# POLICY AND RESOURCES SCRUTINY COMMITTEE – INFORMATION ITEM

**SUBJECT:** TREASURY MANAGEMENT AND CAPITAL FINANCING PRUDENTIAL INDICATORS QUARTER 3 MONITORING REPORT (1ST APRIL 2021 TO 31ST DECEMBER 2021)

**REPORT BY:** CORPORATE DIRECTOR FOR EDUCATION AND CORPORATE SERVICES

## 1. PURPOSE OF REPORT

1.1 To present Members with details of Treasury Management activities and Capital Financing, together with the related Prudential Indicators for the period 1st April 2021 to 31st December 2021.

1.2 To review the Treasury Management Strategy for 2021/22 as set out in the Annual Investment Strategy and Capital Financing Prudential Indicators Report.

## 2. SUMMARY

2.1 The Code of Practice on Treasury Management in the Public Services 2009, which was adopted by the Council on 12th October 2010, sets out a framework of operating procedures, which is encompassed in the Treasury Management Practices (TMPs). TMP6 (Reporting Requirements and Management Information Arrangements) which requires the Authority to approve treasury management semi-annual and annual reports.

2.2 Under the provisions of the Local Government Act 2003, The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003 [The Capital Regulations], and the CIPFA's "The Prudential Code for Capital Finance in Local Authorities" [the Code], the Authority is obliged to approve and publish a number of indicators relevant to Capital Finance and Treasury Management.

2.3 The updated Prudential Code includes a new requirement for local authorities to provide a Capital Strategy, which is to be a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The capital strategy for 2021/22 was submitted to Full Council on the 24th February 2021.

2.4 The Authority's Annual Treasury Strategy and Capital Financing Prudential Indicators for 2021/22 were also approved by Council on the 24th February 2021.

## 3. RECOMMENDATIONS

3.1 Members are asked to note the contents of this report.

## 4. REASONS FOR THE RECOMMENDATIONS

4.1 Compliance with the CIPFA “Code of Practice for Treasury Management in the Public Services”.

## 5. THE REPORT

### 5.1 Treasury Management

5.1.1 Borrowing Activity

The current policy of internal borrowing is not sustainable in the long-term, but where prudent the policy of internal borrowing will be utilised. As at the 31st March 2021 the internal borrowing position was £72m.

The Annual Treasury Management Strategy was approved by Council in February 2021. As part of the strategy approval was given to borrow £37.2m in 2021/22 to part fund the General Fund capital programme if required. A further £52.0m was approved for the HRA to fund the WHQS and Affordable Housing capital programme. The only external borrowing during the reporting period was a further drawdown of £827k from the Salix Loan Facility. Total Salix drawn down to date is £4.1m.

During the period covered by this report, PWLB loans to the value of £3.7m were repaid on maturity. Such loans had an average interest rate of 4.42%. £30k of the WRU Loan and £258k of the Salix Loan was repaid. Total debt outstanding as at 31st December 2021 was £314.4m and comprised of £250.5m PWLB loans; £30m market loans (LOBOs); £10m Bank loan; £20m WG loan, £60k WRU loan; and a £3.9m Salix Energy Finance loan.

With respect to LOBO loans the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. During the reporting period our total LOBO portfolio with a value of £30m had a rate option reviewed, and the lenders chose not to exercise the option. LOBO loans will be further reviewed again later in 2021/22 by lenders, with our total LOBO portfolio of £30m exposed to variable interest rate movement. This represents 9.5% of the Authority’s debt portfolio, which is exposed to interest rate risk. The Authority acknowledges there is an element of refinancing risk.

5.1.2 Rescheduling

The Annual Strategy allows for the utilisation of debt rescheduling providing for both in year and future year savings and additional revenue resources. No rescheduling opportunities were utilised during the period covered by this report.

5.1.3 Investments

During the reported period the Authority was holding £36.5m of long-term investments where the maturity date is greater than 365 days. These investments are in accordance with the approved Investment Strategy. The long-term investments comprise of UK Gilts, Loans to Registered Providers, Real Estate Investment Trusts (REITS) and pooled funds. The value of short-term deposits as at 31st December 2021 was £121.2m.

The total investments held as at 31st December 2021 were £157.7m and had a total average income rate of return equating to 0.69% which is a significant improvement over placing deposits with the Debt Management Office (DMO) whose rates were typically 0.01% during the reporting period. The rate of return is above the target rate, as detailed in the Annual Treasury Management Strategy report to Council, of 0.10%. Investment rates continued to remain low during the reporting period on our traditional style investments e.g. Covered Bonds and Inter-LA lending. As a result of additional monies being received due to Covid-19 most Local Authorities held surplus cash balances and the inter-LA market was virtually non-existent.

During the reporting period, the Authority made a total investment of £10.5m into their pooled funds. These funds allow the Authority to generate enhanced returns and the intention is to hold them for a minimum of five years as per the Treasury Strategy 2021-22. These investments generated an income return of 4.42% during the reporting period.

Due to the low rates on offer it proved more beneficial to the Authority to maintain our cash surpluses to subsidise our capital programme and delay any borrowing during this time of uncertainty. Our overall income return of 0.69% compared to a rate of 0.48% for 9 other Welsh Authorities as per the quarterly figures provided by our Treasury Advisors.

The portfolio as at 31st December 2021 comprised of the following types of investments:

| Counterparty | Investment Product | Sector | £m |
|---|---|---|---|
| **Banks & Building Societies** | Covered bonds | Financial | 4.0 |
| **Banks** | Instant Access | Financial | 24.2 |
| **Money Market Fund** | Cash Pooled Fund | Financial | 40.0 |
| **UK Government** | Gilts | UK Government | 10.0 |
| **UK Government** | Fixed-Term Cash Deposit | UK Government | 50.0 |
| **Local Authorities and Housing Associations** | Fixed-term cash deposits | Local Government | 11.0 |
| **External Fund Managers** | Property Pooled Fund | Property | 10.0 |
| **External Fund Managers** | Bond Pooled Fund | Mixed | 2.5 |
| **External Fund Manager** | Equity Pooled Fund | Mixed | 2.5 |
| **External Fund Manager** | Multi Asset Pooled Fund | Mixed | 2.5 |
| **REIT** | Pooled Fund | Property | 1.0 |
| **Total Investments** | **as at 31st December** | **2021** | **157.7** |

5.1.4 Economic Outlook

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.

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.

Arlingclose expects Bank Rates to rise further during 2022 as per table below.

| **Official Bank Rate** | **Upside Risk** | **Arlingclose (Central case)** | **Downside Risk** |
|---|---|---|---|
| **2022 Q1** | 0.00 | 0.75% | -0.25 |
| **2022 Q2** | 0.25 | 1.00% | -0.25 |
| **2022 Q3** | 0.50 | 1.00% | -0.25 |
| **2022 Q4** | 0.50 | 1.00% | -0.25 |
| **2023** | 0.50 | 1.00% | -0.50 |
| **2024** | 0.50 | 1.00% | -0..50 |

5.1.5 Borrowing Update

Local Authorities can borrow from the PWLB provided they can confirm they are not planning to purchase ‘investment assets primarily for yield’ in the current or next two financial years with confirmation of the purpose of capital expenditure from the Section 151 Officer. 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 to externalise internal borrowing. Acceptable use of PWLB borrowing includes service delivery, housing, regeneration, preventative action, refinancing and treasury management.

HM Treasury published further guidance on PWLB borrowing in August 2021 providing additional detail and clarification predominantly around the definition of 'investment asset primarily for yield'.

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.

The authority is not planning to purchase any investment assets primarily for yield within the next 3 years and so is able to take advantage of the reduction in the PWLB borrowing rate.

The UK Infrastructure Bank, which is wholly owned and backed by HM Treasury, has been set up with £4bn of funding earmarked to lending to Local Authorities. Loans will be available for qualifying projects at gilt yield plus 0.6%, which is 0.2% lower than the PWLB certainty rate.

5.1.6 Counterparty Update

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.

Credit Default Swap (CDS) spreads were flat over the period and are broadly in line with their pre-pandemic levels. The gap in spreads between UK ringfenced and non-ringfenced entities continued to narrow. Over the period Fitch and Moody's upwardly revised to stable the outlook on a number of UK banks and building societies on our counterparty list, recognising their improved capital positions compared to last year and better economic growth prospects in the UK.

The successful vaccine rollout programme is credit positive for the financial services sector in general. While there is still uncertainty around the full extent of the losses banks and building societies will suffer due to the pandemic-related economic slowdown, the sector is in a generally better position compared to earlier this year and 2020.

At the end of this period Arlingclose had completed its full review of its credit advice on unsecured deposits. The maximum duration limit for UK bank entities was extended to 100 days whilst Nationwide BS and non-UK institutions remain on 35 days.

5.1.7 Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. Such investments can comprise of property; shared ownership housing; loans to local businesses/ subsidiaries; and shareholdings. During the reported period the Authority did not hold any non-treasury related investments.

## 5.2 Prudential Indicators

5.2.1 Capital Financing Requirement

The Capital Financing Requirement (CFR) measures the Authority's underlying need to borrow for a capital purpose. In accordance with best professional practice, the Authority does not associate borrowing with particular items or types of expenditure. In practice, the raising and repaying of loans is determined primarily by professional / expert advice and may not necessarily take place in the relevant year. In order to create an operating environment within which the Treasury Manager can legitimately react to appropriate advice, the various authorised limits as identified in Appendix 1 are set at a level in excess of the CFR. In the financial year to date, the Authority has been operating within the approved limits.

Appendix 1 shows a projected CFR value of £390.9m as at 31st March 2022. The actual CFR as at 31st March 2021 was £375.7m. Due to the pandemic certain capital schemes have been delayed or the scheme extended which has resulted in a lower funding requirement than budgeted.

5.2.2 Prudential Indicators – "Prudence"

The Prudential Indicators for Treasury Management are shown in Appendix 1, and the Authority is currently operating within the approved limits.

5.2.3 Prudential Indicators – "Affordability"

There is a requirement to analyse and report the capital financing costs and express those costs as a percentage of the net revenue streams of the Authority. These are identified in Appendix 2 and currently show a projected reduction from the original budget as a consequence of deferred borrowing for the General Fund.

5.2.4 Capital Expenditure and Funding

A summary of capital expenditure and funding is attached at Appendix 3 and shows that there will be an underspend on the core capital budget for HRA due to delays as a result of Covid-19.

## 6. ASSUMPTIONS

6.1 The details set out in the report are based on actuals that have occurred between 1st April 2021 and 31st December 2021 (period 9).

## 7. SUMMARY OF INTEGRATED IMPACT ASSESSMENT

7.1 This report is for information only and no Integrated Impact Assessment is required.

## 8. FINANCIAL IMPLICATIONS

8.1 As detailed throughout the report.

## 9. PERSONNEL IMPLICATIONS

9.1 There are no personnel implications arising from this report.

## 10. CONSULTATIONS

10.1 There are no consultation responses that have not been reflected in this report.

## 11. STATUTORY POWER

11.1 Local Government Acts 1972 and 2003.

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Appendices:

Appendix 1 – Treasury Management Prudential Indicators – Prudence
Appendix 2 – Capital Finance Prudential Indicators – Affordability
Appendix 3 – Capital Expenditure and Funding