Loans Fund Rate, Midlothian's result of 2.95% for 2019/20 was the second lowest Loans Fund Rate amongst all mainland authorities in Scotland (see Appendix 1).

The comparative Loans Fund Rate for 2020/21, of 3.10%, is once again expected to be one of the lowest when benchmarked against all mainland authorities in Scotland (note that at present, these benchmark figures are not yet available).

Deposit Benchmarking

The Council participates in the Scottish Investment Benchmarking Group set up by its Treasury Management Consultants, Link. This service provided by Link provides benchmarking data to authorities for reporting and monitoring purposes, by measuring the security, liquidity and yield within an individual authority portfolio. Based on the Council's funds on deposit as at 31 March 2021, the Weighted Average Rate of Return (WARoR) on deposits of 0.81% against other authorities is shown in the graph below:-



	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
Midlothian Council	0.81%	0.54%	0.27%	0.48%	0.59%	Above

** Models for 30 June 2020, 30 September 2020 and 31 December 2020 are attached as Appendix 3.*

As can be seen from the above graph, Midlothian is performing above the Link model benchmarks (red to green lines), and is achieving one of the highest Weighted Average Rates of Return (WARoR) for the Weighted Average Credit

Risk held, not only amongst peer Councils within the Benchmarking Group but also amongst the population of authorities across the UK.

Debt Performance

Whilst deposit performance criteria have been well developed and universally accepted, debt performance indicators continue to be a more problematic area with the traditional average portfolio rate of interest acting as the main guide. In this respect, the relevant figures for Midlothian are incorporated in the table in Section 3.

11. Conclusion

The Council's overall cost of borrowing continues to benefit significantly from the approved strategy and the proactive Treasury Management activity undertaken.

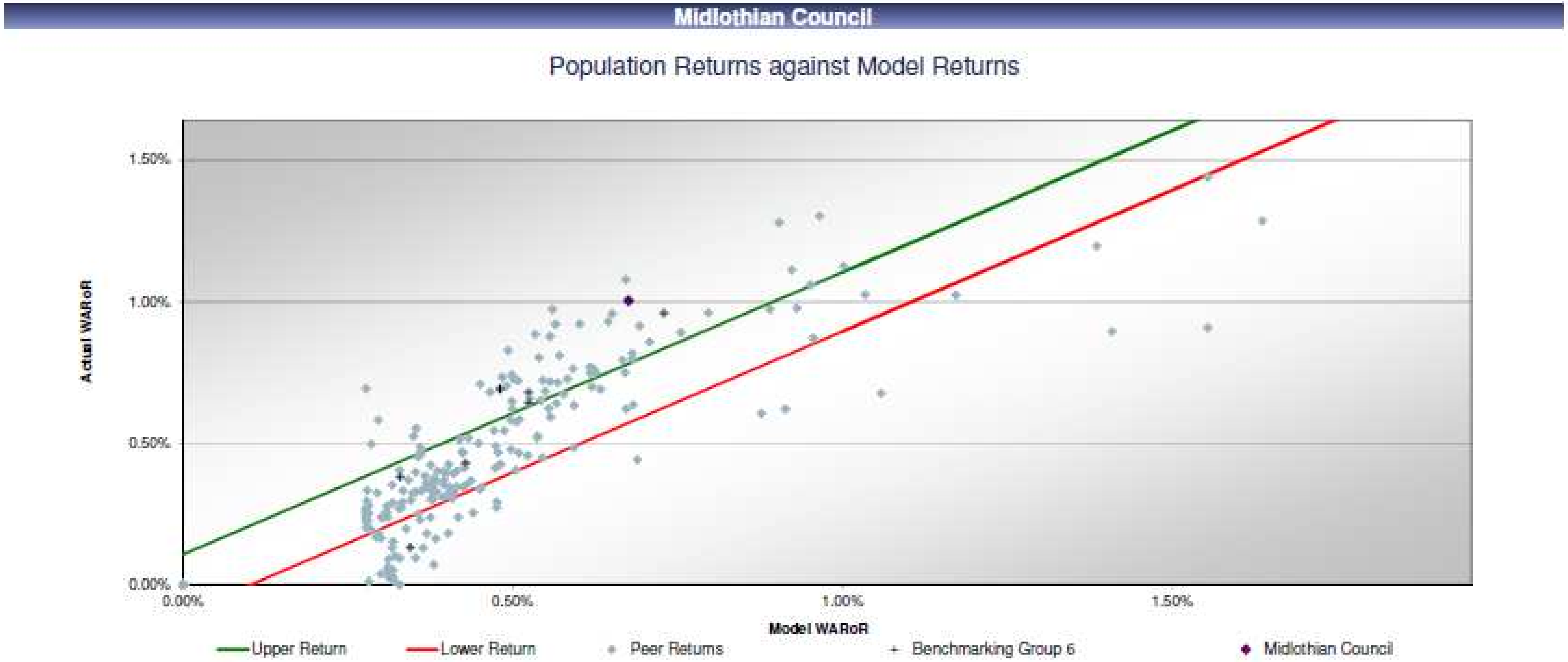
The cost of long term borrowing has been maintained by taking up opportunities to borrow from the PWLB at low interest rates.

A better than average return on deposits has been achieved for the sixteenth consecutive year and Midlothian continues to perform above the Link model benchmarks and is achieving one of the highest Weighted Average Rates of Return (WARoR) for the Weighted Average Credit Risk held, not only amongst peer Councils within the Benchmarking Group but also amongst the population of authorities across the UK.

Overall Midlothian's Loans Fund Rate of 3.10% for the year is expected to be one of the lowest when benchmarked against all mainland Authorities in Scotland.

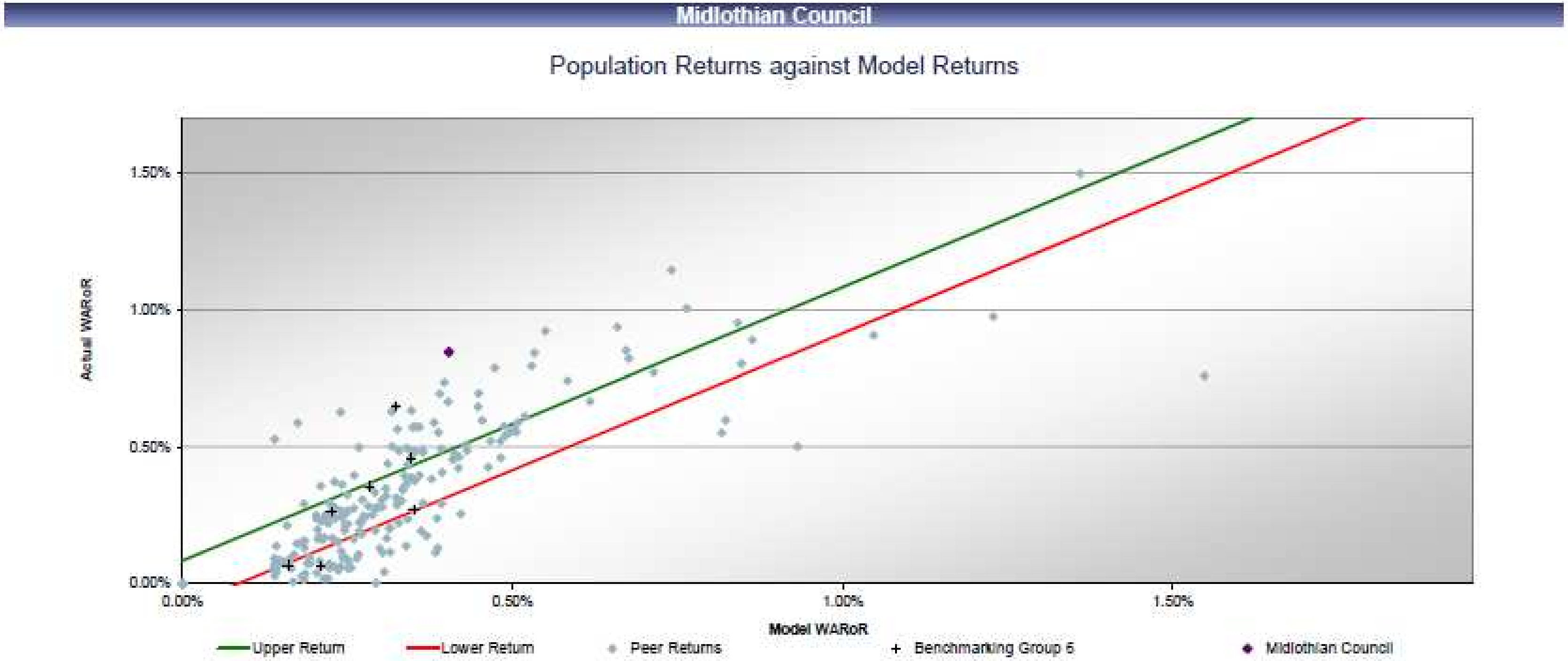
Appendix 3

Midlothian Council Deposit Portfolio return as at 30 June 2020



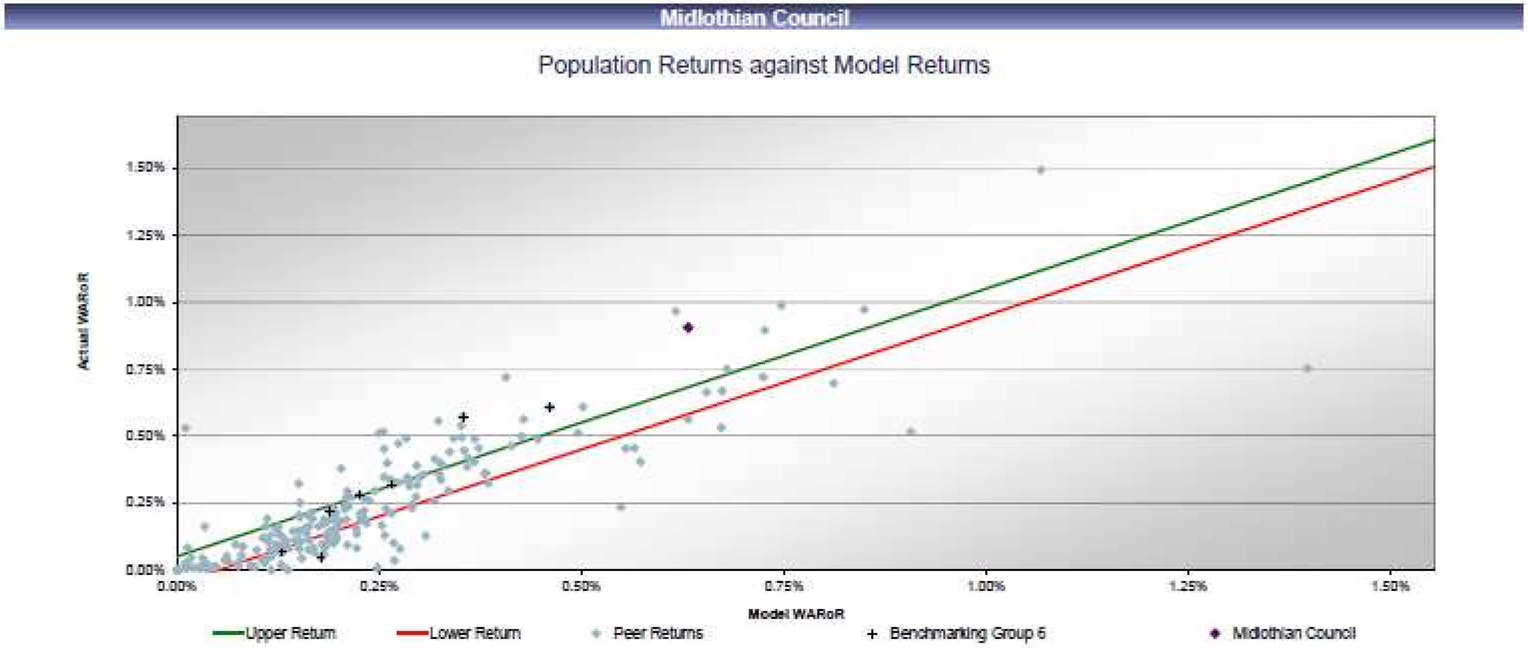
	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
Midlothian Council	1.00%	0.68%	0.33%	0.57%	0.78%	Above

Midlothian Council Deposit Portfolio return as at 30 September 2020



	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
Midlothian Council	0.85%	0.40%	0.44%	0.32%	0.49%	Above

Midlothian Council Deposit Portfolio return as at 31 December 2020



	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
Midlothian Council	0.91%	0.63%	0.27%	0.58%	0.68%	Above