South
Derbyshire
District Council

Treasury Management Report Q3 2021/22

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 23rd February 2022. 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, complying with CIPFA's requirement, was approved by full Council on 23rd February 2022.

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

Economic background: The economic recovery from coronavirus pandemic, together with higher inflation and higher interest rates were major issues over the period.

The Bank of England (BoE) increased Bank Rate to 0.25% in December 2021 but maintained its Quantitative Easing programme at £895 billion. The Monetary Policy Committee (MPC) voted 8-1 in favour of raising rates, and unanimously to maintain the asset purchase programme.

Within the announcement the MPC noted that the pace of the global recovery was broadly in line with its November Monetary Policy Report. Prior to the emergence of the Omicron coronavirus variant, the Bank also considered the UK economy to be evolving in line with expectations, however the increased uncertainty and risk to activity the new variant presents, the Bank revised down its estimates for Q4 GDP growth to 0.6% from 1.0%. Inflation was projected to be higher than previously forecast, with CPI likely to remain above 5% throughout the winter and peak at 6% in April 2022. The labour market was generally performing better than previously forecast and the BoE now expects the unemployment rate to fall to 4% compared to 4.5% forecast previously, but notes that Omicron could weaken the demand for labour.

UK CPI for November 2021 registered 5.1% year on year, up from 4.2% in the previous month. Core inflation, which excludes the more volatile components, rose to 4.0% y/y from 3.4%. The most recent labour market data for the three months to October 2021 showed the unemployment rate fell to 4.2% while the employment rate rose to 75.5%.

Government support in the form of the furlough scheme ended on 30th September 2021 but the subsequent impact on jobs appears to have been more muted than previously been feared. In October 2021, the headline 3-month average annual growth rate for wages were 4.9% for total pay and 4.3% for regular pay. In real terms, after adjusting for inflation, total pay growth was up 1.7% while regular pay was up 1.0%. The change in pay growth has been affected by a change in composition of employee jobs, where there has been a fall in the number and proportion of lower paid jobs.

Gross domestic product (GDP) grew by 1.1% in the third calendar quarter of 2021 according to the final estimate (initial estimate 1.3%), compared to a gain of 5.4% q/q in the previous quarter, with the annual rate slowing to 6.8% from 23.6%. The data however predates the escalation in virus infections caused by the Omicron variant in December which will very likely result in a slowdown in activity in Q4.

GDP growth in the euro zone increased by 2.2% in calendar Q3 2021 following an upwardly revised gain of 2.2% in the second quarter and decline of -0.2% in the first. Headline inflation has been strong, with CPI registering 5.0% year-on-year in December, the sixth successive month of inflation. Core CPI inflation was 2.6% y/y in December, unchanged from November but well up from July's recent low of 0.7% y/y. At these levels, inflation is above the European Central Bank's target of 'below, but close to 2%', putting some pressure on its long-term stance of holding its main interest rate of 0%.

The US economy expanded at an upwardly revised annualised rate of 2.3% in Q3 2021, slowing sharply from gains of 6.7% and 6.3% respectively in the previous two quarters. In its December 2021 interest rate announcement, the Federal Reserve continue to maintain the Fed Funds rate at between 0% and 0.25% but outlined its plan to reduce its asset purchase programme earlier than previously stated and signalled they are in favour of tightening interest rates at a faster pace in 2022, with three 0.25% movements now expected.

Financial markets: Ongoing monetary and fiscal stimulus together with rising economic growth supported equity markets over the period, but higher inflation and the prospect of higher interest rates mixed with a new coronavirus variant ensured it was a bumpy period. The Dow Jones hit another record high during the quarter 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 dominated bond yield movements over the period as initial expectations for transitory price increases turned into worries higher inflation was likely to persist for longer meaning central bank action was likely to start sooner and rates increase at a faster pace than previously thought.

The 5-year UK benchmark gilt yield began the quarter at 0.62% before rising to 0.82%. Over the same period the 10-year gilt yield fell from 1.00% to 0.97% and the 20-year yield declined from 1.35% to 1.20%.

The Sterling Overnight Rate (SONIA) averaged 0.07% over the quarter.

Credit review: Relatively benign credit conditions caused credit default swap (CDS) prices for the larger UK banks to remain low and had steadily edged down throughout the year up until mid-November when the emergence of Omicron has caused them to rise modestly but have since continued their downward trajectory.

The pronounced gap in spreads between UK ringfenced and non-ringfenced entities continued to narrow and has now all but disappeared. At the end of the period Barclays Bank Plc was trading the highest at 53bps and Santander UK Plc the lowest at 26bps. The other ringfenced banks were trading between 34-37bps and Nationwide Building Society was 44bps.

There were a small number of credit rating and outlook changes over the period with Moody's downgrading DZ Bank to Aa2 and upgrading Co-operative Bank to Ba3 while Fitch revised the outlook on Australia and Rabobank to stable and S&P upgraded Nationwide BS, Standard Chartered Bank and Danske Bank to A+.

The ongoing vaccine rollout programme is credit positive for the financial services sector in general but there remains uncertainty around the full extent of the losses banks and building societies will suffer due to the pandemic-related economic slowdown, but 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 for UK and non-UK institutions whereby the maximum duration for all recommended counterparties were extended to 100 days.

As ever, the institutions and durations on the Authority's counterparty list recommended by treasury management advisors Arlingclose remain under constant review.

Local Context

On 31st March 2021, the Authority had net borrowing of (£3.032m) arising from its revenue and capital income and expenditure. This fell to (£22.409M) by the end of the quarter. 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 below.

Capital Financing Requirement (CFR)

	31.03.21 Actual £,000	**31.12.21 Actual £'000**
Housing Revenue Account		
Debt Outstanding	57,423	57,423
Capital Financing Requirement (CFR)	61,584	61,584
Statutory Debt Cap	66,853	66,853
Borrowing Capacity (Cap less Debt Outstanding)	**9,430**	**9,430**
General Fund		
Debt Outstanding	0	0

Capital Financing Requirement (CFR)	4,667	4,667
Borrowing Capacity (Cap less Debt Outstanding)	**4,667**	**4,667**
Total Capital Financing Requirement (CFR)	**66,251**	**66,251**

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 overall treasury management position as at 31st December 2021 and the change during the quarter is shown below.

Treasury Management Summary

	30.06.21 Balance £m	Movement £m	31.12.21 Balance £m	Average Rate %
Long-term borrowing:				
Fixed	47,423	0	47,423	3.19%
Variable	10,000	0	10,000	0.17%
Short-term borrowing	89	0	89	0.00%
Total borrowing	**57,512**	**0**	**57,512**	
Long-term investments	4,000	0	4,000	4.17
Short-term investments	53,500	19,000	72,500	0.09%
Cash and cash equivalents	3,213	289	3,502	0.00%
Total investments	**60,713**	**19,289**	**80,002**	
Net borrowing	**-3,201**	**-19,289**	**-22,490**	

Borrowing update

CIPFA published a revised Prudential Code for Capital Finance in Local Authorities on 20th December 2021. The Code took immediate effect although local authorities may defer introducing the revised reporting requirements until the 2023/24 financial year if they wish.

In order to comply with the Code, authorities must not borrow to invest primarily for financial return. The 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 Code with the PWLB which prohibits access to authorities planning to purchase 'investment assets primarily for yield' 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.

Municipal Bonds Agency (MBA): The MBA is working to deliver a new short-term loan solution, available in the first instance to principal local authorities in England, allowing them access to short-dated, low rate, flexible debt. The minimum loan size is expected to be £25 million. Importantly, local authorities will borrow in their own name and will not cross guarantee any other authorities.

If the Authority intends future borrowing through the MBA, it will first ensure that it has thoroughly scrutinised the legal terms and conditions of the arrangement and is satisfied with them.

UK Infrastructure Bank: £4bn has been earmarked for of lending to local authorities by the UK Infrastructure Bank which is wholly owned and backed by HM Treasury. There is an application and bidding process for these loans which is likely to favour environmental or regeneration projects. Loans will be available for qualifying projects at gilt yields plus 0.6%, which is 0.2% lower than the PWLB certainty rate. The first loan was made by this bank in October 2021 to Tees Valley Combined Authority.

Borrowing Strategy during the period

At 31st December 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	0.17	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.

In keeping with these objectives, no new borrowing was undertaken while £10m of existing loans will be allowed to mature without replacement. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

Treasury Investment Activity

During the last quarter the Authority has received £1.6m central government funding to offer out grant schemes to support small and medium businesses, and members of the public in isolation during the coronavirus pandemic. The additional funds received have been temporarily invested in short-dated, liquid instruments such as call accounts and Money Market Funds. The Authority has distributed £0.5m of these funds by the end of September.

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the quarter, the Authority's investment balance ranged between £60m and £70m, due to timing differences between income and expenditure. The investment position during the quarter is shown in the table below.

Treasury Investment Position

	31.03.21 Balance £'000	**Q3 2021 Movement £'000**	**31.12.21 Balance £'000**	**31.12.21 Rate of Return %**
Banks (unsecured)	-956	4,458	3,502	0.00%
Local Authorities	44,000	20,500	64,500	0.15%
Money Market Funds	13,500	-5,500	8,000	0.02%
CCLA Property Fund	4,000	0	4,000	4.17%
Total investments	**60,544**	**19,458**	**80,002**	

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 have been a feature since March 2020 when Bank Rate was cut to 0.1% have resulted in the return on sterling low volatility net asset value money market funds (LVNAV MMFs) being close to zero even after some managers have temporarily waived or 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) are also largely around zero.

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

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

Security benchmark

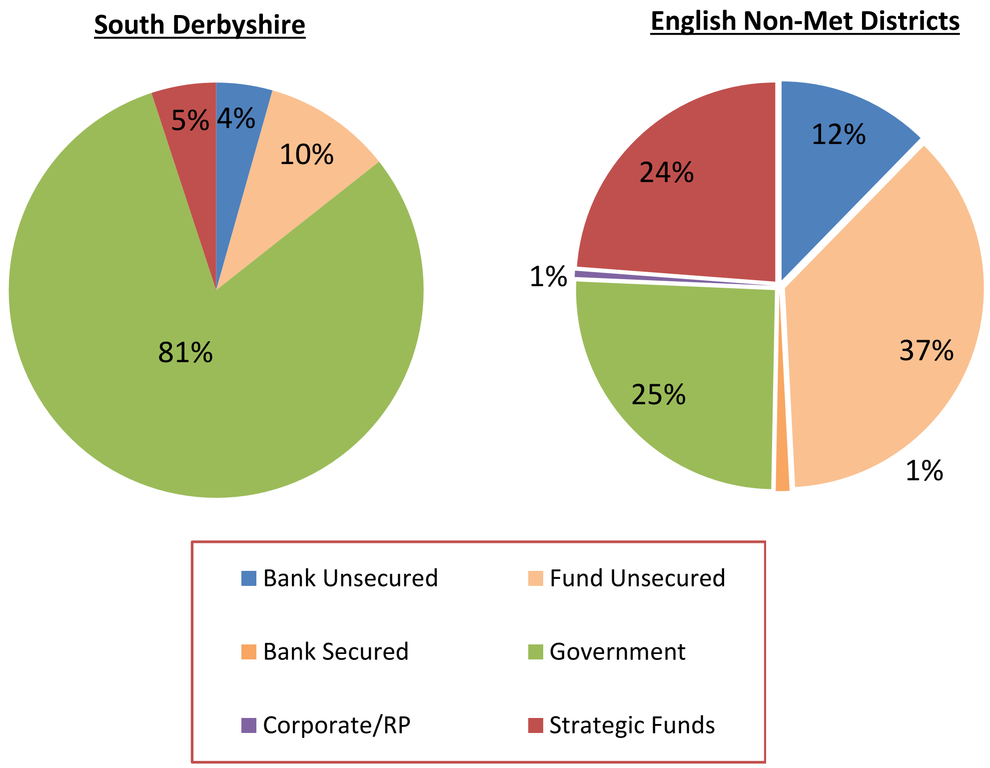
	Credit Score	**Credit Rating**	**Bail-in Exposure**	**Weighted Average Maturity (days)**	**Rate of Return %**
31.12.2021	4.34	AA-	15%	88	0.30%
Similar LAs	4.64	A+	68%	37	0.95%
All LAs	4.64	A+	66%	16	0.66 %

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.



This chart illustrates the type of investment funds held by the Council in comparison to other similar Local Authorities, this shows in greater detail, the comparisons in the bail in exposure and rate of return, on the above security benchmark table. The unsecured funds held by other Local Authorities is a much higher percentage of their investment portfolio, which will offer them a higher rate of return (0.95%), however the bail in exposure risk to funds is 69% of their total portfolio. The Council have invested their funds in much safer secured investments (Government) which my produce a smaller yield (0.38%) but the risk to Council funds is low at 15%.

Externally Managed Pooled Funds

£4m of the Authority’s investments are 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 are expected to generate an average return of £30k - £40k per quarter, its estimated £120k - £160k income return will be achieved this year, which is used to support services in year.

Because the Authority’s externally managed 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.

CCLA Property Fund Performance

		2021/22 Q1	2021/22 Q2	2021/22 Q3
Dividend Received	£	35,660	33,500	35,769
Annual Equivalent Interest Rate	%	3.83%	3.48%	3.54%
Bid (Selling) Price	pence/unit	298.98	309.24	324.83

The mid-market value of the fund as at the 31st December is £4,106,491 and the bid market value is £4,042,769. The quarters market and bid values have increased from September 21 by 8.64%. This reinforces the notion that the Fund should only be considered for long-term investments.

The authority's investment in the CCLA fund will remain stable throughout 21/22 with performance continuing to yield positive dividends.

Performance

Average 7 day Interest Rate

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 second quarter is shown below.

	As at 30.09.21	As at 31.12.21
Average 7-Day Money Market Rate (Target)	0.09%	0.06%
Average Interest Rate Achieved on Short Term Deposits	0.09%	0.09%

Cost of Debt

This indicator shows how much the costs of borrowing impact upon each household (at Band D Council Tax rate) in the District. The impact on Council Tax is positive as the General Fund has no actual debt. The performance for the first quarter is shown below using the current interest received and the estimated annual interest based on current returns. This is compared to the actual annual interest received last year.

General Fund Impact per Council Tax Payer	Actual 31.03.2021	Actual 31.12.21	Estimated 31.03.2022
	£'000	£'000	£'000
Net Interest Received - General Fund	-£247,667	-£87,116	-£150,052
Band D Properties	34,474	35,218	35,218

Cost per Band D Property	**-£7.18**	**-£2.47**	**-£4.26**

The cost of debt on each council tenant (HRA) is shown below. The performance for the first quarter is the actual costs compared to the estimated costs for the year. The fluctuation in interest paid is the decrease in interest rate of the £10m variable loan and the acquisition of new council houses.

HRA Debt Interest per Dwelling	**31.03.21 Actual**	**31.12.2021 Estimated**
HRA Interest Payable	1,540,408	1,521,944
Dwellings	2,974	2,974
Annual Cost per Dwelling	**£517.96**	**£511.75**

Compliance

The Chief Finance Officer reports that during the second quarter treasury management activities have fully complied with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy.

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

Investment limits

Sector	Maximum Investment Q3 2021	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)*****	£2.5m	£3m	35 days	Unlimited	✓
Building societies (unsecured)*****	£2m	£2m	35 days	£5%m	✓
Money Market Funds*****	£14m	£2m	60 days	£16m	✓
Strategic Pooled Funds	£4m	£4m	n/a	£4m	✓
Other Investments*	0	£1m	35 days	Unlimited	✓

Other Revisions to CIPFA Codes

CIPFA published revised Prudential and Treasury Management Codes in December 2021. The Prudential Code takes immediate effect although detailed reporting requirements may be deferred until the 2023/24 financial year and have thus not been included in this report. There is no mention of the date of initial application of the TM Code.

The accompanying guidance notes to the Codes including the treasury management prudential indicators have not yet been published. The main changes or expected changes from previous codes that have not already been discussed above include:

- Additional reporting requirements for the Capital Strategy.
- For service and commercial investments, in addition to assessments of affordability and prudence, an assessment of proportionality in respect of the Authority's overall financial capacity (i.e. whether plausible losses could be absorbed in budgets or reserves without unmanageable detriment to local services).
- Forward looking prudential code indicators must be monitored and reported to members at least quarterly.
- A new indicator for net income from commercial and service investments to net revenue stream.
- Inclusion of the liability benchmark as a treasury management prudential indicator. CIPFA recommends this is presented as a chart of four balances – existing loan debt outstanding;

loans CFR, net loans requirement, liability benchmark – over at least 10 years and ideally cover the authority's full debt maturity profile.

- Excluding investment income from the definition of financing costs.
- Credit and counterparty policies should set out the Authority's policy and practices relating to Environmental, Social and Governance (ESG) investment considerations.
- Additional focus on the knowledge and skills of officers and elected members involved in decision making.

Arlingclose's Outlook for the remainder of 2021/22 and beyond

	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk	0.00	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25

Arlingclose expects Bank Rate to rise again in Q1 2022. We believe the MPC will want to build on the strong message it delivered in December month by tightening policy despite Omicron uncertainty.

Arlingclose therefore expects Bank Rate to rise to 0.50% in Q1 2022, but then remain there. Risks to the forecast are initially weighted to the upside but becoming more balanced over time. The Arlingclose central forecast remains below the market forward curve.

Gilt yields are expected to remain broadly flat from current levels. Yields have fallen sharply at the longer end of the yield curve, but expectations of a rise in Bank Rate have maintained short term gilt yields at higher levels.

Easing expectations for Bank Rate over time could prompt the yield curve to steepen, as investors build in higher inflation expectations.

The risks around the gilt yield forecasts vary. The risk for short and medium term yields is initially on the upside but shifts lower later. The risk for long-term yields is weighted to the upside.

The global recovery from the pandemic has entered a more challenging phase. The resurgence in demand has led to the expected rise in inflationary pressure, but disrupted factors of supply are amplifying the effects, increasing the likelihood of lower growth rates ahead. The advent of the Omicron variant of coronavirus is affecting activity and is also a reminder of the potential downside risks.

Despite relatively buoyant activity survey data, official GDP data indicates that growth was weakening into Q4 2021. Other data, however, suggested continued momentum, particularly for November. Retail sales volumes rose 1.4%, PMIs increased, and the labour market continued to strengthen. The end of furlough did not appear to have had a significant impact on unemployment. Wage growth is elevated.

The CPI inflation rate rose to 5.1% for November and will rise higher in the near term. While the transitory factors affecting inflation are expected to unwind over time, policymakers' concern is persistent medium term price pressure.

These factors prompted the MPC to raise Bank Rate to 0.25% at the December meeting. Short term interest rate expectations remain elevated.

The outlook, however, appears weaker. Household spending faces pressures from a combination of higher prices and tax rises. In the immediate term, the Omicron variant has already affected growth – Q4 and Q1 activity could be weak at best.

Longer-term government bond yields remain relatively low despite the more hawkish signals from the BoE and the Federal Reserve. Investors are concerned that significant policy tightening in the near term will slow growth and prompt the need for looser policy later. Geo-political and coronavirus risks are also driving safe haven buying. The result is a much flatter yield curve, as short-term yields rise even as long-term yields fall.

The rise in Bank Rate despite the Omicron variant signals that the MPC will act to bring inflation down whatever the environment. It has also made clear its intentions to tighten policy further. While the economic outlook will be challenging, the signals from policymakers suggest their preference is to tighten policy unless data indicates a more severe slowdown.