South Derbyshire District Council

Treasury Management Annual Report 20/21

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 2020/21 was approved at a meeting of the Authority on 26th February 2020. 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 are therefore 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 was marginally updated and approved by Finance and Management Committee on 18th March 2021 after full approval at Council on 19th January 2019.

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 coronavirus pandemic dominated 2020/21, leading to almost the entire planet being in some form of lockdown during the year. The start of the financial year saw many central banks cutting interest rates as lockdowns caused economic activity to grind to a halt. The Bank of England cut Bank Rate to 0.1% and the UK government provided a range of fiscal stimulus measures, the size of which has not been seen in peacetime.

Some good news came in December 2020 as two COVID-19 vaccines were given approval by the UK Medicines and Healthcare products Regulatory Agency (MHRA). The UK vaccine rollout started in earnest; over 31 million people had received their first dose by 31st March.

A Brexit trade deal was agreed with only days to spare before the 11pm 31st December 2020 deadline having been agreed with the European Union on Christmas Eve.

The Bank of England (BoE) held Bank Rate at 0.1% throughout the year but extended its Quantitative Easing programme by £150 billion to £895 billion at its November 2020 meeting. In its March 2021 interest rate announcement, the BoE noted that while GDP would remain low in the near-term due to COVID-19 lockdown restrictions, the easing of these measures means growth is expected to recover strongly later in the year. Inflation is forecast to increase in the near-term and while the economic outlook has improved there are downside risks to the forecast, including from unemployment which is still predicted to rise when the furlough scheme is eventually withdrawn.

Government initiatives supported the economy and the Chancellor announced in the 2021 Budget a further extension to the furlough (Coronavirus Job Retention) scheme until September 2021. Access to support grants was also widened, enabling more self-employed people to be eligible for government help. Since March 2020, the government schemes have help protect more than 11 million jobs.

Despite the furlough scheme, unemployment still rose. Labour market data showed that in the three months to January 2021 the unemployment rate was 5.0%, in contrast to 3.9% recorded for the same period 12 months ago. Wages rose 4.8% for total pay in nominal terms (4.2% for regular pay) and was up 3.9% in real terms (3.4% for regular pay). Unemployment is still expected to increase once the various government job support schemes come to an end.

Inflation has remained low over the 12-month period. Latest figures showed the annual headline rate of UK Consumer Price Inflation (CPI) fell to 0.4% year/year in February, below expectations (0.8%) and still well below the Bank of England's 2% target. The ONS' preferred measure of CPIH which includes owner-occupied housing was 0.7% year/year (1.0% expected).

After contracting sharply in Q2 (Apr-Jun) 2020 by 19.8% q/q, growth in Q3 and Q4 bounced back by 15.5% and 1.3% respectively. The easing of some lockdown measures in the last quarter of the calendar year enabled construction output to continue, albeit at a much slower pace than the 41.7% rise in the prior quarter. When released, figures for Q1 (Jan-Mar) 2021 are expected to show a decline given the national lockdown.
After collapsing at an annualised rate of 31.4% in Q2, the US economy rebounded by 33.4% in Q3 and then a further 4.1% in Q4. The US recovery has been fuelled by three major pandemic relief stimulus packages totalling over $5 trillion. The Federal Reserve cut its main interest rate to between 0% and 0.25% in March 2020 in response to the pandemic and it has remained at the same level since. Joe Biden became the 46th US president after defeating Donald Trump.

The European Central Bank maintained its base rate at 0% and deposit rate at -0.5% but in December 2020 increased the size of its asset purchase scheme to €1.85 trillion and extended it until March 2022.
Financial markets: Monetary and fiscal stimulus helped provide support for equity markets which rose over the period, with the Dow Jones beating its pre-crisis peak on the back of outperformance by a small number of technology stocks. The FTSE indices performed reasonably well during the period April to November, before being buoyed in December by both the vaccine approval and Brexit deal, which helped give a boost to both the more internationally focused FTSE 100 and the more UK-focused FTSE 250, however they remain lower than their pre-pandemic levels.

Ultra-low interest rates prevailed throughout most of the period, with yields generally falling between April and December 2020. From early in 2021 the improved economic outlook due to the new various stimulus packages (particularly in the US), together with the approval and successful rollout of vaccines, caused government bonds to sell off sharply on the back of expected higher inflation and increased uncertainty, pushing yields higher more quickly than had been anticipated.
The 5-year UK benchmark gilt yield began the financial year at 0.18% before declining to -0.03% at the end of 2020 and then rising strongly to 0.39% by the end of the financial year. Over the same period the 10-year gilt yield fell from 0.31% to 0.19% before rising to 0.84%. The 20-year declined slightly from 0.70% to 0.68% before increasing to 1.36%.

1-month, 3-month and 12-month SONIA bid rates averaged 0.01%, 0.10% and 0.23% respectively over the financial year.

The yield on 2-year US treasuries was 0.16% at the end of the period, up from 0.12% at the beginning of January but down from 0.21% at the start of the financial year. For 10-year treasuries the end of period yield was 1.75%, up from both the beginning of 2021 (0.91%) and the start of the financial year (0.58%).

German bund yields continue to remain negative across most maturities.

Credit review: After spiking in March 2020, credit default swap spreads declined over the remaining period of the year to broadly pre-pandemic levels. The gap in spreads between UK ringfenced and non-ringfenced entities remained, albeit Santander UK is still an outlier compared to the other ringfenced/retail banks. At the end of the period Santander UK was trading the highest at 57bps and Standard Chartered the lowest at 32bps. The other ringfenced banks were trading around 33 and 34bps while Nationwide Building Society was 43bps.

Credit rating actions to the period ending September 2020 have been covered in previous outturn reports. Subsequent credit developments include Moody's downgrading the UK sovereign rating to Aa3 with a stable outlook which then impacted a number of other UK institutions, banks and local government. In the last quarter of the financial year S&P upgraded Clydesdale Bank to A- and revised Barclay's outlook to stable (from negative) while Moody's downgraded HSBC's Baseline Credit Assessment to baa3 whilst affirming the long-term rating at A1.

The vaccine approval and subsequent rollout programme are both credit positive for the financial services sector in general, but there remains much uncertainty around the extent of the losses banks and building societies will suffer due to the economic slowdown which has resulted due to pandemic-related lockdowns and restrictions. The institutions and durations on the Authority's counterparty list recommended by treasury management advisors Arlingclose remain under constant review, but at the end of the period no changes had been made to the names on the list or the recommended maximum duration of 35 days.

Local Context

On 31st March 2021, the Authority had net borrowing of (£3.03M) arising from its revenue and capital income and expenditure a decrease on net borrowing from 2020 of £10.5M. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR). Actual CRF versus budgeted CFR is summarised below:

Capital Financing Requirement (CFR)	20/21 £'000 Actual
CFR b/fwd	66,572
Add New Financing	0
Less MRP	-197
Less VRP	-131
Less Debt Repayment	0
CFR c/fwd	66,251
General Fund Proportion	4,667
HRA Proportion	61,584
Total CFR	66,251

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's current strategy is to maintain 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 as at the 31st March 2021 and the year on year change is shown in the table below:

Treasury management position

	31.3.20 Balance £m	Movement £m	31.03.21 Balance £m	Average Rate %
Long-term borrowing:				
Fixed	**47,423**	**0**	**47,423**	**3.19%**
Variable	**10,000**	**0**	**10,000**	**0.35%**
Short-term borrowing	**28**	**61**	**89**	**0.00%**
Total borrowing	**57,451**	**61**	**57,512**	
Long-term investments	**4,000**	**0**	**4,000**	**4.47%**
Short-term investments	**43,350**	**14,150**	**57,500**	**0.29%**
Cash and cash equivalents	**2,561**	**(3,517)**	**(956)**	**0.07%**
Total investments	**49,911**	**10,633**	**60,544**	
Net borrowing	**7,540**	**10,572**	**(3,032)**	

The net borrowing of the Council reduced during 2020/21 due to an increase in investments. Government Grant income, lower expenditure and budget savings in year resulted in larger cash balances to invest which is reflected below.

Borrowing Update

In November 2020 the PWLB published its response to the consultation on 'Future Lending Terms'. From 26th November the margin on PWLB loans above gilt yields was reduced from 1.8% to 0.8% providing that the borrowing authority can confirm that it is not planning to purchase 'investment assets primarily for yield' in the current or next two financial years. 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. As part of the borrowing process authorities will now be required to submit more detailed capital expenditure plans with confirmation of the purpose of capital expenditure from the Section 151 Officer. The PWLB can now also restrict local authorities from borrowing in unusual or large amounts.

Acceptable use of PWLB borrowing includes service delivery, housing, regeneration, preventative action, refinancing and treasury management. Misuse of PWLB borrowing could result in the PWLB requesting that Authority unwinds problematic transactions, suspending access to the PWLB and repayment of loans with penalties.

Competitive market alternatives may be available for authorities with or without access to the PWLB. However, the financial strength of the individual authority and borrowing purpose will be scrutinised by commercial lenders.

Borrowing Strategy

At 31st March 2021 the Authority held £57.4m of loans. 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	Variable	10,000	0.23	2021/22
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		**57,423**		
Short-term Parish Council Loans		**89**	0.00	
Total borrowing		**57,512**		

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

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 £49.9

million and £60.4 million due to timing differences between income and expenditure. The investment position is shown in the table below.

Treasury Investment Position

Investments	31.03.20 Balance £'000	2021 Movement £'000	31.03.21 Balance £'000	31.03.21 Rate of Return %
Banks (unsecured)	2,561	(3,517)	(956)	0.00
Local Authorities	40,350	3,650	44,000	0.29
Money Market Funds	3,000	10,500	13,500	0.08
CCLA Property Fund	4,000	0	4,000	4.47
Total investments	**49,911**	**10,633**	**60,544**	

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.

Continued downward pressure on short-dated cash rate brought net returns on sterling low volatility net asset value money market funds (LVNAV MMFs) close to zero even after some managers have temporarily lowered their fees. At this stage net negative returns are not the central case of most MMF managers over the short-term, and fee waivers should maintain positive net yields, but the possibility cannot be ruled out.

Deposit rates with the Debt Management Account Deposit Facility (DMADF) have continued to fall and are now largely around zero.

The net return on Money Market Funds net of fees, which had fallen after Bank Rate was cut to 0.1% in March, are now at or very close to zero; fund management companies have temporarily lowered or waived fees to avoid negative net returns.

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 table below.

Investment Benchmarking – Treasury investments managed in-house (excludes CCLA)

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2021	4.48	AA-	29%	84	0.41
Similar LAs	4.63	A+	65%	40	1.38
All LAs	4.63	A+	63%	15	0.90

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 Funds:

The Council has invested £4m 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 £157K which is used to support services in year.

Similar to many other property funds, dealing (i.e. buying or selling units) in the CCLA Local Authorities' Property Fund was suspended by the fund in March 2020 and lifted in September. There was also a change to redemption terms for the CCLA Local Authorities Property Fund; from September 2020 investors are required to give at least 90 calendar days' notice for redemptions.

The performance of the investment over the year is shown in the table below.

CCLA Property Fund Performance

		2019/20 Q4	2020/21 Q4
Dividend Received	£	40,484	37,084
Annual Equivalent Interest Rate	%	4.57	4.12%
Bid (Selling) Price	pence/unit	291.15	289.08

The mid-market value of the CCLA Property Fund as at the 31st March 2021 is £3,654,460 and the bid market value is £3,597,831 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 is 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 31.03.20	As at 31.03.21
Average 7-Day Money Market Rate (Target)	0.65%	0.11%
Average Interest Rate Achieved on Short Term Deposits	0.66%	0.13%

Compliance

The Chief Finance Officer reported that during the third quarter of 20/21 treasury management activities did not fully comply with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy.

To mitigate the risk of a further breach the cash limits were increased following Committee approval on the 26th November 2020. The limit was increased in the Councils current account Barclays to £3 million and 3 new Money Market Funds were opened increasing the limit to £14 million.

No further breaches were suffered as a result of the Counterparty limit changes.

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

Debt Limits

Debt Limits	Actual Debt 20/21 £'000	Operational Boundary £'000	Authorised Limit £'000
HRA	57,423	57,423	66,853
General Fund	0	5,000	4,988

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	Maximum Investment Q4 2021	Counterparty Limit	Time Limit	Sector Limit	Complied
The UK Government	£19m	£20m	364 days	n/a	✓
Local authorities & other government entities	£42m	£5m	364 days	Unlimited	✓
Banks (unsecured)*****	£2.7m	£3m	35 days	Unlimited	✓
Building societies (unsecured)*****	£4m	£2m	35 days	£5m	✓
Money Market Funds*****	£13.5m	£2m	60 days	£14m	✓
Strategic Pooled Funds	£4m	£4m	n/a	£4m	✓
Other Investments*	0	£1m	35 days	Unlimited	✓

Other

CIPFA consultations: In February 2021 CIPFA launched two consultations on changes to its Prudential Code and Treasury Management Code of Practice. These follow the Public Accounts Committee's recommendation that the prudential framework should be further tightened following continued borrowing by some authorities for investment purposes. These are principles-based consultations and will be followed by more specific proposals later in the year.

In the Prudential Code the key area being addressed is the statement that "local authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed". Other proposed changes include the sustainability of capital expenditure in accordance with an authority's corporate objectives, i.e. recognising climate, diversity and innovation, commercial investment being proportionate to budgets, expanding the capital strategy section on commercial activities, replacing the "gross debt and the CFR" with the liability benchmark as a graphical prudential indicator.

Proposed changes to the Treasury Management Code include requiring job specifications and "knowledge and skills" schedules for treasury management roles to be included in the Treasury Management Practices (TMP) document and formally reviewed, a specific treasury management committee for MiFID II professional clients and a new TMP 13 on Environmental, Social and Governance Risk Management.

IFRS 16: The implementation of the new IFRS 16 Leases accounting standard has been delayed for a further year until 2022/23.