Cabinet **Agenda Item**
30 November 2021

Treasury Management Strategy Mid-Year Review Report 2021/22

Cabinet Member: Councillor Andrew Moore
Responsible Officer: Andrew Jarrett, Deputy Chief Executive (S151).

Reason for Report: To inform the Cabinet of the treasury performance during the first six months of 2021/22, to agree the ongoing deposit strategy for the remainder of 2021/22 and a review of compliance with Treasury and Prudential Limits for 2021/22.

Recommendation(s):

1. **That Cabinet recommends to Council that a continuation of the current policy outlined at paragraphs 6.0 - 6.5 be agreed.**
2. **That Cabinet recommends that Council approves the changes to the Capital Financing Requirement, Operational Boundaries and Authorised Limits for the current year at paragraphs 4.4 - 4.5.**

Relationship to Corporate Plan: Maximising investment return whilst minimising risk of credit default enables the Council to finance the delivery of its Corporate Plan objectives.

Financial Implications: Good financial management and administration underpins the entire strategy. The Council's Treasury Management Strategy should attempt to maximise investment return commensurate with minimum risk to the principal sums invested**.**

Legal Implications: The Council is under a statutory duty to "have regard" to the 2011 CIPFA Treasury Management Code of Practice. The Council's own Financial Regulations include requirements as to the reporting of treasury management information.

Risk Assessment: The Council considers deposit security as the paramount function in any treasury dealings or activities. It should be noted that any investment decisions will always be subject to a degree of risk. However, in complying with an agreed Treasury Management Strategy, these risks would be kept to an acceptable level.

Equality Impact Assessment: It is considered that the impact of this report on equality related issues will be nil.

Climate Change Assessment: No implications relating this report.

1.0 Introduction

1.1 CIPFA's Code of Practice for Treasury Management recommends the annual setting of a Treasury Management Strategy and best practice dictates a half yearly update on treasury performance. This report will not only update Members on the treasury performance over the first six months of 2021/22, but will also seek approval for the ongoing deposit strategy.

2.0 Treasury Performance 01/04/2021 to 30/09/2021

2.1 The table below shows the Council's overall treasury management position for the first six months of 2021/22.

Treasury Position	Average Interest	Total Interest as at 30/09/2021	Forecast Year-End Position
Temporary Investments and Deposits	0.15%	£19k	£40k
CCLA Dividends	3.64%	£91k	£180k
Commercial Activities / Non-Financial Investments (all currently 3Rivers)	4.97%	£258k	£536k
Total		**£368k**	**£751k**

2.2 The General Fund 2021/22 budget for all investment activity is £633k and for the Housing Revenue Account is £10k.

3.0 Commentary from our Treasury Advisors (Link Group)

3.1 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. This has seen interest rates offered by banks and building societies remain low, resulting in returns on temporary investments far below that achieved in recent years. It is expected that the Bank of England will start tightening monetary policy soon to combat growing inflationary pressures, possibly by Quarter 4 of 2021/22, and this is already leading to small increases in interest rates offered by banks.

3.2 At its latest meeting on 24 September, the Monetary Policy Committee (MPC) voted unanimously to leave Bank Rate unchanged at 0.10% and made no changes to its programme of quantitative easing purchases, due to finish by the end of this year at a total of £895bn. Two MPC members voted to stop the last £35bn of purchases as they were concerned that this would add to inflationary pressures.

3.3 There was a major shift in the tone of the MPC's minutes at this meeting from the previous meeting in August, indicating that some tightening in monetary policy was now on the horizon. In his press conference after the August MPC meeting, Governor Andrew Bailey suggested that labour shortages could push up wage growth by more than it expects and that, as a result, CPI inflation would stay above the 2% target for longer. It also discounted sharp increases in monthly inflation figures expected in late 2021, which were largely propelled by events a year ago, such as the cut in VAT in August 2020 for the hospitality industry, and by temporary shortages that would eventually work their way out of the system. In other words, the MPC had been prepared to look through a temporary spike in inflation.

3.4 In August the country was just put on alert. However, this time the MPC indicated there had been a marked rise in concern that more recent price increases, particularly in gas and electricity prices in October and due again next April, are indeed likely to lead to faster and higher inflation expectations, and underlying wage growth. This would in turn increase the risk that price pressures would prove more persistent next year than previously expected. The MPC reaffirmed its commitment to the 2% inflation target in its statement, which suggested that it was now willing to look through the flagging economic recovery during the summer to prioritise bringing inflation down next year. Its primary concern now appears to be that underlying price pressures in the economy are likely to be embedded over the next year, elevating future inflation to stay significantly above its 2% target and for longer.

3.5 Financial markets are now pricing in a first increase in Bank Rate from 0.10% to 0.25% in February 2022, but this looks ambitious as the MPC has stated that it wants to see what happens to the economy, and particularly to employment once furlough ends at the end of September. At the MPC's meeting in February, it will only have available the employment figures for November; to get a clearer picture of employment trends, it would need to wait until the May meeting when it would have data up until February. At its May meeting, it will also have a clearer understanding of the likely peak of inflation.

3.6 The MPC's forward guidance on its intended monetary policy on raising Bank Rate versus selling holdings of bonds (quantitative easing) is as follows: -

- Placing the focus on raising Bank Rate as "the active instrument in most circumstances".
- Raising Bank Rate to 0.50% before starting on reducing its holdings.
- Once Bank Rate is at 0.50%, it would stop reinvesting maturing gilts.
- Once Bank Rate had risen to at least 1%, it would start selling its holdings.

3.7 COVID-19 vaccines have been the game changer that has enormously boosted confidence that life in the UK could largely return to normal during the summer after a third wave of the virus threatened to overwhelm hospitals in the spring. With the household saving rate having been exceptionally high since the first lockdown in March 2020, there is plenty of pent-up demand and purchasing power stored up for services in hard hit sectors like restaurants, travel and hotels. The big question is whether mutations of the virus could develop which render current vaccines ineffective, as opposed to how quickly vaccines can be modified to deal with them and enhanced testing programmes be implemented to contain their spread.

3.8 The pandemic and extreme weather events have been highly disruptive of extended worldwide supply chains. At the current time, there are major queues of ships unable to unload their goods at ports in New York, California and China. Such issues have led to misdistribution of shipping containers around the world and have contributed to a huge increase in the cost of shipping. Combined with a shortage of semi-conductors, these issues have had a disruptive impact on production in many countries. Many western countries are also having difficulty in filling job vacancies. It is expected that these issues will be resolved gradually, but they are currently contributing to a spike upwards in inflation and shortages of materials and goods on shelves.

3.9 The Council's treasury advisor, Link Group, provided the following forecasts on 29 September 2021 (PWLB rates are certainty rates, gilt yields plus 80bps):

Link Group Interest Rate View 29.9.21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
BANK RATE	0.10	0.10	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.75
3 month ave earnings	0.10	0.10	0.20	0.20	0.30	0.40	0.50	0.50	0.60	0.70
6 month ave earnings	0.20	0.20	0.30	0.30	0.40	0.50	0.60	0.60	0.70	0.80
12 month ave earnings	0.30	0.40	0.50	0.50	0.50	0.60	0.70	0.80	0.90	1.00
5 yr PWLB	1.40	1.40	1.50	1.50	1.60	1.60	1.60	1.70	1.70	1.70
10 yr PWLB	1.80	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.10
25 yr PWLB	2.20	2.20	2.30	2.30	2.40	2.40	2.40	2.50	2.50	2.60
50 yr PWLB	2.00	2.00	2.10	2.20	2.20	2.20	2.20	2.30	2.30	2.40

3.10 Bank Rate is not expected to increase quickly after the initial rate rise as the supply potential of the economy has not generally taken a major hit during the pandemic. It should therefore be able to cope well with meeting demand without causing inflation to remain elevated in the medium-term, following an initial surge to around 4% towards the end of 2021. Three increases to Bank Rate are forecast in the period to March 2024, ending at 0.75%.

3.11 As the interest forecast table for PWLB certainty rates above shows, there is likely to be a steady rise over the forecast period, with some degree of uplift due to rising treasury yields in the US. There is likely to be exceptional volatility and unpredictability in respect of gilt yields and PWLB rates due to the following factors:

- How strongly will changes in gilt yields be correlated to changes in US treasury yields?
- Will the Fed take action to counter increasing treasury yields if they rise beyond a yet unspecified level?
- Would the MPC act to counter increasing gilt yields if they rise beyond a yet unspecified level?
- How strong will inflationary pressures turn out to be in both the US and the UK and so impact treasury and gilt yields?
- How will central banks implement their new average or sustainable level inflation monetary policies?
- How well will central banks manage the withdrawal of QE purchases of their national bonds without causing a panic reaction in financial markets?

3.12 Since the start of 2021, there has been a lot of volatility in gilt yields, and hence PWLB rates. During the first part of the year, US President Biden's determination to push through a $1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a recovery package from the Covid-19 pandemic unsettled financial markets. However, this was in addition to the $900bn support package already passed in December 2020 under President Trump. This was then followed by additional Democratic ambition to spend further huge sums on infrastructure and an American families plan.

3.13 These factors could cause an excess of demand in the economy which could then unleash stronger and more sustained inflationary pressures in the US than in other western countries. This could then force the Fed to take much earlier action to start tapering monthly QE purchases and/or increasing the Fed rate from near zero, despite their stated policy being to target average inflation. Weak growth in August (announced 03/09/2021) has spiked anticipation that tapering of monthly QE purchases could start by the end of 2021. These purchases are currently acting as downward pressure on treasury yields. As the US financial markets are, by far, the biggest financial markets in the world, any trend upwards in the US will invariably impact and influence financial markets in other countries. As an average since 2011, there has been a 75% correlation between movements in 10-year treasury yields and 10-year gilt yields. However, gilt yields and treasury yields do not always move in unison.

3.14 One of the key results of the pandemic has been a fundamental rethinking and shift in monetary policy by major central banks like the Fed, the Bank of England and the ECB, to tolerate a higher level of inflation than in the previous two decades when inflation was the prime concern. There is now also a greater emphasis on other targets for monetary policy than just inflation, especially on ‘achieving broad and inclusive “maximum” employment in its entirety’ in the US before consideration would be given to increasing rates.

3.15 The Bank of England has also amended its target for monetary policy so that inflation should be ‘sustainably over 2%’ and the ECB now has a similar policy. For local authorities, this means that investment interest rates and very short term PWLB rates will not be rising as quickly or as high as in previous decades when the economy recovers from a downturn and the recovery eventually runs out of spare capacity to fuel continuing expansion.

4.0 Investment Portfolio

4.1 In accordance with the Code, it is the Council’s priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council’s risk appetite. Due to the current economic climate and low Bank Rate, it is not possible to earn the levels of interest commonly seen in previous decades as investment rates up to 12 months have barely been above zero, with the DMO and some banks even offering negative rates at times for short-dated maturities. Given the expectation that Bank Rate will see several small increases during the current forecast horizon of 31 March 2023, there have been slight increases recently to rates offered by banks and building societies. These rates are still far below the levels seen prior to the pandemic and so investment returns are expected to remain low.

4.2 The Council’s investment portfolio as at 30 September 2021 was made up of short term investments/deposits to the value of £33.93m, comprising of £28.50m in fixed term investments and £5.43m in NatWest call accounts. In addition to this, the Council also holds £5.00m in the CCLA commercial property fund.

4.3 Short term investments/deposits held as at 30 September 2021 are as follows:

Institution	Principal (£)	Rate	Start Date	Maturity Date
Staffordshire Moorlands DC	1,000,000	0.22%	16/10/2020	15/10/2021
Surrey Heath Borough Council	2,000,000	0.05%	10/06/2021	10/12/2021
Ashford Borough Council	2,000,000	0.08%	25/02/2021	25/11/2021
Thurrock Council	2,000,000	0.40%	26/04/2021	25/04/2022
NBK International PLC	1,500,000	0.23%	27/07/2021	27/07/2022
Goldman Sachs International Bank	3,000,000	0.17%	02/08/2021	01/02/2022
Goldman Sachs International Bank	2,000,000	0.185%	04/08/2021	04/02/2022
NBK International PLC	2,000,000	0.12%	04/08/2021	04/02/2022
NBK International PLC	1,500,000	0.06%	16/08/2021	20/10/2021
Coventry Building Society	1,000,000	0.02%	01/09/2021	24/11/2021
Skipton Building Society	5,000,000	0.02%	01/09/2021	20/10/2021
Santander UK PLC	2,000,000	0.08%	14/09/2021	14/03/2022
Coventry Building Society	1,500,000	0.02%	15/09/2021	24/11/2021
Santander UK PLC	2,000,000	0.08%	23/09/2021	22/03/2022

4.4 The Council received an average return of 0.15% on investments during the first six months of 2021/22, down from 0.42% at the same point in the previous year. Returns during the early part of 2021/22 were bolstered by maturing investments made prior to the drop in interest rates in March 2020, and so this rate isn’t representative of the interest rates on offer during that time. In contrast to this, the 0.15% achieved so far in 2021/22 fully reflects the low rates on offer following the drop in Bank Rate to 0.1% in March 2020 and a drop off in demand in the local authority market. Performance is expected to improve slightly in the second half of 2021/22 if recent increases to interest rates continue.

4.5 The Council currently has £5m deposited with the CCLA (Churches, Charities and Local Authorities) commercial property fund, which pays dividends quarterly. For the first two quarters of 2021/22, dividends of 3.64% were received, down slightly from 3.67% for the same period in 2020/21. The dividend payout remained consistent from Q1 to Q2, and there has been a small increase in fund value during 2021 after reductions seen in the previous year due to the Covid-19 pandemic.

5.0 Borrowing Requirements and Prudential Indicators

5.1 The Council has no short-term borrowing but has existing PWLB loans of £36.176m as at 30 September 2021, in addition to £2.436m in finance leases.

5.2 The Council’s revised capital financing requirement (CFR) for 2021/22 is £63.885m. The CFR denotes the Council’s underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Table 4.6 shows the Council has forecast borrowings at 31 March 2022 of £37.542m, and so will have utilised £26.343m of cash flow funds in lieu of borrowing to finance the CFR of £63.885m shown in table 4.5.

5.3 There has so far been no new borrowing in 2021/22, and it is expected that there will not be a need for new borrowing before the end of the financial year. This is a reduction in the level of borrowing forecast at the start of the year, which originally stood at £9.13m, and is mainly due to the impact of the pandemic on the deliverable Capital Programme.

5.4 The Treasury Management Strategy Statement (TMSS) for 2021/22 was approved by Cabinet on 24 February 2021. The underlying TMSS approved previously requires revision in light of a revised deliverable Capital Programme for 2021/22. The proposed changes are set out below:

Prudential Indicator 2021/22	Original £000	Revised Prudential Indicator £000
Authorised Limit	91,000	74,000
Operational Boundary	82,000	65,000
Capital Financing Requirement	80,543	63,885

5.5 The table below shows a breakdown of the revised CFR.

Prudential Indicator – Capital Financing Requirement	2021/22 Original Estimate £000	2021/22 Revised Estimate £000
CFR – Non Housing	11,874	9,676
CFR – Housing	43,406	38,681
CFR – Commercial Activities / Non-Financial Investments	25,263	15,528
Total CFR	**80,543**	**63,885**
Net movement in CFR	**21,958**	**7,880**

5.6 The table below shows the expected debt position at 31 March 2022, which determines the Operational Boundary and Authorised Limit shown in 4.4 above.

Prudential Indicator – External Debt	2021/22 Original Estimate £000	2021/22 Revised Estimate £000
Borrowing	46,234	35,234
Other Long Term Liabilities*	2,404	2,308
Total Debt (Year End Position)	**48,638**	**37,542**

** Includes finance leases*

6.0 Annual Investment Strategy

6.1 Any fixed term investments in the market place (except Debt Management Office [DMO]) are restricted to a maximum term of two years (previously one year). The Council's substantial commitments (particularly the monthly precepts to Devon County Council, the Police and Fire Authority) constrain the term of investments. The Cabinet of 7 February 2019 resolved to diversify the investment portfolio to include non-UK banks with a minimum Sovereign Fitch rating of AAA (highest possible rating).

6.2 The Council will continue to have regard to the MHCLG's Guidance on Local Government Investments ("the Guidance") issued in April 2018 (3rd Edition) and CIPFA's Treasury Management in Public Services Code of Practice and Cross Sectorial Guidance Notes ("the CIPFA Treasury Management Code").

7.0 Lending Criteria and Counterparty Limits

7.1 The current policy allows the lending of funds to be deposited with major UK banks and building societies with an investment period no longer than two years and where the counterparty is required to meet the following ratings requirements: Banks (Fitch F1, F1+) and for building societies based upon a minimum Fitch rating of F1 and an asset base level of at least £1bn. The maximum lending limit to any group counterparty is £5m. The policy includes investments with CCLA property fund and money market funds with a limit of £2m on this option. Note that delegation was provided to the S151 officer and Finance Portfolio Holder in 2011/12 to make reactive decisions when market conditions changed due to volatility in rating changes when our own bankers, NatWest, were downgraded, along with other part nationalised banks. We do not invest any term deposits with the Royal Bank of Scotland Group and only have our call accounts with them.

7.2 Officers would recommend a continuation of the existing policy for investments with banks and building societies, property funds and money market funds.

7.3 In addition to these fixed term deposits, the Council also uses an instant access liquidity account with NatWest (the Council's banker) to sweep any small surplus funds which cannot be placed by our brokers. Again, this account will be subject to the same £5m maximum deposit level, plus the balance of any Covid-19 grant funds.

7.4 The Council will also continue to lend to:

- Local Authorities, Police, Fire & Rescue, Parish Councils and other Public Bodies
- UK Government (including gilts, Treasury Bills and the DMADF)
- Other Bodies.

7.5 The investments that can be made to the organisations stated in paragraph 6.4, will not be constrained to a maximum deposit of £5m due to their lower level of risk. However, other bodies have a monetary limit of £3m.

8.0 Conclusion

8.1 The first half-year performance has been affected by continued low interest rates, however the end of the period has seen some small increases that are expected to continue through the second half of the year. Investment income has been bolstered by the interest received from 3 Rivers Developments Limited being largely unaffected by the reduction in interest rates. The Council's investment in the CCLA property fund saw a slight reduction to quarterly dividends at the start of the pandemic, but have remained stable since and continue to provide a high rate of return in comparison to short term investments.

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