Report to Audit Committee
1 December 2021
By the Director of Corporate Resources
INFORMATION REPORT

Not exempt

Treasury Management and Prudential Indicators mid-year report 2021/22

Executive Summary

This report covers treasury activity and prudential indicators for the first half of 2021/22. During the period the Council complied with its legislative and regulatory requirements and the statutory borrowing limit, the Authorised Limit, was not breached. Activity was in line with indicators apart from the indicator covering interest rate sensitivity where the value at end of September exceeded the estimate. This was due to higher than projected cash balances and is discussed in section 2.14.

At 30 September 2021, the Council had no external debt and its investments totalled £80m (£53.6m at 30 September 2020).

During the first half of 2021/22, the Council's cash balances were invested in accordance with the Council's treasury management strategy. Interest of £0.48m was earned on investments at an average return of 1.3% (1.5% full year 2020/21).

Treasury investment income for the full year is likely to be significantly above the budget as dividends have recovered whereas the budget had anticipated continued low dividend yields. Commercial property income is recovering to some extent but some tenants have suffered in the pandemic and will potentially be unable to pay rents in full.

Recommendations

The Committee is recommended to:

i) Note the treasury management stewardship report at the mid-year 2021/22
ii) Note the mid-year prudential indicators for 2021/22

Reasons for Recommendations

i) This mid-year report is a requirement of the Council's reporting procedures
ii) This report meets the requirements of the relevant CIPFA Codes of Practice for Treasury Management and Prudential Indicators in Capital Finance.

Background Papers
"Capital Strategy 2021/22 incorporating Investment and Treasury Management Strategy" – Audit Committee 16 December 2020
"Budget 2021/22 and Medium-Term Financial Strategy" – Cabinet 28 January 2021

Consultation: Arlingclose Limited. Council's Treasury management advisors
Wards affected: All
Contact: Julian Olszowka, Group Accountant, Technical 01403 215310

Background Information

1 Introduction

The purpose of this report

1.1 This report covers treasury management activity and prudential indicators for the first half of 2021/22. It meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003. The Code recommends that Members are informed of Treasury Management activities at least twice a year.

Background

1.2 In line with the CIPFA Prudential Code for Capital Finance in Local Authorities the Council adopts prudential indicators for each financial year and reports on performance relative to those indicators. This requirement is designed to show that capital spending is prudent, affordable and sustainable and that treasury practices adequately manage risk. The original indicators for 2021/22 together with Capital Strategy were approved by Council on 10 February 2021. The Capital Strategy including the Treasury Management Strategy 2021/22 had been recommended for approval by this Committee on 16 December 2020.

1.3 The economic background to treasury management remains challenging with the recovery from the pandemic and uncertainty over the direction of the economy in the next year or so. Arlingclose Limited, the Council's treasury management advisors, have provided a commentary on the half-year so far in Appendix A.

Local Context

1.4 At the end of 2020/21 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £34.6m, while usable reserves and working capital which are the underlying resources available for investment were £94m. The Council had no borrowing and £59m of investments reflecting its use of internal resources rather than borrowing in order to reduce risk and keep interest costs low.

1.5 On 30 September 2021, the Council had no borrowing and investments of £80m. Investment totals were at all-time highs as Covid-19 related grants flowed in and much of the capital programme was delayed. Short term rates continued at near zero in the period. With the large amounts of cash being held at times, the Council had to use the Government to invest its cash more than it would usually plan to.

1.6 The trajectory of rates on offer for short term cash is currently uncertain with talk of inflation increasing but central banks concerned about choking off economic recovery.

2 Treasury management

Borrowing Activity

2.1 There was no borrowing in the period. No borrowing is envisaged in the second half of the year although the Council's balances will fall towards the end of the year as tax receipts are significantly front loaded.

Investment Activity

2.2 The treasury management position at 30 September 2021 is shown below. This is the month end position, but the daily position can vary as a large portion of income comes in at the beginning of month to be distributed to precepting authorities a few days later.

	31.3.21 Balance £m	**Movement £m**	**30.9.21 Balance £m**	**30.9.21 Rate %**
Call accounts	2.7	0.5	3.2	0.0
Money Market Funds – call	18.0	2.0	20.0	0.0
Money Market Funds – cash plus or short bonds	9.4	4.0	13.4	0.4
Short-term deposits	4.0	14.0	18.0	0.1
Pooled Funds – Property	4.7	0.4	5.1	3.7
Pooled Funds – Multi-Asset	7.0	0.0	7.0	4.4
Pooled Funds – Equity	5.1	0.2	5.3	3.9
Pooled Funds – Bonds	6.0	0.0	6.0	2.1
REIT	2.1	-0.1	2.0	2.2
Total Investments	59.0	21.0	80.0	1.2

2.3 Both the CIPFA Code and government guidance require the Council 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 Council'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.

2.4 Investment income on an accrued basis in the period was £0.48m which is above the budget of £0.39m. The average return was 1.3%, below the budgeted figure of 1.7% but cash balances averaged £70m well over the budgeted £45m. Due to the prudent cash flow projections the Council usually has more cash than budgeted but the pandemic seems to have amplified this with inflows, including Covid-19 grant monies and developer contributions, continuing and spend, notably in the capital programme, being subdued.

2.5 The returns in the second half of the year are expected to continue to show recovery in dividends and the outturn position on income is expected to be £0.13m above budget.

2.6 Given the risk and low returns from short-term unsecured bank investments, the Council has reduced its exposure to them except through well diversified money market funds or call accounts. Otherwise the Council has used local authorities and central government alongside strategic pooled funds. These strategic pooled funds,

comprising equity, bonds and property, are a key part of the strategy. As can be seen from the table above they are a significant contributor to overall income.

2.7 Pooled funds asset values though can be volatile in the short term. The values of pooled funds have recovered from the market crash in March 2020 and at the end of the first half of the year the value of these investments were £1.2m above the initial investment. However, it should be remembered that these investments are longer term so any snapshot of capital gain or loss should not be overemphasised.

Compliance

2.8 The Director of Corporate Resources reports that all treasury management activities undertaken during the first half of 2021/22 complied with the CIPFA Code of Practice and the Treasury Management Strategy recommended by this Committee although one indicator was exceeded. This was the measure for interest sensitivity.

2.9 The interest sensitivity indicator is no longer a CIPFA recommendation but is regarded as good practice. It was set with the expectation that cash balances would have settled back to the levels before the pandemic with much of the Covid grants spent or paid back. This hasn't been the case and combined with a lack of investment opportunities this has led to a large amount of liquid funds which are subject to changes in interest. The indicator quantifies the effect of a 1% change in interest rates. In reality in the current low rate environment a 1% change is very unlikely so the probability of the risk crystallising is very low.

2.10 Security of capital has remained the Council's main investment objective. Key to this is the counterparty policy as set out in its treasury management strategy. Counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

Treasury Management Indicators

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

2.12 **Security benchmark** – The Council set a security benchmark rating of A, which is the average credit rating for the investment portfolio. The average rating was at above the benchmark at A+ during the first half of the year.

2.13 **Liquidity benchmark** – The Council sets a benchmark to maintain a minimum of liquidity. The benchmark set was that £3m is available within a rolling three-month period without additional borrowing. The Director of Corporate Resources can report that liquidity arrangements were well within benchmark during the year to date with overnight cash alone not falling below £15m.

Treasury Management Indicators

2.14 **Interest rate exposures** - This indicator is set to control the Council's exposure to interest rate risk. The exposures to variable rate interest rates is quantified by the one-year revenue impact of a 1% rise or fall in interest rates. The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates. This indicator is over the limit as actual cash balances are significantly more than the projected cash balances and

opportunities to invest for a meaningful return being very limited. It was expected at the time of setting the limits that the considerable Covid-19 grant monies would have been dispensed or paid back to central government but significant sums remain. It is worth noting that the possibility of a 1% reduction from 0.1% to minus 0.9% is very low and that is the turn of events that will reduce the Council's income to the extent shown in the actual indicator value.

Interest rate risk indicator - Upper limit	Limit	Actual	Complied
One-year revenue impact of a 1% rise	£0.2m	£0.25m	x
One-year revenue impact of a 1% fall	£0.2m	£0.25m	x

2.15 Cash balances should reduce in the rest of the year and fixed interest investments made in the second half of the year which will reduce this indicator for the year-end report.

2.16 **Principal sums invested for periods longer than 364 days** – The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its long-term investments. There was one investment of £2.5m for more than 364 days so the Council was well within the indicator set:

	Original Indicator	Maximum Position
Maximum principal sums invested > 364 days	£12m	£2.5m

3 Prudential Indicators 2021/22

3.1 The Local Government Act 2003 requires the Council to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much it can afford to borrow. The objectives of the Prudential Code are to ensure that capital investment plans are affordable, prudent and sustainable. To demonstrate that the Council meets these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

3.2 **The Council's Capital Expenditure and Financing 2021/22 -** This is one of the required prudential indicators and shows total capital expenditure for the year and how this is financed. The estimated indicator is shown below.

2021/22	Original estimate £m	Current projection £m
Total capital expenditure	6.4	5.8
Resourced by:		
External Resources	3.1	2.3
Internal Resources	2.6	3.5
Debt	0.7	0.0
Total financing	6.4	5.8

3.3 The estimated capital spend in 2021/22 is expected to be under the original budget with financing similarly lower than expected. No unfinanced spend is currently projected with more internal resources being used.

3.4 **The Council's overall borrowing need -** The Council's underlying need to borrow is termed the Capital Financing Requirement (CFR). It represents the accumulated net capital expenditure which has not been financed by revenue or other resources. Part of the Council's treasury activities is to address this borrowing need, either

through borrowing from external bodies, or utilising temporary cash resources within the Council.

3.5 The Council is required to make an annual revenue charge, the Minimum Revenue Provision (MRP), to reduce the CFR – effectively a repayment of the borrowing need. The Council's 2021/22 MRP Policy was approved on 10 February 2021 within the 2021/22 Budget report.

3.6 The Council's CFR for the year is shown below, and represents a key prudential indicator. The current projection is slightly less than the original estimate. No increase in long-term borrowing is projected in this financial year.

Capital Financing Requirement and External Debt Year end 2021/22	**Original estimate £m**	**Current projection £m**
CFR	34.0	33.6
External debt	0	0

3.7 External borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2021/22 and next two financial years. No difficulties are envisaged for the current or future years in complying with this Prudential Indicator as no long-term borrowing is currently planned.

3.8 **Borrowing limits** - The Council approved these Prudential Indicators as part of the 2021/22 Budget report.

3.9 **Operational boundary for external debt:** The operational boundary is the Council's estimate of most likely, but not worst-case scenario for external debt.

3.10 **Authorised limit for external debt:** The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

	Limit	Actual	Met?
Operational boundary – borrowing	£0m	£0m	✓
Operational boundary – other long-term liability	£0m	£0m	✓
Operational boundary – **TOTAL**	**£0m**	**£0m**	✓
Authorised limit – borrowing	£15m	£0m	✓
Authorised limit – other long-term liability	£6m	£0m	✓
Authorised limit – **TOTAL**	**£21m**	**£0m**	✓

3.11 **The ratio of financing costs to net revenue stream -** This indicator identifies the trend in the cost of capital (financing costs net of interest and investment income) against the net revenue stream. The indicator for the year was 4%. Based on current estimates the ratio is expected to be 0% for the year. This is because the investment income projection is greater than estimated and now nets down the financing costs calculation to close to zero.

4 Non-Treasury Investments

4.1 The definition of investments in CIPFA's Treasury Management Code covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in DLUHC's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

4.2 The Council has a significant directly owned property portfolio valued at £58m at the end of 2021/22. The original investment strategy set £3.6m as the income net of direct costs figure from the property portfolio and the present forecast is £3.5m. The final income figure is uncertain because of the effects of the pandemic on rents persist with some tenants. The Head of Property and Facilities is engaging with tenants who may be affected and the final income figure will depend on the outcome of discussions.

4.3 There are a number of other indicators that were set for the year that cannot be definitively calculated until the end of the year when the accounts are closed and all relevant income and expenditure is accrued and central expenses are apportioned across all the Council's services. Some indicators can estimated as a snap shot from property records and the table below shows the original estimated indicators and the latest projections.

Indicator	Estimate	Latest
Average Vacancy levels	1%	2%
Tenant over 5%	5	4
Weighted Average Unexpired Lease Term	9yr	14yr
Bad debts written off	£200,000	£170,000

4.4 The Weighted Average Unexpired Lease Term has jumped due to a technical change in the calculation with the inclusion of Swan Walk lease which significantly moves the average. If Swan Walk was excluded, the figure would be close to estimate.

4.5 A number of indicators for the investment properties require the end of year value of properties. A valuation of all properties is carried out at year end as a part of the final accounts. Valuations have been affected by the uncertainty caused by the pandemic and this may still affect the values at 31 March 2022 which is the year end date.

4.6 The Council made one small loan (£0.3m) to a community run leisure centre in 2015. The centre has been given a year's payment holiday in its repayments as it has been heavily affected by the pandemic. It is expected to recommence payment in 2022/23 and no increase in the expectation of any credit loss is envisaged. The interest income of £7,000 will not be paid this year but the unpaid interest will be wrapped up into future interest payments.

4.7 No other loan has been made against the overall limit of £3m. It was expected there would be loans to the Council's housing company this year. None were made in the first half of the year and the probability is that none will be made in the rest of the

year. The initial planning and preparation of sites have taken longer than expected. This is a new venture for the Council and the pandemic and complex planning issues has also slowed progress.

4.8 The Council has a limit on share investment of £0.5m. Equity investment of £125,000 was made in the Councils' Housing Company last year. It is possible more will be made dependent on the circumstances around development sites.

5 Staffing consequences

5.1 There are no direct staff resourcing consequences. However, the risks in the investment environment highlights the continuing need for staff training and staff will take advantage of courses run by its advisors Arlingclose Limited.

6 Financial consequences

6.1 For the first half year interest earned was £0.48m compared to £0.43m last year in the same period. Interest earned in 2021/22 is projected to be £0.92m, which is £0.13m over budget of £0.79m. MRP is projected to be on budget of £0.92m.

7 Other considerations

7.1 There are no consequences of any action proposed in respect of Risk; Crime & Disorder; Human Rights; Equality & Diversity and Sustainability.

Appendix A

Economic background to the midpoint of 2021/22

Economic background: The economic recovery from coronavirus pandemic continued to dominate the first half of the financial year. By the end of the period over 48 million people in the UK had received their first dose of a COVID-19 vaccine and almost 45 million their 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 September 2021 policy announcement, the BoE noted it now expected the UK economy to grow at a slower pace than was predicted in August, as the pace of the global recovery had shown signs of slowing and there were concerns inflationary pressures may be more persistent. Within the announcement, Bank expectations for GDP growth for the third (calendar) quarter were revised down to 2.1% (from 2.9%), in part reflecting tighter supply conditions. The path of CPI inflation is now expected to rise slightly above 4% in the last three months of 2021, due to higher energy prices and core goods inflation. While the Monetary Policy Committee meeting ended with policy rates unchanged, the tone was more hawkish.

Government initiatives continued to support the economy over the quarter but came to an end on 30th September 2021, with businesses required to either take back the 1.6 million workers on the furlough scheme or make them redundant.

The latest labour market data showed that in the three months to July 2021 the unemployment rate fell to 4.6%. The employment rate increased, and economic activity rates decreased, suggesting an improving labour market picture. Latest data showed growth in average total pay (including bonuses) and regular pay (excluding bonuses) among employees was 8.3% and 6.3% respectively over the period. However, part of the robust growth figures is due to a base effect from a decline in average pay in the spring of last year associated with the furlough scheme.

Annual CPI inflation rose to 3.2% in August, exceeding expectations for 2.9%, with the largest upward contribution coming from restaurants and hotels. The Bank of England now expects inflation to exceed 4% by the end of the calendar year owing largely to developments in energy and goods prices. The Office of National Statistics' (ONS') preferred measure of CPIH which includes owner-occupied housing was 3.0% year/year, marginally higher than expectations for 2.7%.

The easing of restrictions boosted activity in the second quarter of calendar year, helping push GDP up by 5.5% q/q (final estimate vs 4.8% q/q initial estimate). Household consumption was the largest contributor. Within the sector breakdown production contributed 1.0% q/q, construction 3.8% q/q and services 6.5% q/q, taking all of these close to their pre-pandemic levels.

The US economy grew by 6.3% in Q1 2021 (Jan-Mar) and then by an even stronger 6.6% in Q2 as the recovery continued. 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: Monetary and fiscal stimulus together with rising economic growth and the ongoing vaccine rollout programmes continued to support equity markets over most of the period, albeit with a bumpy ride towards the end. The Dow

Jones hit another record high while the UK-focused FTSE 250 index continued making gains over pre-pandemic levels. The more internationally focused FTSE 100 saw more modest gains over the period and remains below its pre-crisis peak.

Inflation worries continued during the period. Declines in bond yields in the first quarter of the financial year suggested bond markets were expecting any general price increases to be less severe, or more transitory, that was previously thought. However, an increase in gas prices in the UK and EU, supply shortages and a dearth of HGV and lorry drivers with companies willing to pay more to secure their services, has caused problems for a range of industries and, in some instance, lead to higher prices.

The 5-year UK benchmark gilt yield began the financial year at 0.36% before declining to 0.33% by the end of June 2021 and then climbing to 0.64% on 30th September. Over the same period the 10 year gilt yield fell from 0.80% to 0.71% before rising to 1.03% and the 20-year yield declined from 1.31% to 1.21% and then increased to 1.37%.

The Sterling Overnight Rate (SONIA) averaged 0.05% over the quarter.

Credit background: Credit default swap spreads were flat over most of period and are broadly in line with their pre-pandemic levels. In late September spreads rose by a few basis points due to concerns around Chinese property developer Evergrande defaulting but are now falling back. The gap in spreads between UK ringfenced and non-ringfenced entities continued to narrow, but Santander UK remained an outlier compared to the other ringfenced/retail banks. At the end of the period Santander UK was trading the highest at 53bps and Lloyds Banks Plc the lowest at 32bps. The other ringfenced banks were trading between 37-39bps and Nationwide Building Society was 39bps.

Over the period Fitch and Moody's upwardly revised to stable the outlook on a number of UK banks and building societies on our counterparty list, recognising their improved capital positions compared to last year and better economic growth prospects in the UK.

The successful vaccine rollout programme is credit positive for the financial services sector in general and the improved economic outlook has meant some institutions have been able to reduce provisions for bad loans. While there is still uncertainty around the full extent of the losses banks and building societies will suffer due to the pandemic-related economic slowdown, the sector is in a generally better position now compared to earlier this year and 2020.

At the end of the period Arlingclose had completed its full review of its credit advice on unsecured deposits. The outcome of this review included the addition of NatWest Markets plc to the counterparty list together with the removal of the suspension of Handelsbanken plc. In addition, the maximum duration for all recommended counterparties was extended to 100 days.