North Somerset Council

REPORT TO THE AUDIT COMMITTEE

DATE OF MEETING: 22 SEPTEMBER 2022

SUBJECT OF REPORT: TREASURY MANAGEMENT OUT-TURN REPORT 2021/22

TOWN OR PARISH: ALL

OFFICER/MEMBER PRESENTING: MELANIE WATTS, HEAD OF FINANCE

KEY DECISION: N/A

REASON: This is a report for information.

RECOMMENDATIONS

The Audit Committee is asked to note the treasury management out-turn monitoring report to 31st March 2022 which includes performance, prudential indicators, and commercial investments.

1. SUMMARY OF REPORT

1.1 This report informs the Audit Committee of the council's;

- treasury management activities during 2021/22 and confirms that the activities undertaken during the year have complied with both the requirements of the Accountability and Responsibility Framework and the approved Treasury Management Strategy approved by Council in February 2021.

- treasury management indicators for 2021/22, as required by CIPFA's Prudential Code for Capital Finance in Local Authorities.

- commercial investment property valuations and returns for 2021/22.

2. POLICY

2.1 Part 1 (7) of the Financial Regulations, sets out the councils' policy framework with regards to treasury management activities.

2.2 Following the council's adoption of the 2017 edition of the Chartered Institute of Public Finance and Accountancy (CIPFA) *Treasury Management in the Public Services: Code of Practice*, Members are required to approve an annual treasury management strategy before the start of each financial year and then to receive an in-year monitoring report and an annual report after the end of each financial year. Such reports are required to include a range of core information and so the structure of this report meets those requirements.

3. DETAILS

3.1 Treasury management activities are undertaken by officers within the Finance Service which sits within the Corporate Services Directorate. The remit of officers is broad and covers a range of day-to-day operational tasks relating to the management of cash-flows and resultant outcomes of borrowing and investment decisions, as well as supporting the strategic direction required by the council to deliver its core services and cover key financial risks.

Headline Metrics for the period 1st April 2021 to 31st March 2022

3.2 £789m of cash-flows were managed and turned around during the period; this is £1bn less than the equivalent prior year period, although is to be expected because the 2020/21 financial year reflected the exceptional impacts arising from Covid-19.

3.3 Gross interest income earned on all investments totalled £0.621m, against a budget of £0.530m.

3.4 The average rate of investment return for cash deposit type investments managed by the in-house team in 2021/22 was 0.13% and returns of 3.97% were achieved on external pooled fund investments.

3.5 New additional external borrowing of £0.3m was undertaken during the period and £7.3m of borrowing was repaid, both as planned.

3.6 The council's Treasury Management Indicators for 2021/22 were approved by Council in February 2021. Performance against the key indicators is shown in **Appendix 1**. All indicators are within target levels.

Balance Sheet Summary

3.7 Treasury management related balances are reflected within the council's balance sheet, with some elements being shown as liabilities and others as assets. An extract of the key components is shown in the table below, together with a comparison of the previous year and the change that has occurred.

Table 1.0 Treasury Management Balances within the Balance Sheet

	31/03/21 Balance £m	Movement In Year £m	31/03/22 Balance £m	31/03/22 Rate %
Long-term borrowing	143.4	-6.7	136.7	3.97
Short-term borrowing	7.8	-0.4	7.4	2.32
Total borrowing	**151.2**	**-7.1**	**144.1**	**3.88**
Long-term investments	10.0	0.0	10.0	4.06
Short-term investments - in-house	123.0	34.0	157.0	0.13
Short-term investments - Tradition	10.0	0.0	10.0	0.19
Total investments	**143.0**	**34.0**	**177.0**	
Net (borrowing) / investments	**-8.2**	**41.1**	**32.9**	

3.8 It should be noted that the values reflected within this table are the principal sums of borrowing and investments made which may be different to the final values reflected within the council's statutory accounts. This is because the council is required to follow accounting regulation and gross up these values to include technical adjustments such as accrued interest or reflect impairment assessments.

3.9 Investment balances at 31st March 2022 were £34m higher than in the previous year and this is due to a combination of grants and contributions received in advance at the year end, largely relating to both capital projects and ongoing funding towards Covid-19 impacts and the Government's energy rebate support package.

3.10 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.

Table 1 Balance Sheet Summary	**31/03/21 £m**	**Movement £m**	**31/03/22 £m**
General Fund Capital Financing Requirement	184.9	-1.2	183.7
Less: Other debt liabilities *	34.7	-0.8	33.9
Borrowing Capital Financing Requirement	**150.2**	**-0.4**	**149.8**
External borrowing	151.2	-7.1	144.1
Internal borrowing (over borrowing)	**-1.0**	**6.7**	**5.7**
Usable Reserves	101.3	19.1	120.4
Working Capital	43.1	59.4	16.3
Net investments	**143.4**	**-6.7**	**136.7**

* finance leases and transferred debt that form part of the council's total debt

3.11 On 31st March 2022, the council had net borrowing of £144.1m arising from its revenue and capital income and expenditure, which is £5.7m lower than the calculated borrowing CFR.

Summary of Investment Returns & Activity

3.12 **Overview** – table 1.2 provides an overview of the council's investment portfolio which is diversified across Money Market Funds, Local Authorities, the CCLA Property Fund, highly rated UK and Foreign Banks and UK Building Societies. The council uses AAA rated Money Market funds to maintain very short-term liquidity and had overall investments of £177m as at 31st March 2022. (CCLA – Charities, Churches & Local Authorities).

3.13 The table below shows further analysis of the investments held at 31st March 2022 and 31st March 2021 which adhered to the approved Investment Strategy.

Table 2 Analysis of External Investments (principal sums)			
	31/03/2021 £m	Movement £m	**31/03/2022 £m**
UK Banks	20.0	-6.0	**14.0**
UK Building Societies	0.0	32.0	**32.0**
Debt Management Office	10.0	18.0	**28.0**
Local Authorities	103.0	-10.0	**93.0**
Pooled Investment Funds	10.0	0.00	**10.0**
Total	143.0	34.0	**177.0**

3.14 **Security and liquidity** - it can be seen from the above that at the end of the year a total of £121m was being held with other local authorities (£93m) and the governments' Debt Management Office (DMO) (£28m).

The investment strategy continued to prioritise security and liquidity of cash-flows during last year, which meant that a large proportion of funds were placed into “safe havens” for short periods of time, such as the Debt Management Office (DMO) and inter-authority lending, until further clarity was provided around when funding was needed. The portfolio was therefore less diverse than in other years and investment periods were shorter than planned in the budget. Such measures would have reduced some areas of risk, i.e. operational service delivery, counter-party and country related risks although this could have impacted on inflationary risks and returns.

3.15 **Cash-flows and market rates** – Daily cash inflows and outflows vary over the year with semi-regular peaks and troughs in income and expenditure. For the first 10 months of the year, income tends to exceed expenditure, resulting in a build-up of cash balances. After January, the reduction in monthly council tax income receipts means these balances are depleted in the last two months of the year. This modelling supports a plan whereby the council would usually look to optimise its ability to generate higher yields at the start of a financial year as it locks in a proportion of its investment balances for longer periods of time, and this coincides with a time when there are often more opportunities are available within the market.

Unfortunately, that was not the case in 2021/22 because of the economic situation that prevailed at that time. Whilst the impacts of Covid may be diminished in our minds today, at the beginning of last year the ongoing impacts continued to be felt and they affected the broader economic climate, the underlying bank of England base rate, as well as specific investment opportunities and yields within the markets.

Investment yields for areas with higher levels of security were significantly reduced, notably those such as the inter-local authority and DMO markets and at various points in the year even moved into a negative yield position, meaning that the council could have been exposed to a potential investment ‘cost’ should a deal have been placed at that time. In the last quarter of 2021/22, there was an uplift in the inter-authority rates following bank rate rises between December and March.

3.16 **Investment returns** - the table 1.3 below shows the average rates of return achieved during 2021/22 on investments placed by both treasury teams.

Table 3 Analysis of Investments								
	In-house				Tradition			
	Ave Return (%)	Return (£m)	Ave Time (days)	Ave Loans (No.)	Ave Return (%)	Return (£m)	Ave Time (days)	Ave Loans (No.)
Qtr 1 – to 30th Jun	0.14%	0.108	177	52	0.14%	0.009	311	4
Qtr 2 – to 30th Sept	0.06%	0.020	121	32	0.06%	0.001	243	1
Qtr 3 – to 31st Dec	0.14%	0.033	175	21	0.09%	0.001	334	1
Qtr 4 – to 31st Mar	0.43%	0.028	160	17	0.92%	0.007	364	2
Annual Average for Fixed Term Cash Deposits	**0.13%**	**0.189**	**159**	**122**	**0.18%**	**0.018**	**323**	**4**

Table 3 Analysis of Investments		
	In-house	Tradition

	Ave Return (%)	Return (£m)	Ave Time (days)	Ave Loans (No.)	Ave Return (%)	Return (£m)	Ave Time (days)	Ave Loans (No.)
CCLA pooled fund	4.33%	0.217	365	NA	NA	NA	NA	NA
UBS Multi Asset Fund	4.15%	0.042	365	NA	NA	NA	NA	NA
Ninety-one Diversified Income Fund	3.48%	0.139	365	NA	NA	NA	NA	NA
Annual Average for Pooled Funds	**3.97%**	**0.398**	365	NA	NA	NA	NA	NA

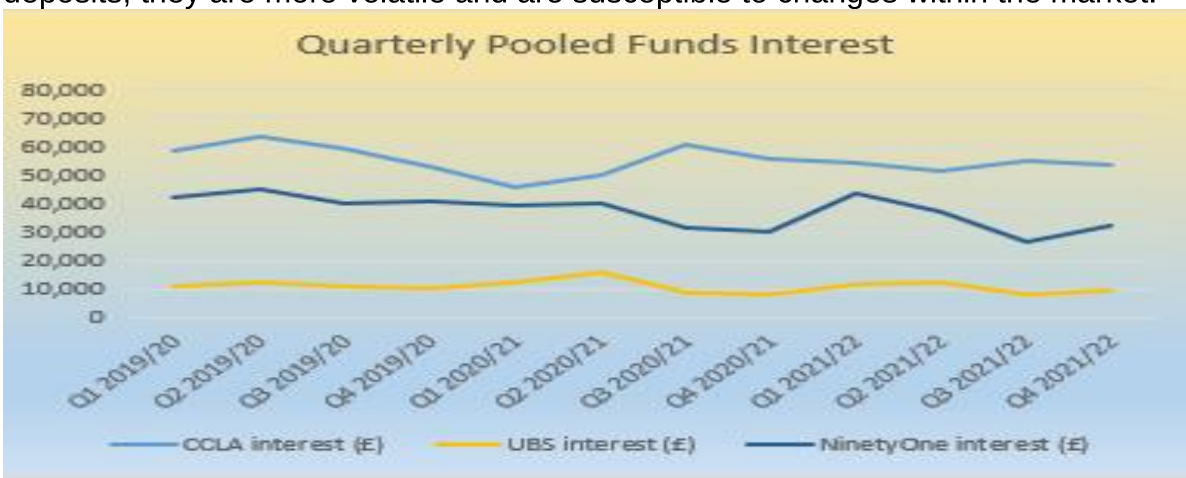
3.17 The first section covers fixed term cash deposits, which are traditional investments placed with banks, building societies, the DMO and other local authorities, where a principal sum is paid to the investor and a yield received at maturity along with the returned investment. The second section covers pooled investment funds where the councils' investment buys shares. Returns are given to the council on a quarterly basis depending on the value of the share price at that time.

3.18 The council's average investment return from its fixed term cash deposits was around 0.13%. This is not unexpected and is largely due to interest rates being depressed against the economic backdrop of continuing uncertainty around Brexit and the Covid-19 pandemic.

3.19 The table also shows that the council's in-house team achieved a marginally lower average rate of return during the year from its investments than that of the external fund manager. This would also be expected as the primary purpose of the in-house team is to manage cash-flows to support the operational delivery of council services whereas the external managers have no such constraints. The number and 'duration' of investments placed by each team differs significantly with the fund manager being able to take opportunities throughout the year to assess the yield curve, which offers higher rates of return for longer investment periods.

3.20 The council's average return from its £10m of pooled investment funds returns of 3.97%.

3.21 The chart below shows the quarterly returns achieved on the council's pooled funds over recent years and whilst they are higher than returns on traditional fixed term cash deposits, they are more volatile and are susceptible to changes within the market.



Budget Implications

3.22 The table below shows that the council received **£621k** from interest income during the year, which is £91k more than budgeted. This is due to a combination of the increase in investment balances during the year, increased interest rates in the last quarter and also stronger than expected CCLA income.

Table 4 Investments Interest Budget						
	In-House – Cash Deposits £000	Money Market Funds £000	Tradition UK Ltd £000	CCLA Property Fund £000	Other Pooled Funds £000	**Total £000**
Interest generated	190	14	19	217	181	**621**
Investment Interest Budget	100	16	15	206	193	**530**
Variance to Budget	90	-2	4	11	-12	**91**

Pooled Funds

3.23 Strategic fund investments are made in the knowledge that capital values will move both up and down over months, quarters and even years which is a significant risk factor for the council to consider when managing public funds. However, such investments are placed knowing that they can provide value in other ways and that the total returns they can offer over the investment period, will often exceed cash interest rates, which means that they provide a more significant contribution into the annual revenue budget compared to other investment products.

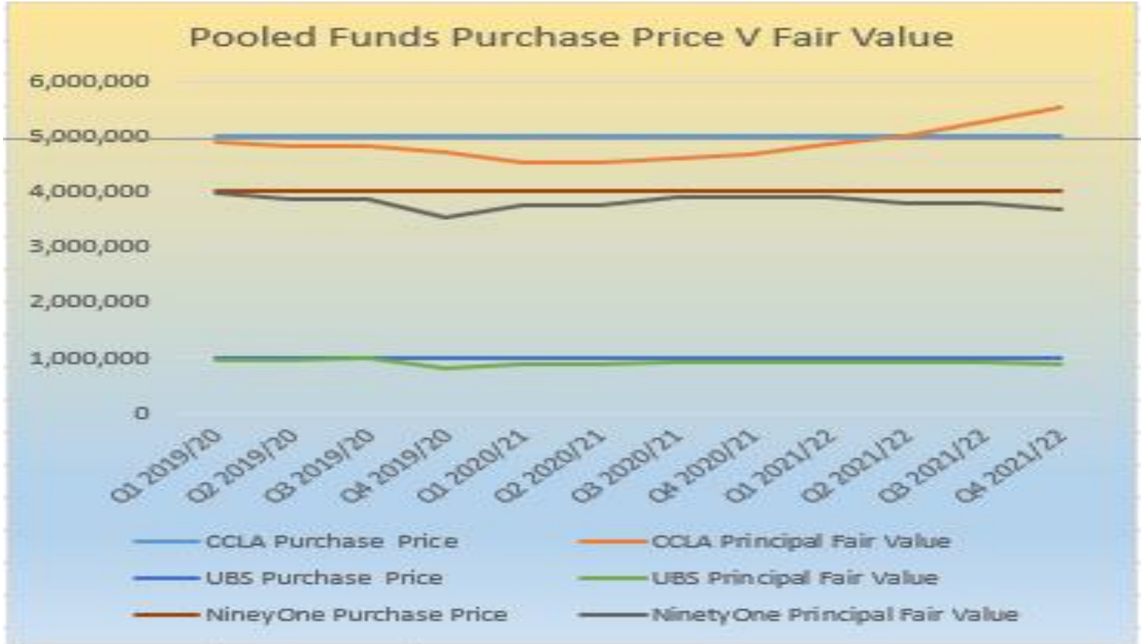
3.24 The treasury objective previously approved by Council was to place £5m of investments in a property fund and £5m in pooled funds, both of which should deliver annual returns of around 4% (based on rates at that time). The CCLA is the only property fund that councils can invest with, although there are a selection of multi-asset funds.

3.25 The council continues to hold the same pooled fund balances as in the previous year end. The initial principal amounts invested were:

- £5m - CCLA (property fund)
- £4m Ninety-One (previously Investec) (multi-asset fund)
- £1m UBS (multi-asset fund)

3.26 These funds have no defined maturity date, although are available for withdrawal after a notice period. Their performance and continued suitability in meeting the council's core investment objectives is regularly reviewed to ensure that they are fit for purpose.

3.27 As with any fund purchase, a capital loss was initially incurred when these investments were taken out although this is being made up over time. The funds' fair values have generally trended upwards since acquisition although they are susceptible to a wide range of factors and events. One notable reduction in the CCLA share price was in March 2020 shortly after the country went into the first period of lock-down, although that has improved over recent months. The latest impact on prices has been prompted by the Russian invasion of Ukraine which has resulted in a reduction multi-asset fund share price. That being said, at the end of the 2021/22 financial year the council's accounts reflected a net gain across all three funds. The cumulative capital gain on these investments is £82k at the year-end 31st March 2022.



3.28 The council has applied the fair value through profit and loss (FVPL) accounting treatment in accordance with guidance and must defer the funds' fair value movements to the Pooled Investment Fund Adjustment Account until 1 April 2023, which is an unusable reserve held on the balance sheet.

Borrowing activity and further update

3.29 At 31st March 2022 the council held £155.3m of external borrowing on its balance sheet which is held with the following counter-parties;

- £140.4m is held with the **Public Works Loan Board** (PWLB),
- £3.1m with SALIX,
- £11.8m managed by Bristol City Council on behalf of 4 councils

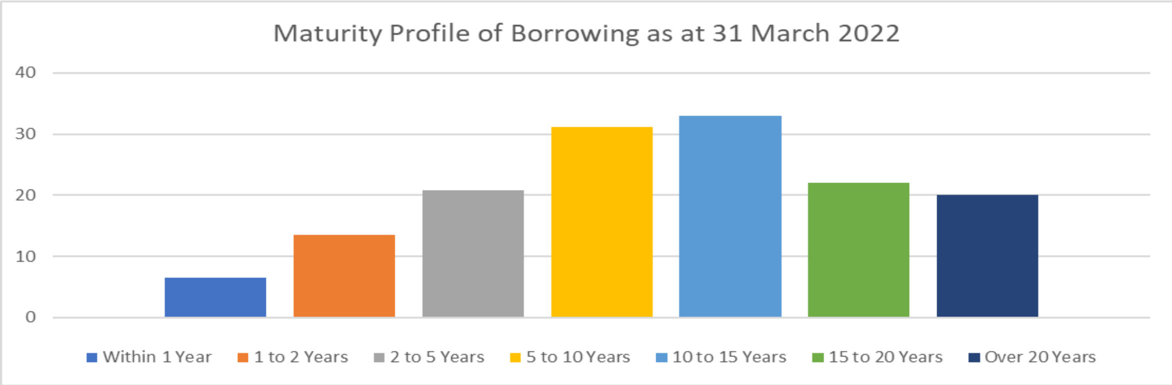
The PWLB is operated by the UK Debt Management Office on behalf of HM Treasury and provides loans to local authorities, and other specified bodies, from the National Loans Fund, with borrowing only available for capital purposes.

Salix is an executive non-departmental public body, sponsored by the Department for Business, Energy and Industrial Strategy (BEIS) who deliver government funding to the public sector to improve energy efficiency, reduce carbon emissions and lower energy bills.

3.30 The maturity profile of PWLB debt is shown in the table and chart below.

Table 1.5 Long-term PWLB debt profile (principal) as at 31st March 2022

	Debt £m	Average Rate %
Less than 1 year	6.00	2.32
Between 1 and 2 years	7.50	4.04
Between 2 and 5 years	20.76	3.87
Between 5 and 10 years	31.17	4.06
Over 10 years	74.95	4.08
	140.38	**3.96**



3.31 No new PWLB borrowing was undertaken, while £6.5m of existing PWLB loans were allowed to mature without replacement. Interest payments totalling £5.728m were paid in year, which was £0.166m lower than the approved budget. The council made a charge of £5.141m within the revenue budget in respect of the minimum revenue provision.

3.32 SALIX have provided funding to North Somerset for green initiatives, in this case energy efficient replacement street lighting. During the year, the council has made a partial repayment of £0.8m from the original loan funding from SALIX and drew down a new tranche of £0.3m bringing the total loan balance to £3.1m. Both tranches are repayable in 10 equal six-monthly instalments over 5 years. There are no interest obligations on this borrowing, although as a result the council does need to recognise this as a soft loan within its statutory accounts.

3.33 The council's balance sheet also reflects long-term borrowing obligations of £11.8m at the end of the year in respect of the former Avon County Council, which is paid off over a period of time. A partial repayment of £0.490m was paid during the year. These loans are currently held and administered by Bristol City Council.

3.34 The Capital Strategy report approved in February 2021 did indicate that the council would be required to borrow further sums to fund its capital programme over a 3-year period however, given the council's surplus cash-flow position, the council has not drawn down any external borrowing in 2021/22. Forecasts will continue to be reviewed to provide an updated assessment to inform future years' borrowing plans. These drivers would include capital expenditure spending profiles, market rates, current and future cash-flow forecasts.

Economic Impacts

3.35 Our treasury management advisor's economic and market review for 2021/22 is included in **Appendix 3**.

3.36 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.

3.37 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.

3.38 Having increased Bank Rate from 0.10% to 0.25% in December, the Bank of England raised it further to 0.50% in February and 0.75% in March 2022.

Commercial Investments

3.39 The council's Commercial Investment Strategy was approved by Council in January 2019. In line with this strategy, the council made two investments in commercial property within the geographical boundary of North Somerset with the aim of earning both an annual return into the revenue budget as well as the potential for long-term capital appreciation. Investment income is received in year through a combination of rental and car parking income at the sites.

3.40 The investments made under the strategy were all agreed in previous years and consist of one outright purchase funded from long term borrowing, the North Worle District Centre, and one property acquired under a finance lease, the Sovereign Centre in Weston-super-Mare. Indicative sums have been set aside for potential improvements to the Sovereign Centre although no decisions to approve spending have taken place. There were no purchases or sale of assets during the 2021/22 financial year and there are no plans to undertake any further commercial investments in the future.

3.41 Performance and management of these assets is supported by specialist property advisors Montagu Evans and their activity is tailored to the specific requirements of each site. The North Worle site is leased to a single tenant and performance since purchase has been as expected within the original business plan. The Sovereign Centre site is more complex as it is an internal shopping centre within the town centre and has been impacted by several factors since acquisition. Monthly meetings are held on site to discuss all aspects of operational delivery and performance.

3.42 Any financial impacts or issues arising from these commercial investments are within the council's regular budget monitoring framework which is presented to the Executive throughout the year. Decisions surrounding capital investments would follow the council's capital governance routes, which will include Boards such as the Capital Programme, Planning and Delivery Board or the Capital Delivery Strategic Group.

3.43 In February 2021 the Executive approved a revised Sovereign Centre Business Plan, setting out the challenges, opportunities, and a new vision for the property. As part of this Business Plan, some of the vacant retail space within the centre is to be converted into office space to diversify away from pure retail use. Funding for this investment will come from the Getting Building Fund, which is a government grant with the regional allocation administered by the West of England Combined Authority (WECA). The project was near to completion at the end of March and should be operational from late summer / early autumn. The business plan shows that such investment should help to improve the financial performance of the Centre in future years although short-term additional support will be required for new operators at the outset.

3.44 Details of the financial performance are contained within the following sections of the report although it should be noted that as at 31 March 2022, these investments continued to be accounted for as an investment property within the balance sheet. The council has no plans to dispose of its commercial investment properties at this time.

Cost and valuation

3.45 All investment properties are re-valued annually by the council's valuers, for inclusion in the annual statutory accounts. The valuations are either prepared by in-house or independent professional valuers, in line with Royal Institute of Chartered Surveyors (RICS) professional guidance.

3.46 The council's portfolio of commercial investment property was valued at £33.0m at 31st March 2022. This is an increase of £0.4m compared to the value at the 2020/21 year-end, although a reduction of £28.2m compared to the original acquisition cost. The properties will be subject to a further revaluation at the end of March 2023.

Table 6 Property held for investment purposes					
Property	**Acquisition cost (Incl fees) £m**	**31/03/2021 Valuation £m**	**31/03/2022 Valuation £m**	**Change over acquisition £m**	**Change over prior year £m**
North Worle District Centre	40.2	29.0	28.0	-12.2	-1.0
Sovereign Centre	21.0	3.6	5.0	-16.0	1.4
Total	**61.2**	**32.6**	**33.0**	**-28.2**	**0.4**

3.47 The North Worle District Centre is leased to Sainsburys. Whilst still at a lower value than at the time of purchase, the food and grocery sector has proven to be better insulated from reductions in valuation than other retail property sectors. The valuation is linked to the rental income generated across the lease period and records show that the lease is due to mature within the next 4 years.

Income compared to budget

3.48 After servicing costs, fees and borrowing costs, commercial investments are budgeted to generate an annual net return to the revenue budget of £0.2m (2020/21 £0.1m). **Appendix 2** contains budget forecasts for each of the council's commercial investments, both of which have provided returns for the year in line with or slightly exceeding budget expectations, at £0.4m (2020/21 £0.1m).

3.49 The main Sainsbury's store at North Worle has remained open and trading throughout the financial year, and the council has continued to receive income as planned.

3.50 Whereas the investment at the Sovereign Centre has continued to be impacted by economic factors, some of which can be attributed to Covid, although not all. Monitoring shows that the council received lower levels of income for car parking activity during the year although this was offset by slightly more rental income. That being said, rent levels continue to be depressed by wider market conditions which are prevalent across the retail sector This can mean that at the end of a rental period, the tenant can expect to re-negotiate a new lease at a lower rent than before in line with market conditions. There also continue to be some vacancies at the Centre following store closures.

3.51 The council has created a commercial investment smoothing reserve as part of its risk management measures which is available to smooth annual fluctuations on the council's revenue budget if needed. This would not only cover periods of higher cost prices or income reductions from vacant units, but the reserve would also cover income reductions that may arise as a result of lease renewals, as they often include rent free periods as part of the renewal terms.

Yield / Return on investment

3.52 As detailed in **Appendix 2**, the council's commercial investments provided an annual yield / return on investment of 0.7% in 2021/22 (0.2% in 2020/21).

4. CONSULTATION

4.1 Financial information and performance details are included within the council's monthly budget monitoring processes and key messages are described within the narrative report where required.

5. FINANCIAL IMPLICATIONS

5.1 Financial implications are contained throughout the body of the report within the relevant sections however, an additional summary has been included to provide a high-level overview of the key components linked with capital financing and investment decisions.

Table 7 - Budget impacts – capital financing and interest			
	2021/22 Budget £000	**2021/22 Out-turn £000**	**2021/22 variance £000**
Interest payable on borrowing	5,894	5,728	-166
Interest receivable on investments	-530	-621	-91
Minimum revenue provision	6,874	5,968	-906
Total	**12,238**	**11,075**	**-1,163**
MRP analysis;			
- Supported Borrowing Minimum Revenue Provision	1,127	900	-227
- Prudential Borrowing Minimum Revenue Provision	4,920	4,241	-679
- Ex-Avon Loan Debt Minimum Revenue Provision	490	490	0
- Finance Leases Minimum Revenue Provision	337	337	0

6. LEGAL POWERS AND IMPLICATIONS

6.1 This report is for information only and covers the council's required obligations.

7. CLIMATE CHANGE AND ENVIRONMENTAL IMPLICATIONS

7.1 The council will continue to avoid any direct treasury management investments in fossil fuel related companies and will engage with its advisors to explore and assess the potential for any future investment opportunities in funds with a Renewable Energy & Sustainability focus as these products continue to be developed by the market in response to the Climate & Nature Emergency agenda.

7.2 The council continued to hold an investment in a Green Deposit account with Barclays Bank. This forms part of the council's fixed term cash deposits and so will earn some interest in the usual way however, the Bank confirms that it will use these funds to support its Green Bond Purchase Programme which is an initiative whereby monies are used to invest in a variety of projects which support the environment such as tree plantation, renewable energy schemes and water waste management activities.

8. RISK MANAGEMENT

8.1 The council faces significant different types and degrees of risk in undertaking its treasury management function, from both internal and external sources. However, the council has implemented, and adheres to, strict policies and internal controls to mitigate such risks.

8.2 The council's primary objectives for the management of its investments are to give priority to the security and liquidity of its funds, before seeking the best rate of return. Most of its surplus cash is therefore held as short-term investments and utilises the UK Government and highly rated banks and pooled funds where appropriate.

8.3 The council's primary objective for the management of its debt is to ensure its long-term affordability. Most of its loans have therefore been borrowed from the Public Works Loan Board at long-term fixed rates of interest.

8.4 However, the combination of short duration investments and long duration debt can expose the council to the risk of falling investment income during periods of low interest rates. This risk is partially mitigated by holding some longer-term investments and reviewing the option to prematurely repay long-term loans.

8.5 The council's lending & borrowing list is regularly reviewed during the financial year. Credit ratings of counter parties are monitored throughout the year. All lending/borrowing transactions are within approved limits and with approved institutions. Investment and borrowing advice is provided by Treasury Management consultants, Arlingclose.

8.6 The CIPFA Treasury Management in the Public Services: Code of Practice requires the council nominate a committee to be responsible for ensuring effective scrutiny of the Treasury Management Strategy and policies. The Audit Committee carries out this scrutiny.

9. EQUALITY IMPLICATIONS

9.1 Not applicable, this report is for information only.

10. CORPORATE IMPLICATIONS

10.1 Treasury management is an integral part of the council's wider financial strategies.

11. OPTIONS CONSIDERED

11.1 The council is required to undertake a treasury management function to support its financial affairs and there are many options within the component parts.

AUTHORS:
Mark Anderson, Principal Accountant (Resources & Financial Planning), 01934 634616

Melanie Watts, Head of Finance, 01934 634618

APPENDICES:

Appendix 1 Performance against Treasury Management Prudential Indicators
Appendix 2 Performance of Non-Treasury Management commercial investments
Appendix 3 External context provided by Arlingclose Ltd (treasury advisers)
Appendix 4 Summary Guide to Credit Ratings
Appendix 5 Glossary of Terms
Appendix 6 Revisions to CIPFA Codes

BACKGROUND PAPERS:

Treasury Management Strategy 2021/22, Executive & Council – February 2021

Appendix 1: Performance against Treasury Management Prudential Indicators

Prudential Indicators: 'Prudential' Code

1.1 The Prudential Code was updated in 2017 following consultation with local authorities to improve the transparency of investment decisions. Changes to the Code include the requirement to produce a capital strategy, and the inclusion of prudential indicators within the report, to allow the reader to understand how overall debt levels link with the capital programme and investment decisions, and how this debt will be repaid.

1.2 The following Treasury Management prudential indicators were set in the Treasury Management Strategy for 2021/22. The limits are shown below, together with the actual indicators for 2021/22.

Affordable borrowing limit / Authorised limit

1.3 The council is legally obliged to set an affordable borrowing limit (also termed the 'authorised limit' for external debt) each year. In line with statutory guidance, a lower "operational boundary" is also set as a warning level should debt approach the affordable limit.

1.4 The council approved the following authorised limit for its total external debt gross of investments for 2021/22. This limit separately identifies borrowing from other long-term liabilities, such as finance leases or lease premium incentives. The actual level of external debt is shown and is well within the limits set at the start of the year.

Authorised Limit for External Debt	**2021/22 Limit £m**	**2021/22 Actual £m**
Borrowing – NSC	204.0	155.3
Other Long-Term Liabilities (Avon debt, leases, temporary borrowing etc)	30.0	22.1
Authority Total	**234.0**	**177.4**

1.5 The council also approved the following operational boundary for external debt for the same period. The operational boundary for external debt was based on the same estimates as the authorised limit, but reflected estimates of the most likely, prudent, but not worst-case scenario, without the additional headroom included within the authorised limit to allow for unusual cash movements. As can be seen below, the actual level of external debt is well within the operational boundary set at the start of the year.

Operational Limit for External Debt	**2021/22 Limit £m**	**2021/22 Actual £m**
Borrowing – NSC	194.0	155.3
Other Long-Term Liabilities (Avon debt, leases etc)	30.0	22.1
Authority Total	**224.0**	**177.4**

Treasury Management Indicators: ‘Treasury Code’

Interest rate exposures

1.6 The treasury management team has an active strategy for assessing interest rate exposure that feeds into the setting of the annual budget, and which is used to update the budget quarterly during the year. This allows any adverse changes to be accommodated. The analysis will also inform whether new borrowing is taken out at fixed or variable interest rates.

Maturity structure of borrowing

1.7 This indicator applies to the financial years 2019/20-2021/22. Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment. This indicator is set to control the council’s exposure to refinancing risk. These limits are shown below, together with the actual percentage of borrowing that is maturing in each period.

Maturity Structure of Borrowing	Upper Limit	Lower Limit	Actual 2021/22	Complied?
Under 12 months	50%	0%	4.27%	Yes
12 months and within 24 months	30%	0%	5.34%	Yes
24 months and within 5 years	40%	0%	14.79%	Yes
5 years and within 10 years	50%	0%	22.20%	Yes
10 years and above	100%	0%	53.40%	Yes

Principal sums invested for periods longer than 364 days

1.8 The purpose of this indicator is to control the council’s exposure to the risk of incurring losses by seeking early repayment of its investments. The total principal sums invested to final maturities beyond the period end are shown below. The council is required to set a maximum amount to be invested beyond the end of the financial year for the forthcoming financial year and the following two years.

Principal sums invested for periods longer than 364 days	2020/21 £m	2021/22 £m	2022/23 £m
Upper Limit of Principal sums invested beyond the year	60	60	60
Actual principal sums invested beyond one year	10	10	N/A
Complied?	Yes	Yes	N/A

Appendix 2: Performance of Non-Treasury Management commercial investments

2.1 The council's commercial investments provided net income of £0.4m in 2021/22, a positive variance compared to budget. Net income from commercial investments for the year 2020/21 was £0.1m.

Property held for investment – Net return compared to budget (£)

Property	Budget 2020/21 £m	Out-turn 2020/21 £m	Budget 2021/22 £m	Out-turn 2021/22 £m
North Worle District Centre	-0.6	-0.6	-0.6	-0.6
Sovereign Centre	0.3	0.3	0.2	0.0
Fees	0.2	0.2	0.2	0.2
Total (income) / expenditure	**-0.1**	**-0.1**	**-0.2**	**-0.4**

2.2 The council's commercial investments provided a yield / return on investment of 0.2% in 2021/22, is the same as recorded in 2020/21.

Property held for investment – Net return compared to budget (Yield)

Property	Budget 2020/21 £m	Out-turn 2020/21 £m	Budget 2021/22 £m	Out-turn 2021/22 £m
North Worle District Centre				
- Net return	-0.6	-0.6	-0.6	-0.6
- Cost	40.2	40.2	40.2	40.2
- (Return) / Loss on investment	**-1.5%**	**-1.5%**	**-1.5%**	**-1.5%**
Sovereign Centre				
- Net return	0.3	0.3	0.2	0.0
- Cost	21.0	21.0	21.0	21.0
- (Return) / Loss on investment	**1.4%**	**1.4%**	**1.0%**	**0.0%**
Fees	**0.2**	**0.2**	**0.2**	**0.2**
Total (Return) / Loss on all investments	**-0.2%**	**-0.2%**	**-0.3%**	**-0.7%**

Appendix 3: External context provided by Arlingclose Ltd (treasury advisers)

3.1. **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.

3.2. The Bank of England (BoE) held Bank Rate at 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.

3.3. 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%.

3.4. 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%.

3.5. 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.

3.6. 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.

3.7. 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.

3.8. 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%.

3.9. 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.

3.10. **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.

3.11. 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.

3.12. 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%

3.13. The Sterling Overnight Rate (SONIA) averaged 0.39% over the quarter.

3.14. **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 council's counterparty to 'stable', recognising their improved capital positions compared to 2020 and better economic growth prospects in the UK.

3.15. 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.

3.16. 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.

3.17. 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 council's counterparty list recommended by Arlingclose remains under constant review.

Appendix 4: Summary Guide to Credit Ratings

Rating	Details
AAA	Highest credit quality – lowest expectation of default, which is unlikely to be adversely affected by foreseeable events.
AA	Very high credit quality - expectation of very low default risk, which is not likely to be significantly vulnerable to foreseeable events.
A	High credit quality - expectations of low default risk which may be more vulnerable to adverse business or economic conditions than is the case for higher ratings.
BBB	Good credit quality - expectations of default risk is currently low but adverse business or economic conditions are more likely to impair this capacity.
BB	Speculative - indicates an elevated vulnerability to default risk, particularly in the event of adverse changes in business or economic conditions over time.
B	Highly speculative - indicates that material default risk is present, but a limited margin of safety remains. Capacity for continued payment is vulnerable to deterioration in the business and economic environment.
CCC	Substantial credit risk - default is a real possibility.
CC	Very high levels of credit risk - default of some kind appears probable.
C	Exceptionally high levels of credit risk - default is imminent or inevitable.
RD	Restricted default - indicates an issuer that has experienced payment default on a bond, loan, or other material financial obligation but which has not entered bankruptcy filings, administration, receivership, liquidation or other formal winding-up procedure, and which has not otherwise ceased operating.
D	Default - indicates an issuer that has entered bankruptcy filings, administration, receivership, liquidation, or other formal winding-up procedure, or which has otherwise ceased business.

Appendix 5: Glossary of Terms

Authorised Limit – the maximum amount of external debt at any one time in the financial year.

Bank Rate – the Bank of England base rate.

Capital Financing Requirement – financing needs of the council – i.e., the requirement to borrow.

CIPFA - the Chartered Institute of Public Finance and Accountancy. The institute is one of the leading professional accountancy bodies in the UK and the only one which specialises in the public sector. It is responsible for the education and training of professional accountants and for their regulation through the setting and monitoring of professional standards. Uniquely among the professional accountancy bodies in the UK, CIPFA has responsibility for setting accounting standards for a significant part of the economy, namely local government. CIPFA's members work, in public service bodies, in the national audit agencies and major accountancy firms.

CLG – Communities and Local Government – see MHCLG.

Counterparty – the organisation the council is investing with.

Credit Rating – an assessment of the credit worthiness of an institution.

Creditworthiness – a measure of the ability to meet debt obligations.

Finance Lease - a finance lease is a lease that is primarily a method of raising finance to pay for assets, rather than a genuine rental. The latter is an operating lease. The key difference between a finance lease and an operating lease is whether the lessor (the legal owner who rents out the assets) or lessee (who uses the asset) takes on the risks of ownership of the leased assets. The classification of a lease (as an operating or finance lease) also affects how it is reported in the accounts.

Gilts – long term fixed income debt security (bond) issued by the UK Government and traded on the London Stock Exchange.

LIBID – London Interbank BID Rate – the interest rate at which London banks are willing to borrow from one another.

MHCLG – Ministry of Housing, Communities and Local Government. The Government department that sets policy on supporting local government, communities and neighbourhoods, regeneration, housing, planning building and the environment and fire. The name for this Government department has recently changed and is now known as **DLUHC**, which is the **Department for Levelling Up, Housing and Communities**.

Minimum Revenue Provision - the minimum amount which must be charged to an authority's revenue account each year and set aside towards repaying borrowing.

Money Market - the market in which institutions borrow and lend.

Money Market Rates – interest rates on money market investments.

Ninety-One – one of the council's cash managers who invest in multi-asset funds. They were previously known as Investec.

Operational Boundary – the most likely, prudent but not worst-case scenario of external debt at any one time.

Pooled Funds – investments are made with an organisation who pool together investments from other organisations and apply the same investment strategy to the portfolio. Pooled fund investments benefit from economies of scale, which allows for lower trading costs per pound, diversification, and professional money management.

Prudential Code – a governance procedure for the setting and revising of prudential indicators. Its aim is to ensure, within a clear framework, that the capital investment plans of the council are affordable, prudent, and sustainable and that treasury management decisions are taken in accordance with good practice.

Prudential Indicators – indicators set out in the Prudential Code that calculates the financial impact and sets limits for treasury management activities and capital investment.

PWLB (Public Works Loans Board) - a central government agency which provides long and medium-term loans to local authorities at interest rates only slightly higher than those at which the Government itself can borrow. Local authorities can borrow to finance capital spending from this source.

Sovereign – the countries the council can invest in.

Tradition UK Ltd – is one of the council's cash managers who manage £10m of investments on our behalf. Tradition place funds in fixed term cash deposits with a range of financial institutions.

Treasury Management – the management of the council's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risk associated with those activities and the pursuit of optimum performance with those risks.

Treasury Management Practices – schedule of treasury management functions and how those functions will be carried out.

Variable Net Asset Value money market funds – the principal invested may fluctuate below that invested.

Appendix 6: Revision to CIPFA Codes

6.1. Revisions to CIPFA Codes

6.2. 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.

6.3. 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.

6.4. 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. Due to the absence of guidance, the council is waiting until 2023/24 to introduce the revised reporting requirements.

6.5. 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.

6.6. 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.

6.7. 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.

6.8. The council will follow the same process as the Prudential Code, i.e., delaying changes in reporting requirements to the 2023/24 financial year.