South Derbyshire District Council

Treasury Management Annual Report 21/22

Introduction

The Authority has 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 of the Authority on 24th February 2021. The Authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk remains central to the Authority's treasury management strategy.

The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 18th March 2021.

The detail that follows is in accordance with the CIPFA Code and is written with support from the Council's Treasury Advisor, Arlingclose.

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.

The Bank of England (BoE) increased 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.

The 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 2022, the Authority had net investments of £20.498m arising from its revenue and capital income and expenditure an increase on net investments from 2021 of £3.032m. 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 the table below.

Capital Financing Requirement (CFR)	21/22 £'000 Actual
CFR b/fwd	66,251
Add New Financing	0
Less MRP	-182
Less VRP	-76
Less Debt Repayment	-10,000
CFR c/fwd	55,993
General Fund Proportion	4,409
HRA Proportion	51,584
Total CFR	55,993

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 at 31st March 2022 and the year on year change is shown in the table below

Treasury management position

	31.3.21 Balance £m	Movement £m	31.03.22 Balance £m	Average Rate %
Long-term borrowing: Fixed	**47,423**	**0**	**47,423**	**3.19**

Variable Short-term borrowing	**10,000** **89**	**(10,000)** **0**	**0** **89**	**0** **0**
Total borrowing	**57,512**	**(10,000)**	**47,512**	
Long-term investments Short-term investments Cash and cash equivalents	**4,000** **57,500** **(956)**	**0** **2,500** **4,966**	**4,000** **60,000** **4,010**	**3.53** **0.25** **0.20**
Total investments	**60,544**	**7,466**	**68,010**	
Net investments	**3,032**	**17,466**	**20,498**	

The net investments of the Council increased during 2021/22 due to an increase in investments. A £5.9m grant was received on 30th March 2022 for Council Tax rebates to help protect households for rising energy costs. This receipt was invested with the DMO. Furthermore, lower expenditure and budget savings in year resulted in larger cash balances to invest which is reflected below.

The first instalment of £10m was paid on 28th March 2022 to PWLB resulting in a reduction in total borrowing.

Borrowing Update

The Authority was not planning to borrow to invest primarily for commercial return and so is unaffected by the changes to the Prudential Code.

Borrowing Strategy

At 31st March 2022 the Authority held £47.4m of loans a decrease of £10m from 31st March 2021 due to the first instalment payment of the principle amount.

These loans were taken out by the Authority in 2011/12 for the purpose of HRA self-financing. The principal element of these loans is repayable in full on maturity, with interest being paid each March and September.

The short-term borrowing of £89k relates to deposits received from two Parish Councils within the District. These loans can be recalled on immediate notice. Interest is calculated at the Bank of England Base Rate, less 1%. No interest is currently being paid due to the Base Rate being less than 1%.

The following table shows the maturity dates of the loans and rate of interest payable.

Borrowing Position

Loan Profile	**Type**	**Value £'000**	**Rate %**	**Maturity**
Public Works Loan Board	Fixed	10,000	2.70	2023/24
Public Works Loan Board	Fixed	10,000	3.01	2026/27

Public Works Loan Board	Fixed	10,000	3.30	2031/32
Public Works Loan Board	Fixed	10,000	3.44	2036/37
Public Works Loan Board	Fixed	7,423	3.50	2041/42
Total Long-term borrowing		**47,423**		
Short-term Parish Council Loans		**89**	0.00	
Total borrowing		**47,512**		

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.

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 £52m and £77.5m million due to timing differences between income and expenditure. The investment position is shown below.

During the year the Authority received central government funding to support small and medium businesses during the coronavirus pandemic through grant schemes. £4.53m was received for Restart Grants and Omicron Hospitality & Leisure Grants, which were temporarily invested in short-dated, liquid instruments such as call accounts and Money Market Funds. £4.68m was disbursed by the end of March 2022 with the balance topped up by the Government in May 2022.

Treasury Investment Position

Investments	31.03.21 Balance £'000	2022 Movement £'000	31.03.22 Balance £'000	31.03.22 Rate of Return %
Banks (unsecured)	(956)	4,966	4,010	0.20
Local Authorities	44,000	8,000	52,000	0.25
Money Market Funds	13,500	(5,500)	8,000	0.06
CCLA Property Fund	4,000	0	4,000	3.53
Total investments	**60,544**	**7,466**	**68,010**	

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. At 31st March, the 1-day return on the Authority's MMFs ranged between 0.51% - 0.54% p.a.

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. The average return on the Authority's DMADF deposits was 0.05%.

Given the increasing risk and low returns from short-term unsecured bank investments, the Authority has diversified into higher yielding asset classes (CCLA fund) and continues to hold £4m in the pooled property fund

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking below.

<u>Investment Benchmarking – Treasury investments managed in-house (excludes CCLA)</u>

	Credit Score	**Credit Rating**	**Bail-in Exposure**	**Weighted Average Maturity (days)**	**Rate of Return %**
31.03.2022	4.28	AA-	19%	107	1.55
Similar LAs	4.37	AA-	61%	43	2.38
All LAs	4.39	AA-	60%	14	2.10

Benchmarking Key:

Credit Score	This is a value weighted average score calculated by weighting the credit score of each investment by its value. A higher number indicates a higher risk.
Credit Rating	This is based on the long-term rating assigned to each institution in the portfolio, by ratings agencies Fitch, Moody's and Standard & Poor's. Ratings rang from AAA to D, and can be modified by +/
Bail in Exposure	The adoption of a bail in regime for failed banks results in a potential increased risk of loss of funds for local authority should this need to be implemented. Therefore, a lower exposure to bail in investments reduces this risk.

Weighted Average Maturity	This is an indicator of the average duration of the internally managed investments. Similar authorities have a similar profile to South Derbyshire; other larger authorities tend to hold a greater proportion of fund in money markets than fixed term deposits with other LAs, due to their cash flow requirements.

Externally Managed Pooled Funds: £4m of the Authority's investments is invested in externally managed strategic pooled 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 income return of £139,622 which is used to support services in year.

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 income funds in the Authority's portfolio. The prospect of higher inflation and rising bond yields did however result in muted bond fund performance. 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 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 performance of the investment over the year is shown in the table below.

CCLA Property Fund Performance

		2020/21	**2021/22**
		Q4	**Q4**
Dividend Received	£	37,084	34,693
Annual Equivalent Interest Rate	%	4.12%	3.28%
Bid (Selling) Price	pence/unit	289.08	339.82

The mid-market value of the CCLA Property Fund as at the 31st March 2022 is £4,295,917 and the bid market value is £4,229,332 with the total number of units held being 1,244,580.

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 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. In light of their performance over the medium/long-term and the Authority's latest cash flow forecasts, investment in these funds has been maintained.

Performance Indicators

The main indicator the Council uses to measure its return on short-term investments to average over the year, is the Average 7-Day Money Market Rate. This is a standard measure of performance. Performance for the last year is shown below.

	As at 31.03.21	As at 31.03.22
Average 7-Day Money Market Rate (Target)	0.11%	0.19%
Average Interest Rate Achieved on Short Term Deposits	0.13%	0.26%

Compliance

The Chief Finance Officer 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 below.

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

Debt Limits

	Actual Debt 21/22	Operational Boundary	Authorised Limit
Debt Limits	**£'000**	**£'000**	**£'000**
HRA	47,423	47,423	66,853
General Fund	0	5,000	4,409

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. The total debt for the year did not exceed the operational boundary.

Compliance with specific investment limits is demonstrated in the table below:

Investment Limits

Sector	2021/22 Maximum	Counterparty Limit	Time Limit	Sector Limit	Complied
The UK Government	£20m	£25m	364 days	n/a	✓
Local authorities & other government entities	£46m	£5m	364 days	Unlimited	✓

Banks (unsecured)*	£2.8m	£3m	35 days	Unlimited	✓
Building societies (unsecured)*	£2m	£2m	35 days	£5m	✓
Money Market Funds*	£14m	£2m	60 days	£14m	✓
Strategic Pooled Funds	£4m	£4m	n/a	£4m	✓
Other Investments*	0	£1m	35 days	Unlimited	✓

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 2024.