Report to: **Policy and Resources Committee, 24th May 2022**

Report of: **Head of Finance**

Subject: **TREASURY MANAGEMENT ANNUAL REPORT – 2021/22**

1. Recommendation

1.1 That the Committee note the details included within the Treasury Management Annual Report for 2021/22; and

1.2 That the Treasury Management Annual Report for 2021/22 is referred to full Council for information, in accordance with the CIPFA Treasury Management Code.

2. Introduction

2.1 In February 2010 the Council formally 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 Council to approve treasury management semi-annual and annual reports.

2.2 The Council's treasury management strategy for 2021/22 was approved by Council on 23rd February 2021. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk remains central to the Council's treasury management strategy.

2.3 Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 edition (the CIPFA code) which requires the Council to approve a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. The report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

3. Local Context

3.1 On 31st March 2022, the Council had net investments of £8.7m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), whilst usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1 : Balance Sheet Summary

	31.03.21 Actual £m	**Movement £m**	**31.03.22 Actual**
General Fund CFR	28.3	(0.7)	27.6
Less: External Borrowing	(20.1)	1.3	(18.8)
Internal Borrowing	8.2	0.6	8.8
Less: Usable reserves	(29.4)	6.5	(22.9)
Less: Working capital	4.4	(17.8)	(13.4)
Treasury Investments	16.8	10.7	27.5

3.2 Lower interest rates have lowered the cost of short-term temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The Council pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

3.3 The treasury management position as at 31st March 2022 and the change during the year is shown in table 2 below.

Table 2: Treasury Management Summary

	31.03.21 Actual £m	**Movement £m**	**31.03.22 Actual £m**
Long-term borrowing	20.1	(1.3)	18.8
Short-term borrowing	Nil	Nil	Nil
Total borrowing	**20.1**	**(1.3)**	**18.8**
Long-term investments	(2.7)	(0.5)	(3.2)
Short-term investments	(15.0)	(9.5)	(24.5)
Cash and cash equivalents	0.9	(0.7)	0.2
Total investments	**(16.8)**	**(10.7)**	**(27.5)**
Net investments	**3.3**	**(12.0)**	**(8.7)**

4. Revised CIPFA Codes, Updated PWLB Lending Guidance & Borrowing Update

4.1 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. Councils 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.

4.2 CIPFA published its revised Prudential Code for Capital Finance and Treasury Management Code on 20th December 2021. The key changes in the two codes are around permitted reasons to borrow, knowledge and skills, and the management of non-treasury investments. The principles of the Prudential Code took immediate effect although Councils can defer introducing the revised reporting requirements until the 2023/24 financial year.

4.3 To comply with the Prudential Code, Councils must not borrow to invest primarily for financial return. This Code also states that it is not prudent for Councils to make investment or spending decision that will increase the CFR unless directly and primarily related to the functions of the Council. Existing commercial investments are not required to be sold; however, Councils with existing commercial investments who expect to need to borrow should review the options for exiting these investments.

4.4 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.

4.5 Unlike the Prudential Code, there is no mention of the date of initial application in the Treasury Management Code. The TM Code now includes extensive additional requirements for service and commercial investments, far beyond those in the 2017 version. The Council will follow the same process as the Prudential Code, i.e. delaying changes in reporting requirements to the 2023/24 financial year.

5. Borrowing Strategy

5.1 At 31st March 2022 the Council held £18.8m of loans as part of its strategy for funding previous years' capital programmes. Outstanding loans on 31st March are summarised in Table 3 below.

Table 3: Borrowing Position

	31.03.21 Actual £m	**Movement £m**	**31.03.22 Actual £m**
Public Works Loan Board	14.989	(1.255)	13.734
Banks (LOBO)	5.072	Nil	5.072
Banks (fixed-term)	Nil	Nil	Nil
Local authorities (long-term)	Nil	Nil	Nil
Local authorities (short-term)	Nil	Nil	Nil
Total borrowing	**20.061**	**(1.255)**	**18.806**

5.2 The Council's external loans are a £5m Lender Option Borrower Option (LOBO) loan and £13.734m of Public Works Loans Board (PWLB) loans. The LOBO was taken out for a period of 50 years from the 3rd December 2004.

5.3 The Council's approval for the building of Perdiswell Swimming Pool was for funding of £10.4m which included external borrowing of £6.2m. During 2020/21 the Council's cashflow position and increasing CFR, due to the capital programme, necessitated taking out a further portion of external borrowing. Therefore a £6.0m PWLB Annuity loan was borrowed for a period of 10 years from April 2020. The principal repaid on this loan during 2021/22 was £554,784.

5.4 Subsequently following purchases of property from the Property Development Fund, the Council took out a further PWLB Annuity loan in March 2021 of £7.0m, also for a period of 10 years. The principal repaid on this loan during 2021/22 was £661,404. The Council will continue to only consider externally borrowing and incurring interest costs when necessary, as this is the most prudent approach. In addition, during 2021/22 a PWLB maturity loan to the value of £33,210 was allowed to mature without replacement.

5.5 The Council'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 Council's long-term plans change, being a secondary objective.

5.6 During 2021/22, PWLB funding margins have lurched quite substantially and there remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields plus 0.80%. The Council will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.

5.7 LOBO loans: The Council continues to hold one £5m LOBO (Lender's Option Borrower's Option) loan where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. The lender did not exercise their option during the year and the rate remains at 4.50%. The likelihood of the option being taken remains extremely low in the current interest rate environment. The Council has approved a strategy for the replacement of the LOBO loan in the event that the lender exercises their option and increases the interest rate. The agreed action, in this event, is to replace with a shorter dated loan and keep the rate as low as possible bearing in mind the Financing Requirement contained in the Council's Treasury Management Strategy (Prudential Borrowing Limits).

5.8 The interest payable in 2021/22 on existing loans was £513k (2020/21: £447k). This increase was due to the additional PWLB borrowing as stated at paragraph 5.4. The budget is set to be £527k in 2022/23.

5.9 The long-term interest rates on offer are monitored on a daily basis. The latest capital programme 2022-27 which was approved by Council on 23 February 2022 includes significant borrowing for the Future High Streets Fund project, therefore as spend is committed towards this, further external borrowing may be required during 2022/23 and future years.

5.10 The Council approved its Authorised Limit in 2021/22 for external debt at £49.0m. The approved Operational Limit was £43.5m. The Operational Limit is calculated on the same basis as the Authorised Limit but differs in that it excludes short term borrowing. The Council's external debt as at 31st March 2022 was £18.8m which is within the limits set in the Treasury Management Strategy.

6. <u>Investments</u>

6.1 The Council manages its investments in-house and invests with the institutions listed in the Council's approved lending list. The Council invests its short-term core cash for a range of periods from overnight to 365 days, dependent on the Council's cash flows, its interest rate view and the interest rates on offer.

6.2 The Council currently invests in four types of instrument - Fixed Term Deposits, Instant Access Deposits, Certificates of Deposit and Money Market Funds. On advice from our treasury advisors Arlingclose we do not currently invest with Building Societies. The Council plans to continue to invest mainly in Money Market Funds and with other Local Authorities during 2022/23 as these both offer high levels of security and provide competitive rates of return. The Council diversified its portfolio at the end of April 2018 by placing a £3m longer-term investment with the CCLA Property Fund with a recommended time horizon of greater than 5 years.

6.3 The Council's average investment level for the year (or equated value) was £31.7m (2020/21: £16.5m). This increase is due to the Council receiving large amounts of Covid-related grants from central government during 2021/22, some of which were distributed out to businesses and individuals during the course of the year and some retained by the Council. The annual return earned on short-term investments was 0.07% (2020/21: 0.07%) which is approximately 0.07% below the benchmark SONIA rate (Sterling Overnight Index Average) for the year which was 0.14%. This is due to the majority of the Council's cash being kept liquid and not placed out for periods longer than 3 months. Base rate was 0.10% for the majority of the financial year until mid-December before rising three times to 0.75% by the end of March. The longer-term Property Fund investment achieved an annual return of 3.47%.

6.4 The Council achieved £20,811 of interest from its short-term investments in 2021/22 (2020/21: £9,650) and £104,303 from its long-term investment (2020/21: £117,498).

6.5 It should be noted that the return on investments has been severely suppressed for the past 14 years. For comparison, in 2007/08 the interest rate was in excess of 5% and the annual interest earned was £727,000. This is in main due to the economic crash of 2008/09 and the effect of the government scheme called 'Funding for Lending' launched in July 2012 and ending early in 2018. This caused a flood of cheap credit to be made available to banks which then resulted in rates falling further. These rates continued at very low levels during 2021/22 as banks continued to strengthen their balance sheet positions in response to the European banking regulation Basel III causing their appetite for cash to remain low. Subsequently Covid-19 caused a further lowering of rates in March 2020 to almost zero. More recently there are signs that investment rates are beginning to rise again. Further background on the economic conditions in 2021/22 is contained in **Appendix 1**.

6.6 Tables 4 to 8 below provide further details on our investments and our lending portfolio as at 31st March 2022. Further detail on performance against budget can be found within the Q4 Financial Monitoring report 2021/22.

Table 4: Summary of Interest Received 2021/22

	Interest Received £
Short Term investment interest received in year (cash)	20,811
Short-Term investment interest to be received in 22/23 relating to 21/22 (accrual)	Nil
Total Short-Term investment interest received	**20,811**
Long-Term investment interest received	104,303
Total investment interest received	**125,114**

Table 5: Investment Balances 2021/22

	Investment Balances (£m)
Total Investment balance as at 1st April 2021	18.0
Short-Term periodic investments made in year	1,489.3
Short-Term investments matured in year	(1,479.8)
Total Short-Term investments as at 31st March 2022	**24.5**
Long-Term investments on-going	3.0
Total investment balance as at 31st March 2022	**27.5**

Table 6: External Lending Investment Portfolio as at 31st March 2022

Borrower	Issue Date	Maturity Date	Investment £m	Interest Rate
DMO (Central Government)	31/03/22	01/04/22	24.5	0.50%
Sub-Total			**24.5**	
CCLA Property Fund	28/04/18	Long-term	3.0	3.47%
Total			**27.5**	

Table 7: Investment Limits

	2021/22 Max. amount placed per Institute	**31.03.22 Actual per Institute**	**2021/22 Limit per Institute**	**Complied**
DMO or UK Treasury Bills	£30.5m	£24.5m	No limit	√
Corporate Bonds	Not used	Nil	£3m	√

UK Local Authority	Not used	Nil	£3m	√
Term Deposits with Banks	Not used	Nil	£3m	√
Certificates of Deposit with Banks	Not used	Nil	£3m	√
Call and Notice Accounts with Banks	Not used	Nil	£3m	√
Banks nationalised or part-nationalised by UK Government	Not used	Nil	£3m	√
Floating Rates Notes with Banks	Not used	Nil	£3m	√
Money Market Funds	£3m	Nil	£3m	√
Property Funds	£3m	£3m	£5m	√

6.7 The Head of Finance reports that all treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the Council's approved Strategy.

Table 8: Investment Benchmarking

	Credit Score	**Credit Rating**	**Bail-in exposure**	**Weighted Average Maturity (days)**	**Average Rate of Return %**
Worcester City 31.03.2021	3.67	AA-	0%	1	0.65%
Worcester City 31.03.2022	2.67	AA	0%	1	0.89%
Similar LAs	4.37	AA-	61%	43	1.18%
All LAs	4.39	AA-	60%	14	0.97%

6.8 As can be seen from the table above, the Council has been able to lower its average credit score and bank bail-in exposure by avoiding investments with banks and favouring central government deposits or money market funds which are much safer.

6.9 £3m of the Council's investments are now held in an externally managed strategic pooled Property Fund where short-term security and liquidity are lesser considerations and the objectives instead are regular revenue income and long-term price stability. This has enabled the Council to maintain its overall average rate of return in line with other LAs. Because this fund has no defined maturity date, but is available for withdrawal after a notice period, its performance and continued suitability in meeting the Council's investment objectives is regularly reviewed. Investments such as these 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 five-year period total returns should exceed cash interest rates.

6.10 In the nine months to December improved market sentiment was reflected in equity, property and multi-asset fund valuations and, in turn, in the capital value of the Council's property fund investment. This moved up from £2.7m to £3.2m. The prospect of higher inflation and rising bond yields did however result in muted bond fund performance. In the January- March quarter the two dominant themes were tighter UK and US monetary policy and higher interest rates, and the military invasion of Ukraine by Russia in February, the latter triggering significant volatility and uncertainty in financial markets.

6.11 In light of Russia's invasion, Arlingclose contacted the fund managers of our Money Market fund investments and confirmed no direct exposure to Russian or Belarusian assets had been identified. Indirect exposures were immaterial. It should be noted that that any assets held by banks and financial institutions (e.g. from loans to companies with links to those countries) within MMFs and other pooled funds cannot be identified easily or with any certainty as that level of granular detail is unlikely to be available to the fund managers or Arlingclose in the short-term, if at all.

7. Treasury Management Indicators

7.1 The Council measures and manages its exposures to treasury management risks using the following indicators.

7.2 Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2 etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	31.03.22 Actual	**2021/22 Target**	**Complied?**
Portfolio average credit rating	AA	AA-	Yes

7.3 Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

	31.03.22 Actual	**2021/22 Target**	**Complied?**
Total cash available within 3 months	£24.5m	£5m	Yes

7.4 Interest Rate Exposures: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interests was:

	31.03.22 Actual £000	**2021/22 Limit £000**	**Complied?**
Upper limit on one-year revenue impact of a 1% rise in interest rates	15	105	Yes
Upper limit on one-year revenue impact of a 1% fall in interest rates	Nil	(105)	Yes

The impact of a change in interest rates is calculated on the assumption that maturing loans and investment will be replaced at current rates.

7.5 Maturity Structure of Borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

Refinancing rate risk indicator	**31.03.22 Actual**	**Upper limit**	**Lower limit**	**Complied?**
Under 12 months	34%	100%	0%	Yes
12 months and within 24 months	7%	100%	0%	Yes
24 months and within 5 years	21%	100%	0%	Yes
5 years and within 10 years	38%	100%	0%	Yes
10 years and above	0%	100%	0%	Yes

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. Note: LOBO option dates are treated as potential repayment dates.

7.6 Principal Sums Invested for Periods Longer than a year: 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 limits on the long-term principal sum invested to final maturities beyond the period end were:

	2021/22	**2022/23**	**2023/24**
Actual principal invested beyond year end	£3m	£3m	£3m
Limit on principal invested beyond year end	£6m	£6m	£6m
Complied?	Yes	Yes	Yes

7.7 IFRS 16

The implementation of the new IFRS 16 Leases accounting standard was due to come into for force for local authorities from 1st April 2022. Following a consultation CIFPA/LASAAC announced an optional two-year delay to the implementation of this standard a decision which was confirmed by the Financial Reporting Advisory Board in early April 2022. Councils can now choose to adopt the new standard on 1st April 2022, 1st April 2023 or 1st April 2024. The Council intends to adopt the new standard on 1st April 2024.

8. Non-Treasury Investments

8.1 The definition of investments in CIPFA's revised 2021 Treasury Management Code covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. Investments that do not meet the definition of treasury management investments (i.e. management of surplus cash) are categorised as either for service purposes (made explicitly to further service objectives) and or for commercial purposes (made primarily for financial return).

8.2 Investment Guidance issued by the Department for Levelling Up Housing and Communities (DLUHC) and Welsh Government also broadens the definition of investments to include all such assets held partially or wholly for financial return.

8.3 The Council held £19,269,750 of such investments in:

- Directly owned property = £18,401,950
- Loan to Worcestershire F.A. = £750,000
- Loan to Lower Wick Swimming Pool = £97,800
- Loan to Kiln CIC = £20,000
- Shared ownership housing = Nil
- Shareholding in subsidiaries = Nil
- Loans to subsidiaries = Nil

8.4 These investments generated £1,127,970 of gross income in 2021/22.

Ward(s): **All**

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Appendix 1

Treasury Management Annual Report
Background information from our Treasury advisors; Arlingclose

Economic Background for 2021/22

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.

Bank Rate was 0.1% at the beginning of the reporting period. April and May saw the economy gathering momentum as the shackles of the pandemic restrictions were eased. Despite the improving outlook, market expectations were that the Bank of England would delay rate rises until 2022. Rising, persistent inflation changed that.

UK CPI was 0.7% in March 2021 but thereafter began to steadily increase. Initially driven by energy price effects and by inflation in sectors such as retail and hospitality which were re-opening after the pandemic lockdowns, inflation then was believed to be temporary. Thereafter price rises slowly became more widespread, as a combination of rising global costs and strong demand was exacerbated by supply shortages and transport dislocations. The surge in wholesale gas and electricity prices led to elevated inflation expectations. CPI for February 2022 registered 6.2% year on year, up from 5.5% in the previous month and the highest reading in the National Statistic series. Core inflation, which excludes the more volatile components, rose to 5.2% y/y from 4.4%.

The government's jobs furlough scheme insulated the labour market from the worst effects of the pandemic. The labour market began to tighten and demand for workers grew strongly as employers found it increasingly difficult to find workers to fill vacant jobs. Having peaked at 5.2% in December 2020, unemployment continued to fall and the most recent labour market data for the three months to January 2022 showed the unemployment rate at 3.9% while the employment rate rose to 75.6%. Headline 3-month average annual growth rate for wages were 4.8% for total pay and 3.8% for regular pay. In real terms, after adjusting for inflation, total pay growth was up 0.1% while regular pay fell by 1.0%.

With the fading of lockdown – and, briefly, the 'pingdemic' – restraints, activity in consumer-facing sectors improved substantially as did sectors such as oil and mining with the reopening of oil rigs but materials shortages and the reduction in the real spending power of households and businesses dampened some of the growth momentum. Gross domestic product (GDP) grew by an upwardly revised 1.3% in the fourth calendar quarter of 2021 according to the final estimate (initial estimate 1.0%) and took UK GDP to just 0.1% below where it was before the pandemic. The annual growth rate was revised down slightly to 7.4% (from 7.5%) following a revised 9.3% fall in 2020.

Having increased Bank Rate from 0.10% to 0.25% in December, the Bank of England hiked it further to 0.50% in February and 0.75% in March. At the meeting in February, the Monetary Policy Committee (MPC) voted unanimously to start reducing the stock of its asset purchase scheme by ceasing to reinvest the proceeds from maturing bonds as well as starting a programme of selling its corporate bonds.

In its March interest rate announcement, the MPC noted that the invasion of Ukraine had caused further large increases in energy and other commodity prices, with the expectation that the conflict will worsen supply chain disruptions around the world and push CPI inflation to around 8% later in 2022, even higher than forecast only a month before in the February Monetary Policy Report. The Committee also noted that although GDP in January was stronger than expected with business confidence holding up and the labour market remaining robust, consumer confidence had fallen due to the squeeze in real household incomes.

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 list to 'stable', recognising their improved capital positions compared to 2020 and better economic growth prospects in the UK.

Fitch also revised the outlook for Nordea, Svenska Handelsbanken and Handelsbanken plc to stable. The agency considered the improved economic prospects in the Nordic region to have reduced the baseline downside risks it previously assigned to the lenders.

The successful vaccine rollout programme was credit positive for the financial services sector in general and the improved economic outlook meant some institutions were able to reduce provisions for bad loans. However, in 2022, the uncertainty engendered by Russia's invasion of Ukraine pushed CDS prices modestly higher over the first calendar quarter, but only to levels slightly above their 2021 averages, illustrating the general resilience of the banking sector.

Having completed its full review of its credit advice on unsecured deposits, in September Arlingclose extended the maximum duration limit for UK bank entities on its recommended lending list from 35 days to 100 days; a similar extension was advised in December for the non-UK banks on this list. As ever, the institutions and durations on the Council's counterparty list recommended by Arlingclose remains under constant review.