Appendix D

Treasury Management Outturn Report 2021/22

Introduction

In February 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.

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.

Treasury risk management at the Authority is conducted within the framework of 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 a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report.

The 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: The continuing economic recovery from coronavirus pandemic, together with the war in Ukraine, higher inflation, and higher interest rates were major issues over the period.

Bank Rate was 0.1% at the beginning of the reporting period. April and May saw the economy gathering momentum as the shackles of the pandemic restrictions were eased. Despite the improving outlook, market expectations were that the Bank of England would delay rate rises until 2022. Rising, persistent inflation changed that.

UK CPI was 0.7% in March 2021 but thereafter began to steadily increase. Initially driven by energy price effects and by inflation in sectors such as retail and hospitality which were re-opening after the pandemic lockdowns, inflation then was believed to be temporary. Thereafter price rises slowly became more widespread, as a combination of rising global costs and strong demand was exacerbated by supply shortages and transport dislocations. The surge in wholesale gas and electricity prices led to elevated inflation expectations. CPI for February 2022 registered 6.2% year on year, up from 5.5% in the previous month and the highest reading in the National Statistic series. Core inflation, which excludes the more volatile components, rose to 5.2% y/y from 4.4%.

The government's jobs furlough scheme insulated the labour market from the worst effects of the pandemic. The labour market began to tighten and demand for workers grew strongly as employers found it increasingly difficult to find workers to fill vacant jobs. Having peaked at 5.2% in December 2020, unemployment continued to fall and the most recent labour market data for the three months to January 2022 showed the unemployment rate at 3.9% while the employment rate rose to 75.6%.

Headline 3-month average annual growth rate for wages were 4.8% for total pay and 3.8% for regular pay. In real terms, after adjusting for inflation, total pay growth was up 0.1% while regular pay fell by 1.0%.

With the fading of lockdown – and, briefly, the 'pingdemic' – restraints, activity in consumer-facing sectors improved substantially as did sectors such as oil and mining with the reopening of oil rigs but materials shortages and the reduction in the real spending power of households and businesses dampened some of the growth momentum. Gross domestic product (GDP) grew by an upwardly revised 1.3% in the fourth calendar quarter of 2021 according to the final estimate (initial estimate 1.0%) and took UK GDP to just 0.1% below where it was before the pandemic. The annual growth rate was revised down slightly to 7.4% (from 7.5%) following a revised 9.3% fall in 2020.

Having increased Bank Rate from 0.10% to 0.25% in December, the Bank of England hiked it further to 0.50% in February and 0.75% in March. At the meeting in February, the Monetary Policy Committee (MPC) voted unanimously to start reducing the stock of its asset purchase scheme by ceasing to reinvest the proceeds from maturing bonds as well as starting a programme of selling its corporate bonds.

In its March interest rate announcement, the MPC noted that the invasion of Ukraine had caused further large increases in energy and other commodity prices, with the expectation that the conflict will worsen supply chain disruptions around the world and push CPI inflation to around 8% later in 2022, even higher than forecast only a month before in the February Monetary Policy Report. The Committee also noted that although GDP in January was stronger than expected with business confidence holding up and the labour market remaining robust, consumer confidence had fallen due to the squeeze in real household incomes.

GDP growth in the euro zone increased by 0.3% in calendar Q4 2021 following a gain of 2.3% in the third quarter and 2.2% in the second. Headline inflation remains high, with CPI registering a record 7.5% year-on-year in March, the ninth successive month of rising inflation. Core CPI inflation was 3.0% y/y in March, was well above the European Central Bank's target of 'below, but close to 2%', putting further pressure on its long-term stance of holding its main interest rate of 0%.

The US economy expanded at a downwardly revised annualised rate of 6.9% in Q4 2021, a sharp in increase from a gain of 2.3% in the previous quarter. In its March 2022 interest rate announcement, the Federal Reserve raised the Fed Funds rate to between 0.25% and 0.50% and outlined further increases should be expected in the coming months. The Fed also repeated it plan to reduce its asset purchase programme which could start by May 2022.

Financial markets: The conflict in Ukraine added further volatility to the already uncertain inflation and interest rate outlook over the period. The Dow Jones started to decline in January but remained above its pre-pandemic level by the end of the period while the FTSE 250 and FTSE 100 also fell and ended the quarter below their pre-March 2020 levels.

Bond yields were similarly volatile as the tension between higher inflation and flight to quality from the war pushed and pulled yields, but with a general upward trend from higher interest rates dominating as yields generally climbed.

The 5-year UK benchmark gilt yield began the quarter at 0.82% before rising to 1.41%. Over the same period the 10-year gilt yield rose from 0.97% to 1.61% and the 20-year yield from 1.20% to 1.82%.

The Sterling Overnight Rate (SONIA) averaged 0.39% over the quarter.

Credit review: In the first half of FY 2021-22 credit default swap (CDS) spreads were flat over most of period and are broadly in line with their pre-pandemic levels. In September spreads rose by a few basis points due to concerns around Chinese property developer Evergrande defaulting but then fell back. Fitch and Moody's revised upward the outlook on a number of UK banks and building societies on the Authority's counterparty to 'stable', recognising their improved capital positions compared to 2020 and better economic growth prospects in the UK.

Fitch also revised the outlook for Nordea, Svenska Handelsbanken and Handelsbanken plc to stable. The agency considered the improved economic prospects in the Nordic region to have reduced the baseline downside risks it previously assigned to the lenders.

The successful vaccine rollout programme was credit positive for the financial services sector in general and the improved economic outlook meant some institutions were able to reduce provisions for bad loans. However, in 2022, the uncertainty engendered by Russia's invasion of Ukraine pushed CDS prices modestly higher over the first calendar quarter, but only to levels slightly above their 2021 averages, illustrating the general resilience of the banking sector.

Having completed its full review of its credit advice on unsecured deposits, in September Arlingclose extended the maximum duration limit for UK bank entities on its recommended lending list from 35 days to 100 days; a similar extension was advised in December for the non-UK banks on this list. As ever, the institutions and durations on the Authority's counterparty list recommended by Arlingclose remains under constant review.

Revised CIPFA Codes, Updated PWLB Lending Facility Guidance

In August 2021 HM Treasury significantly revised guidance for the PWLB lending facility with more detail and 12 examples of permitted and prohibited use of PWLB loans. 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.

CIPFA published its revised Prudential Code for Capital Finance and Treasury Management Code on 20th December 2021. The key changes in the two codes are around permitted reasons to borrow, knowledge and skills, and the management of non-treasury investments.

The principles of the Prudential Code took immediate effect although local authorities could defer introducing the revised reporting requirements until the 2023/24 financial year if they wish.

To comply with the Prudential Code, authorities must not borrow to invest primarily for financial return. This Code also states that it is not prudent for local authorities to make investment or spending decision that will increase the CFR unless directly and primarily related to the functions of the authority. Existing commercial investments are not required to be sold; however, authorities with existing commercial investments who expect to need to borrow should review the options for exiting these investments.

Borrowing is permitted for cashflow management, interest rate risk management, to refinance current borrowing and to adjust levels of internal borrowing. Borrowing to refinance capital expenditure primarily related to the delivery of a local authority's function but where a financial return is also expected is allowed, provided that financial return is not the primary reason for the expenditure. The changes align the CIPFA Prudential Code with the PWLB lending rules.

Unlike the Prudential Code, there is no mention of the date of initial application in the Treasury Management Code. The TM Code now includes extensive additional requirements for service and commercial investments, far beyond those in the 2017 version.

*T*he Authority will follow the same process as the Prudential Code, i.e. delaying changes in reporting requirements to the 2023/24 financial year.

Local Context

On 31st March 2021, the Authority had net borrowing of £20.95m 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 £m
General Fund CFR	55.25
Less other debt liabilities	0.0
Total CFR	**55.25**
External borrowing	39.40
Internal borrowing	**15.85**
Less: Usable reserves	-37.61
Less: Working capital	0.81
Net Borrowing	**20.95**

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 and keep interest costs low.

The treasury management position on 31st March 2022 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.21 Balance £m	**Movement £m**	**31.3.22 Balance £m**	**31.3.22 Rate %**
Long-term borrowing	21.40	-0.53	20.87	2.00
Short-term borrowing	18.00	-5.00	13.00	0.11
Total borrowing	**39.40**	**-5.53**	**33.87**	**1.42**
Long-term investments	8.45	2.11	10.56	3.97
Short-term investments	5.00	5.00	10.00	0.75
Cash and cash equivalents	5.00	7.00	12.00	0.28
Total investments	**18.45**	**14.11**	**32.56**	**1.61**
Net borrowing	**20.95**	**-19.64**	**1.31**	

Borrowing Update

The Authority currently holds £56.2m in commercial investments that were purchased prior to the change in the CIPFA Prudential Code. Before undertaking further additional borrowing the Authority will review the options for exiting these investments.

Borrowing strategy

At 31st March 2022 the Authority held £33.87m of loans, decrease of £5.53m from 31st March 2021, as part of its strategy for funding previous years' capital programmes. Outstanding loans on 31st March are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.21 Balance £m	Net Movement £m	31.3.22 Balance £m
Public Works Loan Board	21.40	-0.53	20.87
Local authorities (short-term)	18.00	-5.00	13.00
Total borrowing	**39.40**	**-5.53**	**33.87**

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 borrowing was undertaken while £5m of existing short-term loans were allowed to mature without replacement. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

Long-dated Loans borrowed	Amount £m	Rate %	Period (Years)
PWLB Maturity Loan 1	11.00	2.35	40
PWLB Maturity Loan 2	3.00	2.47	40
PWLB EIP Loan 1	5.00	1.05	15
PWLB EIP Loan 2	3.00	1.80	15
Total borrowing	22.00	2.00	

The Authority's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short- and long-term borrowing was maintained.

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

Treasury Investment Activity

CIPFA published a revised Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes on 20th December 2021. These define treasury management investments as investments that arise from the organisation's cash flows or treasury risk management activity that ultimately represents balances that need to be invested until the cash is required for use in the course of business.

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 £27 and £36 million 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 Principal Outstanding £m	**Net Movement £m**	**31.3.22 Principal Outstanding £m**
Banks & building societies (unsecured)	2.00	-2.00	0.00
Government (incl. local authorities)	2.00	13.50	15.50
Money Market Funds	3.00	3.50	6.50
Registered Providers	3.00	-2.00	1.00
Real Estate Investment Trusts	0.00	0.50	0.50
Other Pooled Funds	8.99	0.00	8.99
Total investments	**18.99**	**13.50**	**32.49**

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 were a feature since March 2020 when Bank Rate was cut to 0.1%, prevailed for much of the 12-month reporting period which resulted in the return on sterling low volatility net asset value (LVNAV) Money Market Funds being close to zero even after some managers have temporarily waived or lowered their fees. However, higher returns on cash instruments followed the increases in Bank Rate in December, February, and March.

Similarly, deposit rates with the Debt Management Account Deposit Facility (DMADF) initially remained very low with rates ranging from 0% to 0.1% but following the hikes to policy rates increased to between 0.55% and 0.85% depending on the deposit maturity.

Given the risk and low returns from short-term unsecured bank investments, the Authority further diversified into more secure and higher yielding asset classes as shown in table 4 above with £0.50m that is available for longer-term investment invested in a Real Estate Investment Trust.

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	5.40	A+	50%	93	2.46%
31.03.2022	4.33	AA-	28%	128	1.61%
Similar LAs	4.37	AA-	61%	43	1.18%
All LAs	4.39	AA-	60%	14	0.97%

Externally Managed Pooled Funds: £9.6m of the Authority's investments is invested in externally managed strategic pooled equity, 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 £968k, comprising a £368k income return which is used to support services in year, and £600k of capital growth.

In the nine months to December improved market sentiment was reflected in equity, property, and multi-asset fund valuations and, in turn, in the capital values of the Authority's property, equity and multi-asset income funds in the Authority's portfolio. In the January- March quarter the two dominant themes were tighter UK and US monetary policy and higher interest rates, and the military invasion of Ukraine by Russia in February, the latter triggering significant volatility and uncertainty in financial markets.

In light of Russia's invasion, Arlingclose contacted the fund managers of our MMF, cash plus and strategic funds and confirmed no direct exposure to Russian or Belarusian assets had been identified. Indirect exposures were immaterial. It should be noted that that any assets held by banks and financial institutions (e.g. from loans to companies with links to those countries) within MMFs and other pooled funds cannot be identified easily or with any certainty as that level of granular detail is unlikely to be available to the fund managers or Arlingclose in the short-term, if at all.

The change in the Authority's funds' capital values and income earned over the 12-month period 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. *The Authority invested a further £500k during 2021/22 in the Fundamentum Real Estate Investment Trust.*

The Authority had budgeted £300k income from these investments in 2021/22. Income received was £368k.

Non-Treasury Investments

The definition of investments in CIPFA's revised 2021 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. Investments that do not meet the definition of treasury management investments (i.e., management of surplus cash) are categorised as either for service purposes (made explicitly to further service objectives) and or for commercial purposes (made primarily for financial return).

Investment Guidance issued by the Department for Levelling Up Housing and Communities (DLUHC) and Welsh Government also broadens the definition of investments to include all such assets held partially or wholly for financial return.

The Authority also held £56.2m of such investments in directly owned property as shown in the table below:

Property	**Purchase date**	**Purchase Price**	**Sector**
Challenge House, Tewkesbury	Dec-16	£8,730,000	Office
Challenge House, Tewkesbury	Dec-16	£5,820,000	Industrial
Retail units, Clevedon	Jul-06	£2,199,250	Retail
The Chase, Hertford	Nov-17	£3,700,000	Office
SPL House, Ellesmere Port	Nov-17	£3,490,000	Industrial
Wickes, Trowbridge	Dec-17	£5,542,000	Retail
Edmund House, Leamington	Aug-18	£3,610,000	Office
M&S, Walton on the Naze	Oct-18	£4,335,000	Retail
Vaughan Park, Tipton	May-20	£9,365,000	Industrial
Volvo, Crawley	Dec-20	£9,400,000	Alternatives
Total		**£56,191,250**	

These investments generated £2.60m of investment income for the Authority after taking account of direct costs, representing a rate of return of 4.62%.

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 £	**Budget £**	**Over/ Under £**	**Actual %**	**Benchmark %**	**Over/ under**

Treasury Investments	429,218	345,000	84,218	1.29	0.24	1.05
Borrowing	462,932	480,000	17068	1.29	N/A	N/A
GRAND TOTAL	**-33,713**	**-135,000**	**101,287**	**N/A**	**N/A**	**N/A**

<u>Compliance</u>

The Head of Finance and Assets reports that all treasury management activities undertaken during the year 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 7 below.

<u>Table 7: Debt Limits</u>

	2021/22 Maximum	**31.3.22 Actual**	**2021/22 Operational Boundary**	**2021/22 Authorised Limit**	**Complied?** Yes/No
Borrowing	£39.40	£33.87	55.0m	60.0m	**Yes**

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.

<u>Table 8: Investment Limits</u>

	2021/22 Maximum	**31.3.22 Actual**	**2021/22 Limit**	Complied? Yes/No
Local authorities & other government entities	£2.0m	£2.0m	£2.0m	Yes
Secured investments	£0.0m	£0.0m	£2.0m	Yes
Banks (unsecured)	£2.0m	£0.0m	£2.0m	Yes
Building societies (unsecured)	£0.0m	£0.0m	£1.0m	Yes
Registered providers (unsecured)	£2.0m	£1.0m	£2.0m	Yes
Money market funds	£2.0m	£2.0m	£2.0m	Yes
Strategic pooled funds	£3.93m	£3.93m	£4.0m	Yes
Real estate investment trusts	£0.5m	£0.5m	£2.0m	Yes
Any group of pooled funds under the same management (limits per manager)	£3.93m	£3.93m	£5.0m	Yes
Negotiable instruments held in a broker's nominee account (limits per broker)	£0.0m	£0.0m	£5.0m	Yes
Foreign countries (limits per country)	£2.0m	£0.0m	£2.0m	Yes

<u>Treasury Management Indicators</u>

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.

	31.3.22 Actual	2021/22 Target	Complied?
Portfolio average credit rating	AA-	A	Yes

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:

	31.3.22 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	38.38%	100%	0%	Yes
12 months and within 24 months	0%	100%	0%	Yes
24 months and within 5 years	0%	100%	0%	Yes
5 years and within 10 years	0%	100%	0%	Yes
10 years and above	61.62%	100%	0%	Yes

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:

	2021/22	2022/23	2023/24
Actual principal invested beyond year end	£1.0m	£1.0m	£0.0m
Limit on principal invested beyond year end	£6m	£5m	£4m
Complied?	Yes	Yes	Yes

Other

IFRS 16: The implementation of the new IFRS 16 Leases accounting standard was due to come into for force for local authorities from 1st April 2022. Following a consultation CIFPA/LASAAC announced an optional two year delay to the implementation of this standard a decision which was confirmed by the Financial Reporting Advisory Board in early April 2022. Authorities can now choose to adopt the new standard on 1st April 2022, 1st April 2023 or 1st April 2024. The Authority intends to adopt the new standard on 1st April *2023*.