Treasury Management Report Q1 2021/22

Introduction

In March 2012 the Authority 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 Authority to approve treasury management semi-annual and annual reports. This quarterly report provides an additional update.

The Authority's treasury management strategy for 2021/22 was approved at a meeting on 3rd March 2021. The Authority 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 Authority's treasury management strategy.

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 Authority's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 3rd March 2021.

External Context

Economic background: Economic resurgence from coronavirus pandemic continued to dominate the first quarter of the financial year. In the biggest inoculation programme the country has ever undertaken, over 44 million people in the UK had received their first dose of a COVID-19 vaccine with 32 million also having a second dose.

The Bank of England (BoE) held Bank Rate at 0.1% throughout the period and maintained its Quantitative Easing programme at £895 billion, unchanged since the November 2020 meeting. In its June 2021 policy announcement, the BoE expected the economy to experience a temporary period of strong GDP growth and above-target CPI inflation, after which growth and inflation is expected to fall back. There were, however, two-sided risks around this central path, and it is possible that near-term upward pressure on prices could prove somewhat larger than expected. The Bank's Monetary Policy Committee does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably.

Government initiatives continued to support the economy over the quarter, following the range of measures announced by the Chancellor in the 2021 Budget, which included extending the furlough (Coronavirus Job Retention) scheme until September 2021.

The latest labour market data showed that in the three months to April 2021 the unemployment rate fell to 4.7%, although it is likely that labour market slack has remained higher than implied by this measure. Some individuals stopped looking for work during the pandemic and were therefore recorded as inactive. There is uncertainty around how many of these individuals will resume their search for a job, and when. Latest data showed growth in average total pay (including bonuses) and regular pay (excluding bonuses) among employees was 5.6% for the three months February to April 2021. The seemingly high growth partly reflected a base effect from a decline in average pay in the spring of last year, associated with the reduced pay of employees on the furlough scheme.

Annual CPI inflation rose to 2.1% in May on the back of base effects in spring 2020 and partly due to higher energy and commodity prices and supply-side bottlenecks. The BoE expects inflation to

exceed 3% for a temporary period. The ONS' preferred measure of CPIH which includes owner-occupied housing was also 2.1% year/year, marginally higher than expectations.

The reimposition of restrictions on activity in the first quarter of calendar 2021 year resulted in GDP falling 1.6% in Q1. GDP growth was strong in April at 2.3% with the partial easing of restrictions on non-essential retail and outdoor hospitality. Housing market activity remained strong, aided by the extension of the stamp duty threshold and an increase in mortgage approvals for house purchases.

The US economy rebounded by 4.3% in Q4 2020 (Oct-Dec) and then an even stronger 6.4% in Q1 as the recovery continued to be fuelled by $5 trillion worth of pandemic stimulus packages. The Federal Reserve maintained its main interest rate at between 0% and 0.25% over the period.

The European Central Bank maintained its base rate at 0%, deposit rate at -0.5%, and asset purchase scheme at €1.85 trillion.

Financial markets: Ongoing monetary and fiscal stimulus together with improving economic growth prospects and successful vaccine rollout programmes continued to boost equity markets over the period. The Dow Jones reached a record high during the period while the UK-focused FTSE 250 index was back above pre-pandemic levels and the more internationally focused FTSE 100 had recouped around three-quarters of 2020 losses.

Inflation worries continued during the period but declines in bond yields between April and June suggest bond markets may be expecting any general price increases to be less severe, or more transitory, that was previously thought.

The 5-year UK benchmark gilt yield began the financial year at 0.36% before declining to 0.32% by the end of June 2021. Over the same period the 10-year gilt yield fell from 0.80% to 0.71%, despite jumping to 0.90% in May. The 20-year yield declined from 1.31% to 1.21%.

1-month, 3-month and 12-month SONIA bid rates averaged 0.03%, 0.02% and 0.15% respectively over the period.

Credit review: Credit default swap spreads were relatively flat over the period and remain only slightly above their pre-pandemic levels. The gap in spreads between UK ringfenced and non-ringfenced entities remained, and Santander UK remained an outlier compared to the other ringfenced/retail banks. At the end of June, Santander UK was trading the highest at 52bps and Standard Chartered the lowest at 31bps. The other ringfenced banks were trading between 32 and 34bps while Nationwide Building Society was 38bps.

There were only a small number of credit rating actions over the period. Fitch revised a number of Singaporean and Australian banks as well as Close Brothers to stable, and also upgraded Coventry Building Society to 'A' (from 'A-'). Towards the end of the period Fitch revised the United Kingdom's outlook to stable from negative.

S&P also revised some Australian banks to stable, as well as Transport for London, which a week or so later received a £1.08 billion bailout from the UK government. S&P also downgraded the long- and short-term ratings of DZ Bank (Germany) to A+ and A-1 from AA- and A-1+ respectively. In late June S&P took further rating actions, upwardly revising the outlooks for a number of UK and European banks from negative to stable, or in the case of Barclays and Nationwide from stable to positive.

The successful vaccine rollout programme is 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 Authority'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 31st March 2021, the Authority had net borrowing of £34.3m 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

	31.3.21 Actual £000
General Fund CFR	65,267
HRA CFR	73,726
Total CFR	**138,993**
Less: Usable reserves	(90,805)
Less: Working capital	(13,875)
Net borrowing	**34,313**

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 pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk.

The treasury management position on 30th June 2021 and the change over the quarter is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.21 Balance £000	**Movement £000**	**30.6.21 Balance £000**	**30.6.21 Rate %**
Long-term borrowing	73,187	2,443	75,631	
Short-term borrowing	18,443	(7,443)	11,000	
Total borrowing	**91,631**	**0**	**86,631**	**3.46%**
Long-term investments	49,549	451	50,000	
Short-term investments	4	0	4	
Cash and cash equivalents	7,765	719	8,484	
Total investments	**57,318**	**1,170**	**58,488**	**2.18%**
Net borrowing	**34,313**		**28,143**	

£5m of short-term borrowing repaid in the quarter to 30 June.

Borrowing Update

Local authorities can borrow from the PWLB provided they can confirm they are not planning to purchase 'investment assets primarily for yield' in the current or next two financial years, with confirmation of the purpose of capital expenditure from the Section 151 Officer. 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.

Acceptable use of PWLB borrowing includes service delivery, housing, regeneration, preventative action, refinancing and treasury management.

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.

The Authority is not planning to purchase any investment assets primarily for yield within the next three years and so is able fully access the PWLB

Municipal Bonds Agency (MBA): The MBA is working to deliver a new short-term loan solution, available in the first instance to principal local authorities in England, allowing them access to short-dated, low rate, flexible debt. The minimum loan size is expected to be £25 million. Importantly, local authorities will borrow in their own name and will not cross guarantee any other authorities.

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.

UK Infrastructure Bank: £4bn has been earmarked for of lending to local authorities by the UK Infrastructure Bank. The availability of this lending to local authorities is due to commence in summer 2021 for which there is expected to be a bidding process. Loans will be available for qualifying projects at gilt yields plus 0.6%, which is 0.2% lower than the PWLB certainty rate.

Borrowing Strategy during the period

At 30th June 2021 the Authority held £11m of loans, a decrease of £5m 31st March 2021, as part of its strategy for funding previous years' capital programmes. Outstanding loans on 30th June are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.21 Balance £000	**Net Movement £000**	**30.6.21 Balance £000**
Public Works Loan Board	75,631	0	75,631
Local authorities (short-term)	16,000	(5,000)	11,000
Total borrowing	**91,631**		**86,631**

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

In keeping with these objectives, no new long-term borrowing was undertaken. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

With short-term interest rates remaining much lower than long-term rates and with surplus of liquidity continuing to feature in the LA to LA market, the Authority considered it to be more cost effective in the near term to use internal resources or borrowed rolling temporary / short-term loans instead. The net movement in temporary / short-term loans is shown in table 3 above.

The Authority has an increasing CFR due to the capital programme and an estimated borrowing requirement as determined by the Liability Benchmark which also takes into account usable reserves and working capital.

Treasury Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances ranged between £72m and £52m due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.21 Balance £000	**Net Movement £000**	**30.6.21 Balance £000**	**30.6.21 Income Return %**
Banks & building societies (unsecured)	7,764	(1,634)	6,134	0.10%
Money Market Funds	5	2,349	2,354	0.01%
Other Pooled Funds				
• *Short-dated bond funds*	8,032	(32)	8,000	
• *Strategic bond funds*	8,386	(386)	8,000	
• *Property funds*	5,585	415	6,000	
• *Multi asset income funds*	27,546	454	28,000	
Other Pooled Funds Sub-total	**49,549**	451	**50,000**	3%
Total investments	**57,318**	1,170	**58,488**	

Both the CIPFA Code and government guidance require the Authority 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 Authority'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.

Ultra low short-dated cash rates which have been a feature since March 2020 when Bank Rate was cut to 0.1% have resulted in the return on sterling low volatility net asset value money market funds (LVNAV MMFs) being close to zero even after some managers have temporarily waived or lowered their fees. At this stage net negative returns are not the central case of most MMF 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) are also largely around zero.

Given the increasing risk and low returns from short-term unsecured bank investments, the Authority has diversified into more secure and/or higher yielding asset classes as shown in table 4 above. £50m that is available for longer-term investment is available for longer-term investment is held in pooled investment funds.

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 %
31.03.2021 30.06.2021	5.33 5.21	A+ A+	100% 100%	1 1	3.01% 7.52%
Similar LAs **All LAs**	4.60 4.64	A+ A+	68% 67%	41 12	3.32% 2.13%

Externally Managed Pooled Funds: £50m of the Authority's investments are held in externally managed strategic pooled bond, multi-asset and property funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds generated an average total return of 9.70%, comprising a 2.81% income return which is used to support services in year, and 6.89% of capital growth.

The Authority is invested in bond, multi-asset and property funds. The improved market sentiment in the past 6 months is reflected in property and multi-asset fund valuations which is reflected in the capital values of the Authority's property and multi-asset income funds in the Authority's portfolio. The prospect of higher inflation and rising bond yields resulted in muted bond fund performance. The change in capital values and income earned is shown in Table 4.

Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's medium- to long-term investment objectives are regularly reviewed. 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.

Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. This is replicated in the Investment Guidance issued by the Ministry of Housing, Communities and Local Government (MHCLG) and Welsh Government, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

Following the approval of the Property Investment Strategy in November 2016, work continues to identify and progress suitable investments to deliver economic regeneration and to generate additional income streams for the future. Additionally, the Property Investment team continues to work on a number of residential developments both utilising DDC owned properties and land, as well as with external developers.

The 2021/22 budget includes a forecast of total income (rent and service charges) of £1.94m. Costs including management costs, minimum revenue provision and long term borrowing of £1.30m are forecast resulting in retained income for the General Fund of £640k.

Treasury Performance

The Authority 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 £000	Budget £000	Over/ under	Actual %	Benchmark %
Interest Received	1,503	1,750	(247)	2.18	0.02
Interest Payable	2,521	2,521	0	3.46%	3.46%

Compliance

The Strategic Director of Corporate Resources reports that all treasury management activities undertaken during the quarter complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 8 below.

Table 7: Debt Limits

	30.6.21 Actual	2021/22 Operational Boundary	2021/22 Authorised Limit	Complied?
Borrowing	£86.3m	£333m	£338.5m	✓

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

	30.6.21 Actual	2021/22 Limit	Complied?
Any single organisation, except the UK Government	<1m	£8m per bank	✓
Any group of organisations under the same ownership	0	£16m per group	✓

Negotiable instruments held in a broker's nominee account	0	£15m	✓
UK Government	0	Unlimited	✓
Building societies (unsecured)	0	£8m	✓
Strategic pooled funds	£50m	£10m per fund	✓
Money market funds	£2m	£10m per fund	✓
Operational bank	£6m	£20m	✓

Treasury Management Indicators

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

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

Credit risk indicator	30.6.21 Actual	2021/22 Target	Complied?
Portfolio average credit rating	5.21	6	✓

Liquidity: The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing.

Liquidity risk indicator	30.6.21 Actual	2021/22 Target	Complied?
Total cash available within 3 months	£8.4m	£8m	✓

Interest Rate Exposures: This indicator is set to control the Authority'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	30.6.21 Actual	2021/22 Limit	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	584	500	✓
Upper limit on one-year revenue impact of a 1% fall in interest rates	584	500	✓

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 Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

Refinancing rate risk indicator	30.6.21 Actual £000	Upper Limit	Lower Limit	Complied?
Under 12 months	13,443	25%	0%	✓
12 months and within 24 months	3,812	50%	0%	✓
24 months and within 5 years	8,188	50%	0%	✓
5 years and within 10 years	16,493	100%	0%	✓
10 years and above	44,695	100%	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 Authority'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:

Price risk indicator	2021/22	2022/23	2023/24
Actual principal invested beyond year end	0	0	0
Limit on principal invested beyond year end	£30m	£30m	£30m
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. The revised codes are yet to be released. However, from feedback documents the following changes are likely:

Prudential Code:

- Clarification and definitions to define commercial activity and investment, and that an authority must not borrow to invest for the primary purpose of commercial return.
- Defining acceptable reasons to borrow money: (i) financing capital expenditure primarily related to delivering a local authority's functions, (ii) temporary management of cash flow within the context of a balanced budget, (iii) securing affordability by removing exposure to future interest rate rises and (iv) refinancing current borrowing, including replacing internal borrowing.
- Proportionality will be included as an objective; new indicators for net income from commercial and service investments to net revenue stream.
- A specific objective around commercial investment with the intention of embedding good practice across authorities.

Treasury Management Code:

- Inclusion of the liability benchmark as a mandatory treasury indicator.
- Implementation of a treasury management knowledge and skills framework.

- Incorporating ESG issues as a consideration within TMP 1 Risk Management.

Outlook for the remainder of 2021/22

The medium-term global economic outlook has continued to improve with the rollout of vaccination programmes. The UK has continued to benefit from its initial rapid vaccine rollout and has shifted focus onto second vaccinations to increase protection to counter a third wave of Covid variant.

The opening up of the UK economy in Q2/Q3 will continue to prompt a sharp increase in GDP.

While downside risks seem to have fallen somewhat after recent trends in GDP and labour, the upside risks remain relatively balanced with the MPC reiterating its commitment not to tighten policy until there is clear evidence that the recovery is eliminating spare capacity in the economy.

Inflation has moved above the Bank of England's 2% target. Alongside the increase in commodity prices, the MPC has acknowledged the prospect of a sharper upturn in inflation, with the potential CPI could rise above 3% in the coming months. However, the nature of the commodity price rise and the base effect easing, this is likely a more transitory effect.

Upward pressure on gilt yields could continue in the short term due to the preponderance of strong data, but this is likely to ease once inflation fears recede as the effect of weak base effects subsides and growth figures return to more normal levels.

Arlingclose expects Bank Rate to remain at the current 0.10% level. The risk of movement in Bank Rate in the short term is low.

Gilt yields could continue to increase in the short term but will begin to plateau and reduce once the market's expectation of rises in Bank Rate and inflation fears subside. Longer term yields may face upward pressure towards the end of Arlingclose's forecast period as the economy moves back to a sustained footing and policy expectations start to strengthen.

Downside risks remain – the damage from the pandemic will have lasting effects and there is the risk of further virus mutations due to the uneven global rollout of vaccines. Downside risks also arise from potential future vaccine shortages as the global demand for vaccines increases.

	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24
Official Bank Rate													
Upside risk	0.15	0.15	0.15	0.15	0.30	0.30	0.30	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	0.10	0.15	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20