Treasury Management Annual Report 2021/22 (Corporate Head of Finance – Paul French)

Synopsis of report:
This is the annual report on treasury management activity and performance for the 2021/22 financial year

Recommendations:
None - For information only

1. **Background Information**

1.1 The Council's treasury management activity is underpinned by CIPFA's (Chartered Institute of Public Finance and Accountancy*)* Code of Practice on Treasury Management ("the Code"), and the CIPFA Prudential Code for Capital Finance in Local Authorities ("the Prudential Code"). These require local authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities at least twice a year.

1.2 The Council's Treasury Management Strategy for 2021/22 was approved by this Committee at its meeting on 21 January 2021 and was subsequently approved at Full Council on 9 February 2021. This report sets out the Council's performance against the criteria in these reports for 2021/22.

1.3 Treasury management is defined as: "The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

1.4 No treasury management activity is without risk; The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities focuses on their risk implications for the organisation, and any financial instruments entered into to manage these risks.

1.5 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.

1.6 In its oversight role, the Overview and Scrutiny Select Committee considered this report on 7 July 2022.

2. **Prudential and Treasury Indicators and Compliance**

2.1 In compliance with the requirements of the Code this report provides members with a summary report of the treasury management activity during 2021/22. Officers can confirm that during the year, the Council complied with all its legislative and regulatory requirements and its Treasury Management Statement and Treasury Management Practices.

2.2 During the year the Council operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy and in compliance with the Council's Treasury Management Practices and a prudent approach was taken in relation to all investment activity with priority being given to security and liquidity over yield.

2.3 A full set of prudential and treasury indicators for 2021/22 are set out in Appendix A

3 Risk management

3.1 The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity. The Treasury Management Strategy Statement (TMSS) for 2021/22, which includes the Annual Investment Strategy, sets out the Council's investment priorities as being:

Credit risk

Counterparty credit quality is assessed and monitored with reference to credit ratings; credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; any potential support mechanisms and share price.

Liquidity risk

In keeping with the DLUHC Guidance on Investments, the Council maintains a sufficient level of liquidity through the use of Money Market Funds and call accounts.

Yield

The Council seeks to optimise returns commensurate with its objectives of security and liquidity.

4 Economic background

4.1 The following section was provided by the Council's Treasury Advisors, Link Asset Services and reflects the market position in April 2022:

4.2 Over the last two years, the coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it left Bank Rate unchanged at its subsequent meetings until raising it to 0.25% at its meeting on 16th December 2021, 0.50% at its meeting of 4th February 2022 and then to 0.75% in March 2022.

4.3 The UK economy has endured several false dawns through 2021/22, but with most of the economy now opened up and nearly back to business-as-usual, the GDP numbers have been robust and sufficient for the MPC to focus on tackling the second-round effects of inflation, now that the CPI measure has already risen to 6.2% and is likely to exceed 8% in April.

4.4 Gilt yields fell towards the back end of 2021, but despite the war in Ukraine gilt yields have shot higher in early 2022. At 1.38%, 2-year yields remain close to their recent 11-year high and 10-year yields of 1.65% are close to their recent six-year high. These rises have been part of a global trend as central banks have suggested they will continue to raise interest rates to contain inflation.

4.5 Historically, a further rise in US Treasury yields will probably drag UK gilt yields higher. There is a strong correlation between the two factors. However, the squeeze on real household disposable incomes arising from the 54% leap in April utilities prices as well as rises in council tax, water prices and many phone contract prices, are strong headwinds for any economy to deal with. In addition, from 1st April 2022, employees also pay 1.25% more in National Insurance tax. Consequently, inflation will be a bigger drag on real incomes in 2022 than in any year since records began in 1955.

4.6 Average inflation targeting was the major change in 2020/21 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 2020 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 mantra now seems very dated. Inflation is the "genie" that has escaped the bottle, and a perfect storm of supply side shortages, labour shortages, commodity price inflation, the impact of Russia's invasion of Ukraine and subsequent Western sanctions all point to inflation being at elevated levels until well into 2023.

4.7. 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 US Federal Reserve 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.

5 Borrowing Activity in 2021/22

5.1 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 resources used to pay for the capital spend. It represents the 2021/22 unfinanced capital expenditure, and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

5.2 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 that 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.

5.3 During 2021/22, the Council maintained an under-borrowed position. This meant that the capital borrowing need, the CFR, was not fully funded with loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as investment returns were low and minimising counterparty risk on placing investments also needed to be considered.

5.4 Table 1 sets out the borrowing activity for the year.

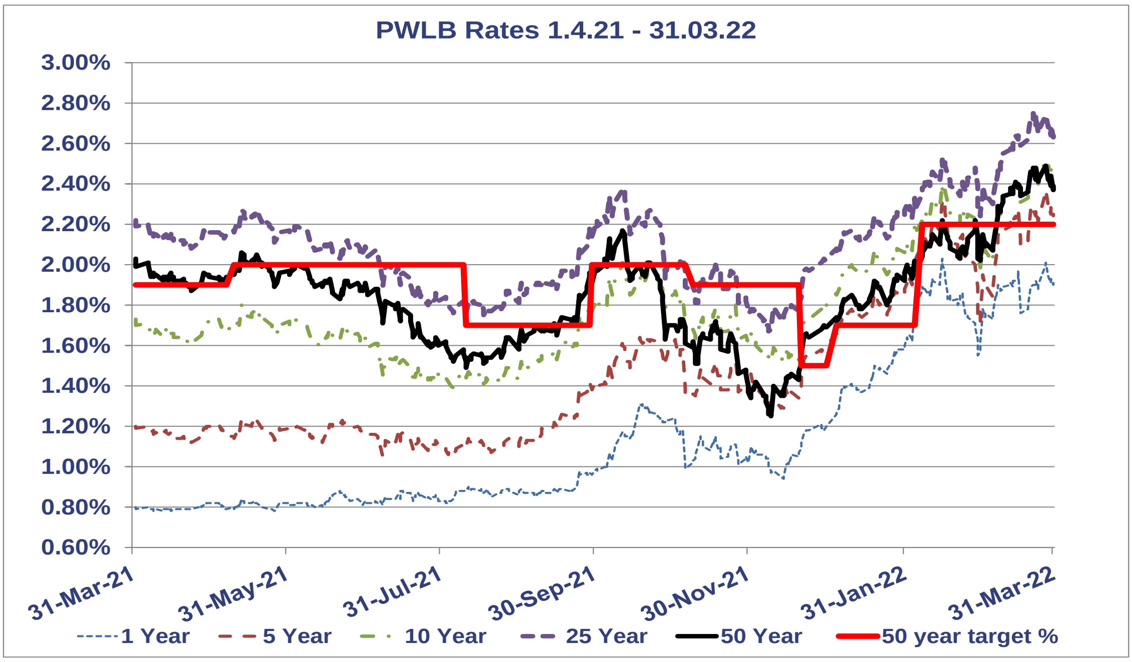
Table 1 – Borrowing activity in 2021/22

	Opening Balance £'000	New borrowing £'000	Borrowings repaid £'000	Closing balance £'000
HRA - PWLB	101,956	0	1,956	100,000
General Fund - PWLB	520,336	20,000	41,336	499,000
General Fund - Other	5,000	50,000	269	54,731

	627,292	**70,000**	**43,561**	**653,731**

5.5 During the year the Council repaid a £40million loan to the PWLB and replaced it with the prearranged £40million annuity loan with Phoenix Life as agreed by the Corporate Management Committee in 2018. This represents the Council's first and only Annuity loan which repays an element of the principal sum borrowed each year and in 2021/22 £269,000 was repaid as can be seen in the above table.

5.6 Interest rate forecasts expected only gradual rises in medium and longer-term fixed borrowing rates during 2021/22 and the two subsequent financial years until the turn of the year, when inflation concerns increased significantly. Internal, variable, or short-term rates, were expected to be the cheaper form of borrowing until well in to the second half of 2021/22. The actual PWLB rates during the year were as follows:



5.7 There are strict criteria set out that forbid councils from borrowing more than, or in advance of, their needs purely in order to profit from the investment of the extra sums borrowed. The Council has undertaken no such borrowing.

5.8 The Council operates two "loans pools", one for the HRA and one for the General Fund to comply with the HRA ring fence requirements. The HRA average interest rate for the year was 3.38% and the General Fund was 2.31%. A schedule of the outstanding loans at the end of the year is set out at Appendix B.

6 Interest rates in 2021/22

6.1 Investment returns remained close to zero for much of 2021/22. Most local authority lending managed to avoid negative rates and one feature of the year was the continued growth of inter local authority lending. The expectation for interest rates within the treasury management strategy for 2021/22 was that Bank Rate would remain at 0.1% until it was clear to the Bank of England that the emergency level of rates introduced at the start of the Covid-19 pandemic were no longer necessitated.

6.2 The Bank of England and the Government also maintained various monetary and fiscal measures, supplying the banking system and the economy with massive amounts of cheap credit so that banks could help cash-starved businesses to survive the various lockdowns/negative impact on their cashflow. 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 remained low until towards the turn of the year when inflation concerns indicated central banks, not just the Bank of England, would need to lift interest rates to combat the second-round effects of growing levels of inflation (CPI was 6.2% in February).

6.3 While the Council has taken a cautious approach to investing, 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.

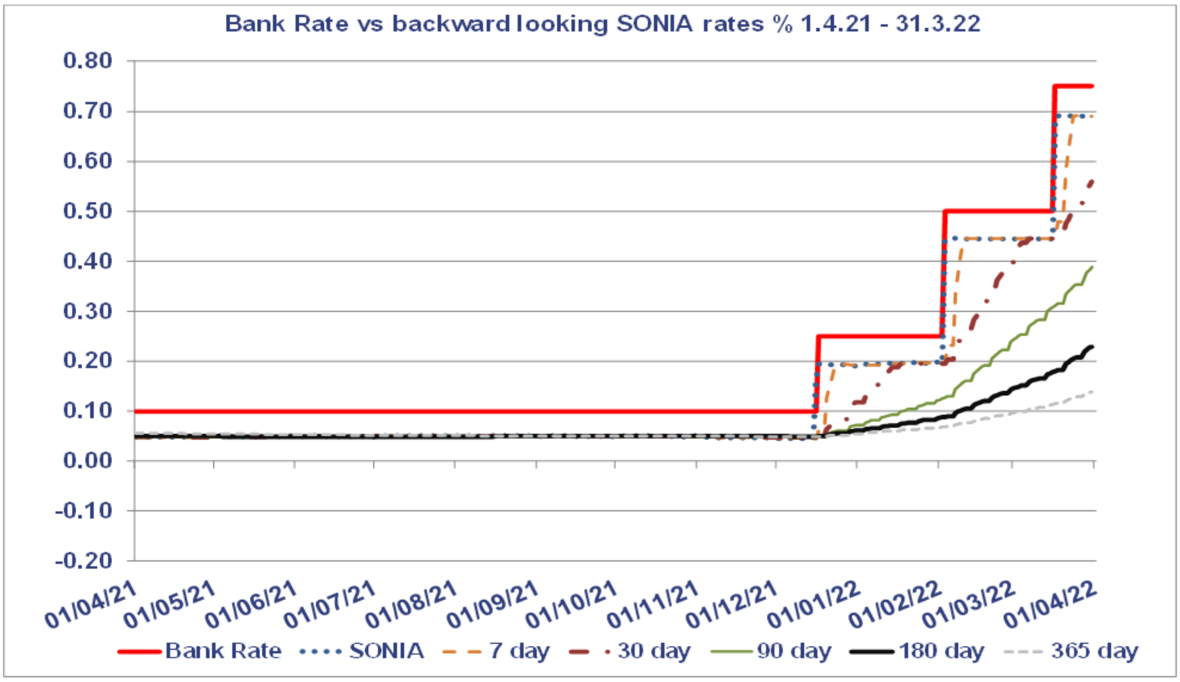
6.4 Investment balances have been kept to a minimum through the agreed strategy of using reserves and balances to support internal borrowing, rather than borrowing externally from the financial markets. External borrowing would have incurred an additional cost, due to the differential between borrowing and investment rates as illustrated in the charts shown above and below. Such an approach has also provided benefits in terms of reducing counterparty risk exposure, by having fewer investments placed in the financial markets

Change to interest rate benchmarks

6.5 LIBOR (the London Inter-bank Offered Rate) a globally accepted key benchmark interest rate for over 35 years, was replaced by the reformed sterling overnight index average (SONIA) from 31 December 2021. LIBOR was a forward looking rate where you can borrow today for a three-month (or other) period and know how much interest you will need to pay at the end of that period. It was therefore vulnerable to manipulation because it is calculated using forecasts submitted by selected banks.

6.6 SONIA is published daily and measures the cost of overnight borrowing on a backward looking basis. If you borrow today for a three-month period you will not know your interest costs upfront but, at the end of the period, your interest will be calculated by reference to each daily SONIA rate during that period. As such, SONIA and LIBOR are not readily comparable as LIBOR was forward looking and SONIA backward looking, but as a tool for measuring performance, SONIA is a more accurate measure of the market conditions at the time of our investments.

6.7 The new SONIA rates during the period were as follows:



	Bank Rate	SONIA	7 day	30 day	90 day	180 day	365 day
High	0.75	0.69	0.69	0.56	0.39	0.23	0.14
High Date	17/03/2022	18/03/2022	25/03/2022	31/03/2022	31/03/2022	31/03/2022	31/03/2022
Low	0.10	0.05	0.05	0.05	0.05	0.05	0.05
Low Date	01/04/2021	15/12/2021	16/12/2021	16/12/2021	16/12/2021	07/06/2021	13/12/2021
Average	0.19	0.14	0.13	0.12	0.09	0.07	0.06
Spread	0.65	0.65	0.65	0.51	0.34	0.18	0.09

6.8 The Council's actual interest rate performance during the year was 0.36%. The Council's overall performance compares favourably with the new average SONIA rates as can be seen in the above table.

6.9 The Council's Treasury Management Strategy sets out a lower rate of interest for the Housing Revenue Account based on the risk free nature of the account. This lower rate is achieved by deducting the credit risk margin from the actual rate achieved by the Council. The resulting interest rate applicable to the HRA during 2021/22 was 0.24%.

6.10 One reason for the Council's favourable interest rate was due to the investment in two Pooled Funds (operated by CCLA (Churches, Charities and Local Authorities) Investment Management Limited). These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Investments in these funds are long term in nature and over long term horizons they provide investors with strong levels of interest (in the form of dividends) relative to other forms of investment. However past performance has also shown that the capital values of these assets can be subject to large fluctuations (both up and down) over relatively short time frames.

6.11 The movement of the Council's two CCLA pooled funds is as follows:

Table 2 – Pooled Funds in 2021/22				
	Original Investment £	**Value 31 March 2021 £**	**Value 31 March 2022 £**	**Annual Return %**
CCLA Property Fund	2,000,000	2,305,553	2,710,240	3.8
CCLA Diversified Income Fund	2,000,000	1,987,139	2,079,266	2.2

The differences between the Original Sums invested and the Values at 31 March 2022 are held on the Council's Balance Sheet in the Pooled Investments Adjustment Account.

6.12 Another good performer for the Council has been its investment with the Funding Circle, a platform for lending to small businesses based throughout the UK. This investment vehicle has averaged a 5% return over the life of the investments for the Council. Unfortunately, In March 2022 the Council received the following confirmation from The Funding Circle:

"After two years of the platform being paused for new investment from retail investors as we navigated and adapted to the Covid pandemic, we have taken the decision to permanently close the retail platform for new investments. This includes buying and selling loans through the Secondary Market. We will continue to manage your loan portfolio on an ongoing basis until all your remaining loans have been repaid or recovered"

During the pandemic the Council had been slowly withdrawing its investment in The Funding Circle as loans and interest were repaid and will keep doing so until all loans have matured.

7 Investment Outturn for 2021/22

7.1 The Council's investment policy is governed by DLUHC investment guidance and is reflected in the Annual Investment Strategy approved by the Council each year. This policy sets out the approach for choosing investment counterparties and 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 investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

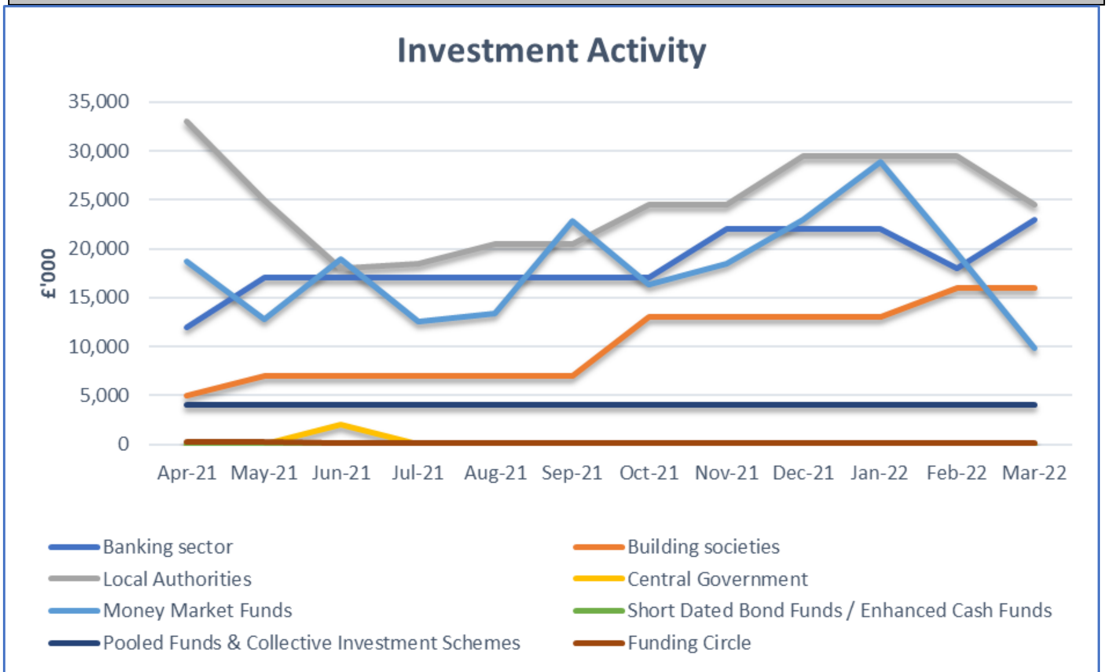
7.2 Investments of £77.424million were held by the Council at 31 March 2022 with Investment turnover principally driven by the availability of counterparties that meet the criteria set out in the Annual Investment Strategy. Table 3 summarises investment activity during the course of the year, split between the sectors of the counterparties that the funds were invested with.

Table 3 - Investment activity in 2021/22

	Opening Balance	New Investments	Investments Recalled	Closing Balance
	£000	£000	£000	£000
Specified Investments				
Banking sector	12,000	32,000	21,000	23,000
Building societies	5,000	42,000	31,000	16,000
Local Authorities	33,000	29,500	38,000	24,500
Central Government	0	2,000	2,000	0
Money Market Funds	12,490	124,135	126,805	9,820
Unspecified Investments				
Short Dated Bond Funds / Enhanced Cash Funds	0	0	0	0
Pooled Funds & Collective Investment Schemes	4,000	0	0	4,000
Funding Circle	206	0	102	104
	66,696	229,635	218,907	77,424

7.4 The monthly movement in balances between these categories is set out in Table 4 below and reflects the available counterparties and investment rates at that time.

Table 4 - Movement between investments during 2021/22



7.5 A full list of investments held at 31 March 2022 is set out in Appendix C.

7.6 In addition to the normal money markets, the Council also invests in its own companies by way of loans provided to them for the purchase of assets from the Council (that the Council cannot hold itself) and via working capital loans. All such Loan Agreements have been approved by Full Council at rates set in accordance with European Commission competition rules. The table below sets out these loans and the income to the Council.

Loan Type	**Original Investment £**	**Annual Interest £**	**Interest Rate %**
Development Loans - AddlestoneOne	25,326,000	1,276,433	5.04
Development Loans - Other	1,000,000	48,600	4.86
Working Capital Loans	445,000	33,553	7.54
Working Capital Loans	300,000	22,080	7.36
Working Capital Loans	1,500,000	103,600	7.40
Totals	**28,571,000**	**1,484,266**	

7.7 The Council's cash balances comprise revenue and capital resources and cash flow monies (creditors etc). Interest earned on these balances is derived from in-house managed investments. The table below shows gross investment income achieved in 2021/22 alongside the interest paid on borrowings:

Table 7 – Net investment income / Debt interest 2021/22			
	Original Estimate £'000	Revised Estimate £'000	Outturn £'000
Investment income earned	91	213	126
Dividend income earned	120	120	152
Interest on loans to RBC companies	1,477	1,484	1,484
Gross investment income	**1,688**	**1,817**	**1,762**
Management expenses	(50)	(36)	(37)
Interest paid on deposits and other balances	(2)	(1)	(2)
Debt interest	(18,523)	(16,642)	(16,174)
Net Investment Income / (Debt interest)	**(16,877)**	**(14,562)**	**(14,451)**

This is broken down between services as follows:

General Fund	(13,461)	(11,171)	(11,111)
Housing Revenue Account	(3,246)	(3,391)	(3,340)
Net Investment Income / (Debt interest)	**(16,877)**	**(14,562)**	**(14,451)**

7.8 Aside from the parameters set in the Annual Investment Strategy, the main factors that determine the amount of investment income are the level of interest rates, cash flow and the level of reserves and balances. The impact of capital cash flows – receipts from sales and timing of capital projects – also has a significant impact on cash flows.

8. **Legal Implications**

8.1 The powers for a local authority to borrow and invest are governed by the Local Government Act 2003 and associated Regulations. A local authority may borrow or invest for any purpose relevant to its functions, under any enactment, or for the purpose of the prudent management of its financial affairs. The Regulations also specify that authorities should have regard to the CIPFA Treasury Management Code, the Government Investments Guidance and the CIPFA Prudential Code for Capital Finance in Local Authorities when carrying out their treasury management functions.

9**. Council Policy**

9.1 This is set out in the Treasury Management Policy Statement, the Annual Investment Strategy, and associated Practices and Schedules.

9.2 The Council's treasury management policy statement states:

*"*The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation, and any financial instruments entered into to manage these risks.*"*

9.3 It is the security of investments that has always been the main emphasis of our treasury strategy. In balancing risk against return, Officers continue to place emphasis on the control of risk over yield.

10. Conclusions

10.1 The financial year continued the challenging investment environment of previous years. The management of counterparty risk remains our primary treasury management priority. The criteria in the Annual Investment Strategy are continuously reviewed to minimise risk as far as reasonably possible whilst retaining the ability to invest with secure institutions.

(for information)

Background Papers - None