**OVERVIEW AND SCRUTINY COMMITTEE**

**DATE OF MEETING: 14 DECEMBER 2021**

**TITLE OF REPORT: TREASURY MANAGEMENT STRATEGY STATEMENT HALF-YEAR REVIEW REPORT 2021/22**

**Report of: Head of Corporate Services**

**Cabinet Member: Councillor James Radley, Deputy Leader and Portfolio Holder for Finance and Assets**

## 1. PURPOSE OF REPORT

1.1 To report the Council's Treasury Management activities and performance during the first half of the 2021/22 financial year (April-September 2021).

## 2. OFFICER RECOMMENDATION

2.1 That the Overview and Scrutiny Committee review the report providing scrutiny and challenge in advance of the report being reviewed by Cabinet.

2.2 That the Overview and Scrutiny Committee endorse the recommendation to Cabinet to increase the Barclays Counterparty limit to £10m until the 31 March to accommodate the investment in the Barclays Green Investment fund.

2.3 That following the acquisition of Centenary House, the Overview and Scrutiny Committee endorse the recommendation to increase the Operational Boundary and Authorised Limit as detailed in Paragraph 4.3.

## 3. BACKGROUND

### 3.1 Capital Strategy

3.1.1 In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued revised Prudential and Treasury Management Codes. These require all local authorities to prepare a Capital Strategy which is to provide the following:

- a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services.
- an overview of how the associated risk is managed.
- the implications for future financial sustainability.

The Capital Strategy is updated annually and reviewed and approved by Cabinet as part of the annual budget setting process.

## 3.2 Treasury management

3.2.1 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of our Treasury management operations are to ensure this cash flow is adequately planned, with surplus monies being invested in low-risk counterparties, providing adequate liquidity, before considering optimising investment return.

3.2.2 The second main function of Treasury management is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer-term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer-term cash may involve arranging long or short-term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

3.2.3 Treasury management is defined as: The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

## 4. INTRODUCTION

4.1 This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017). The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the full Council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report, (stewardship report), covering activities during the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is Overview and Scrutiny Committee.

4.2 This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first half of the 2021/22 financial year.

- A review of the Treasury Management Strategy Statement and Annual Investment Strategy.
- The Council's capital expenditure, as set out in the Capital Strategy, and prudential indicators.
- A review of the Council's investment portfolio for 2021/22.
- A review of the Council's borrowing strategy for 2021/22.
- A review of any debt rescheduling undertaken during 2021/22.
- A review of compliance with Treasury and Prudential Limits for 2021/22.

4.3 This report requests two key changes to the Treasury Management Strategy Statement and Annual Investment Strategy approved in February 2021.

- The first change is to increase the Barclays's counterparty limit from £5m to £10m to accommodate the Green Investment Account. The total limit for Barclays will include both the main current accounts used for day-to-day operations and Green Investment Account.

- The second change is to increase in Operational Boundary from £25m to £38m and Authorised Limit from £30m to £43m to accommodate for revised Capital expenditure estimated for 2021-22. This is to take account of the investment made in Centenary House.

## 5. ECONOMICS AND INTEREST RATES – Economic Update provided by Link Asset Management

5.1. " *On the 24th of September 2021, the Monetary Policy Committee (MPC) voted unanimously to leave the Bank Rate unchanged at 0.10% and made no changes to its programme of quantitative easing purchases due to finish by the end of this year at a total of £895bn; two MPC members voted to stop the last £35bn of purchases as they were concerned that this would add to inflationary pressures.*

*5.1.2 There was a major shift in the tone of the MPC's minutes at this meeting from the previous meeting in August which had majored on indicating that some tightening in monetary policy was now on the horizon, but also not wanting to stifle economic recovery by too early an increase in Bank Rate. In his press conference after the August MPC meeting, Governor Andrew Bailey said, "the challenge of avoiding a steep rise in unemployment has been replaced by that of ensuring a flow of labour into jobs" and that "the Committee will be monitoring closely the incoming evidence regarding developments in the labour market, and particularly unemployment, wider measures of slack, and underlying wage pressures." In other words, it was flagging up a potential danger that labour shortages could push up wage growth by more than it expects and that, as a result, CPI inflation would stay above the 2% target for longer. It also discounted sharp increases in monthly inflation figures in the pipeline in late 2021 which were largely propelled by events a year ago e.g., the cut in VAT in August 2020 for the hospitality industry, and by temporary shortages which would eventually work their way out of the system: in other words, the MPC had been prepared to look through a temporary spike in inflation.*

5.1.3 *In August the country was put on alert. However, this time the MPC's words indicated there had been a marked increase in concern that more recent increases in prices, particularly the increases in gas and electricity prices in October and due again next April, are, indeed, likely to lead to faster and higher inflation expectations and underlying wage growth, which would in turn increase the risk that price pressures would prove more persistent next year than previously expected. Indeed, to emphasise its concern about inflationary pressures, the MPC pointedly chose to reaffirm its commitment to the 2% inflation target in its statement; this suggested that it was now willing to look through the flagging economic recovery during the summer to prioritise bringing inflation down next year. This is a reversal of its priorities in August and a long way from words at earlier MPC meetings which indicated a willingness to look through inflation overshooting the target for limited periods to ensure that inflation was 'sustainably over 2%'. Indeed, whereas in August the MPC's focus was on getting through a winter of temporarily high energy prices and supply shortages, believing that inflation would return to just under the 2% target after reaching a high around 4% in late 2021, now its primary concern is that underlying price pressures in the economy are likely to get embedded over the next year and elevate future inflation to stay significantly above its 2% target and for longer.*

5.1.4 *Financial markets are now pricing in a first increase in Bank Rate from 0.10% to 0.25% in February 2022, but this looks ambitious as the MPC has stated that it wants to see what happens to the economy, and particularly to employment once furlough ends at the end of September. At the MPC's meeting in February it will only have available the employment figures for November: to get a clearer picture of employment trends, it would need to wait until the May meeting when it would have data up until February. At its May meeting, it will also have a clearer understanding of the likely peak of inflation.*

5.1.5 *The MPC's forward guidance on its intended monetary policy on raising Bank Rate versus selling (quantitative easing) holdings of bonds is as follows:*

- *Placing the focus on raising Bank Rate as "the active instrument in most circumstances".*
- *Raising Bank Rate to 0.50% before starting on reducing its holdings.*
- *Once Bank Rate is at 0.50% it would stop reinvesting maturing gilts.*
- *Once Bank Rate had risen to at least 1%, it would start selling its holdings.*

5.1.6 *COVID-19 vaccines. These have been the game changer which have enormously boosted confidence that life in the UK could largely return to normal during the summer after a third wave of the virus threatened to overwhelm hospitals in the spring. With the household saving rate having been exceptionally high since the first lockdown in March 2020, there is plenty of pent-up demand and purchasing power stored up for services in hard hit sectors like restaurants, travel and hotels. The big question is whether mutations of the virus could develop which render current vaccines ineffective, as opposed to how quickly vaccines can be modified to deal with them and enhanced testing programmes be implemented to contain their spread.*

5.1.7 *US. See comments below on US treasury yields.*

*5.1.8 EU. The slow role out of vaccines initially delayed economic recovery in early 2021 but the vaccination rate has picked up sharply since then. After a contraction in GDP of -0.3% in Q1, Q2 came in with strong growth of 2%, which is likely to continue into Q3, though some countries more dependent on tourism may struggle. Recent sharp increases in gas and electricity prices have increased overall inflationary pressures but the ECB is likely to see these as being only transitory after an initial burst through to around 4%, so is unlikely to be raising rates for a considerable time.*
*German general election. With the CDU/CSU and SDP both having won around 24-26% of the vote in the September general election, the composition of Germany's next coalition government may not be agreed by the end of 2021. An SDP-led coalition would probably pursue a slightly less restrictive fiscal policy, but any change of direction from a CDU/CSU led coalition government is likely to be small. However, with Angela Merkel standing down as Chancellor as soon as a coalition is formed, there will be a hole in overall EU leadership which will be difficult to fill.*

*5.1.9 China. After a concerted effort to get on top of the virus outbreak in Q1 2020, economic recovery was strong in the rest of the year; this enabled China to recover all the initial contraction. During 2020, policy makers both quashed the virus and implemented a programme of monetary and fiscal support that was particularly effective at stimulating short-term growth. At the same time, China's economy benefited from the shift towards online spending by consumers in developed markets. These factors helped to explain its comparative outperformance compared to western economies during 2020 and earlier in 2021. However, the pace of economic growth has now fallen back after this initial surge of recovery from the pandemic and China is now struggling to contain the spread of the Delta variant through sharp local lockdowns - which will also depress economic growth. There are also questions as to how effective Chinese vaccines are proving. In addition, recent regulatory actions motivated by a political agenda to channel activities into officially approved directions, are also likely to reduce the dynamism and long-term growth of the Chinese economy.*

*5.1.10 Japan. 2021 has been a patchy year in combating Covid. However, after a slow start, nearly 50% of the population are now vaccinated and Covid case numbers are falling. After a weak Q3 there is likely to be a strong recovery in Q4. The Bank of Japan is continuing its very loose monetary policy but with little prospect of getting inflation back above 1% towards its target of 2%, any time soon: indeed, inflation was negative in July. New Prime Minister Kishida has promised a large fiscal stimulus package after the November general election – which his party is likely to win.*

*5.1.11 World growth. World growth was in recession in 2020 but recovered during 2021 until starting to lose momentum more recently. Inflation has been rising due to increases in gas and electricity prices, shipping costs and supply shortages, although these should subside during 2022. It is likely that we are heading into a period where there will be a reversal of world globalisation and a decoupling of western countries from dependence on China to supply products, and vice versa. This is likely to reduce world growth rates from those in prior decades.*

*5.1.12 Supply shortages. The pandemic and extreme weather events have been highly disruptive of extended worldwide supply chains. At the current time there are major queues of ships unable to unload their goods at ports in New York, California and China. Such issues have led to misdistribution of shipping containers around the world and have contributed to a huge increase in the cost of shipping. Combined with a shortage of semi-conductors, these issues have had a disruptive impact on production in many countries. Many western countries are also hitting up against a difficulty in filling job vacancies. It is expected that these issues will be gradually sorted out, but they are currently contributing to a spike upwards in inflation and shortages of materials and goods on shelves. "*

## 5.2 Interest rate forecasts

5.2.1 The Council's Treasury advisor, Link Asset Management provided the following forecasts on 29th September 2021 (PWLB rates are certainty rates, gilt yields plus 80bps):

| Link Group Interest Rate View 29.9.21 | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Dec-21 | Mar-22 | Jun-22 | Sep-22 | Dec-22 | Mar-23 | Jun-23 | Sep-23 | Dec-23 | Mar-24 |
| BANK RATE | 0.10 | 0.10 | 0.25 | 0.25 | 0.25 | 0.25 | 0.50 | 0.50 | 0.50 | 0.75 |
| 3 month ave earnings | 0.10 | 0.10 | 0.20 | 0.20 | 0.30 | 0.40 | 0.50 | 0.50 | 0.60 | 0.70 |
| 6 month ave earnings | 0.20 | 0.20 | 0.30 | 0.30 | 0.40 | 0.50 | 0.60 | 0.60 | 0.70 | 0.80 |
| 12 month ave earnings | 0.30 | 0.40 | 0.50 | 0.50 | 0.50 | 0.60 | 0.70 | 0.80 | 0.90 | 1.00 |
| 5 yr PWLB | 1.40 | 1.40 | 1.50 | 1.50 | 1.60 | 1.60 | 1.60 | 1.70 | 1.70 | 1.70 |
| 10 yr PWLB | 1.80 | 1.80 | 1.90 | 1.90 | 2.00 | 2.00 | 2.00 | 2.10 | 2.10 | 2.10 |
| 25 yr PWLB | 2.20 | 2.20 | 2.30 | 2.30 | 2.40 | 2.40 | 2.40 | 2.50 | 2.50 | 2.60 |
| 50 yr PWLB | 2.00 | 2.00 | 2.10 | 2.20 | 2.20 | 2.20 | 2.20 | 2.30 | 2.30 | 2.40 |

*Additional notes by Link on this forecast table:*

- *LIBOR and LIBID rates will cease from the end of 2021. Work is currently progressing to replace LIBOR with a rate based on SONIA (Sterling Overnight Index Average). In the meantime, our forecasts are based on expected average earnings by local authorities for 3 to 12 months.*
- *Our forecasts for average earnings are averages i.e., rates offered by individual banks may differ significantly from these averages, reflecting their different needs for borrowing short term cash at any one point in time.*

5.2.2 The coronavirus outbreak has had a significant effect on the UK and other economies across the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it has left the Bank Rate unchanged.

5.2.3 As shown in the forecast table above, an increase in the Bank Rate from 0.10% to 0.25% has now been included in quarter 2 of 2022/23, a second increase to 0.50% in quarter 2 of 23/24 and a third one to 0.75% in quarter 4 of 23/24.

## 5.3 Significant risks to the forecasts (provided by Link Asset Management)

- COVID vaccines do not work to combat new mutations and/or new vaccines take longer than anticipated to be developed for successful implementation.
- The pandemic causes major long-term scarring of the economy.
- The Government implements an austerity programme that supresses GDP growth.
- The MPC tightens monetary policy too early – by raising Bank Rate or unwinding Quantative Easing.
- The MPC tightens monetary policy too late to ward off building inflationary pressures.
- Major stock markets e.g., in the US, become increasingly judged as being over-valued and susceptible to major price corrections. Central banks become increasingly exposed to the "moral hazard" risks of having to buy shares and corporate bonds to reduce the impact of major financial market selloffs on the general economy.
- Geo-political risks are widespread e.g., German general election in September 2021 produces an unstable coalition or minority government and a void in high-profile leadership in the EU when Angela Merkel steps down as Chancellor of Germany; on-going global power influence struggles between Russia/China/US.

## 5.4 The balance of risks to the UK economy (provided by Link Asset Management)

5.4.1 The overall balance of risks to economic growth in the UK is now to the downside, including residual risks from Covid and its variants - both domestically and their potential effects worldwide.

## 5.5 Forecasts for Bank Rate

5.5.1 The Bank Rate is not expected to increase quickly after the initial rate rise as the supply potential of the should be able to cope well with meeting demand without causing inflation. Three increases in Bank rate are forecast in the period to March 2024, ending at 0.75%. However, these forecasts may well need changing within a relatively short time frame for the following reasons:

- There are increasing grounds for viewing the economic recovery as running out of steam during the summer and now into the autumn. This could lead into stagflation which would create a dilemma for the MPC as to which way to face.
- Will some current key supply shortages e.g., petrol and diesel, spill over into causing economic activity in some sectors to take a significant hit?
- Rising gas and electricity prices in October and next April and increases in other prices caused by supply shortages and increases in taxation next April, are already going to deflate consumer spending power without the MPC having to take any action on Bank Rate to cool inflation.

5.5.2 In summary, with the high level of uncertainty prevailing on several different fronts, it is likely that these forecasts will need to be revised again soon - in line with what the new news is.

## 5.6 Forecasts for PWLB rates and gilt and treasury yields

5.6.1 As the interest forecast table for PWLB certainty rates above shows, there is likely to be a steady rise over the forecast period, with some degree of uplift due to rising treasury yields in the US.

5.6.2 There is likely to be exceptional volatility and unpredictability in respect of gilt yields and PWLB rates due to the following factors:

- How strongly will changes in gilt yields be correlated to changes in US treasury yields?
- Will the Fed take action to counter increasing treasury yields if they rise beyond a yet unspecified level?
- Would the MPC act to counter increasing gilt yields if they rise beyond a yet unspecified level?
- How strong will inflationary pressures turn out to be in both the US and the UK and so impact treasury and gilt yields?
- How will central banks implement their new average or sustainable level inflation monetary policies?
- How well will central banks manage the withdrawal of QE purchases of their national bonds i.e., without causing a panic reaction in financial markets as happened in the “taper tantrums” in the US in 2013?
- Will exceptional volatility be focused on the short or long-end of the yield curve, or both?

5.6.3 The forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU within our forecasting period.

## 5.7 Gilt and treasury yields

5.7.1 Since the start of 2021, there has been a lot of volatility in gilt yields, and hence PWLB rates. During the first part of the year, US President Biden’s, and the Democratic party’s determination to push through a $1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a recovery package from the Covid pandemic was what unsettled financial markets. However, this was in addition to the $900bn support package already passed in December 2020 under President Trump. This was then followed by additional Democratic ambition to spend further huge sums on infrastructure and an American families plan over the next decade which are caught up in Democrat / Republican haggling. Financial markets were alarmed that all this stimulus, which is much bigger than in other western economies, was happening at a time in the US when:

- A fast vaccination programme has enabled a rapid opening up of the economy.
- The economy had already been growing strongly during 2021.

- It started from a position of little spare capacity due to less severe lockdown measures than in many other countries. A combination of shortage of labour and supply bottle necks is likely to stoke inflationary pressures more in the US than in other countries.
- And the Fed was still providing monetary stimulus through monthly QE purchases.

5.7.2 These factors could cause an excess of demand in the economy which could then unleash stronger and more sustained inflationary pressures in the US than in other western countries. This could then force the Fed to take much earlier action to start tapering monthly QE purchases and/or increasing the Fed rate from near zero, despite their stated policy being to target average inflation.

5.7.3 There are also possible DOWNSIDE RISKS from the huge sums of cash that the UK residents have saved during the pandemic; when savings accounts earn little interest, it is likely that some of this cash mountain could end up being invested in bonds and so push up demand for bonds and support their prices i.e., this would help to keep their yields down.

**5.8 The balance of risks to medium to long term PWLB rates**

5.8.1 There is a balance of upside risks to forecasts for medium to long term PWLB rates.

**5.9 A new era – a fundamental shift in central bank monetary policy**

5.9.1 One of the key results of the pandemic has been a fundamental rethinking and shift in monetary policy by major central banks to tolerate a higher level of inflation than in the previous two decades when inflation was the prime target to bear down on so as to stop it going above a target rate. There is now also a greater emphasis on other targets for monetary policy than just inflation, especially on ‘achieving broad and inclusive “maximum” employment in its entirety’ in the US before consideration would be given to increasing rates.

## 6. TREASURY MANAGEMENT STRATEGY AND ANNUAL INVESTMENT STRATEGY UPDATE

6.1 The Treasury Management Strategy Statement (TMSS) for 2021/22 was approved by the Council on 19 January 2021.

6.2 The underlying TMSS approved previously requires revision in the light of economic and operational movements during the year. The proposed changes and supporting detail for the changes are set out below:

- Increase of counterparty limit for Barclays from £5m to £10m to accommodate for Barclays Green Deposit Account. Total limit for Barclays

would include main call account used for day-to-day operations and Green Investment Account.

- Increase in Operational boundary from £25m to £38m and Authorised limit from £30m to £43m to accommodate for revised capital expenditure estimated for 2021-22. This is to reflect expenditure on Centenary House.

| Prudential Indicator | 2021/22 Original £'000 | 2021/22 Revised £'000 |
|---|---|---|
| Authorised Limit | 30,000 | 43,000 |
| Operational Boundary | 25,000 | 38,000 |
| Capital Financing Requirement | 31,194 | 51,784 |

## 7. THE COUNCIL'S CAPITAL POSITION (PRUDENTIAL INDICATORS)

### 7.1 This part of the report is structured to update:

- The Council's capital expenditure plans.
- How these plans are being financed.
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow.
- Compliance with the limits in place for borrowing activity.

### 7.2 Prudential Indicator for Capital Expenditure

7.2.1 This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

| Capital Expenditure by Service | 2021/22 Original Estimate £'000 | Current Position £'000 | 2021/22 Revised Estimate £'000 |
|---|---|---|---|
| Corporate Services | 65 | 18,966 | 23,891 |
| Community Services | 500 | 395 | 433 |
| Place | - | - | 24 |
| Environmental and Technical Services | 1,020 | 206 | 6,648 |
| Commercialisation | 6,800 | - | - |
| **Total capital expenditure** | **8,385** | **19,567** | **30,996** |

## 7.3 Changes to the Financing of the Capital Programme

7.3.1 The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

| Capital Expenditure | 2021/22 Original Estimate £'000 | 2021/22 Revised Estimate £'000 |
|---|---|---|
| **Total capital expenditure** | **8,385** | **30,996** |
| **Financed by:** | | |
| Capital grants | 1,482 | 1,482 |
| Capital receipts | 103 | 103 |
| **Total financing** | **1,585** | **1,585** |
| **Borrowing requirement** | **6,800** | **29,411** |

## 7.4 Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

7.4.1 The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period, which is termed the Operational Boundary.

**7.4.2 Prudential Indicator – Capital Financing Requirement.** Original forecasted Capital Financing Requirement increased in line with increase in Capital expenditure due to Centenary House.

### 7.4.3 Prudential Indicator – the Operational Boundary for external debt

| Operational Boundary for external debt | 2021/22 Original £'000 | 2021/22 Revised £'000 |
|---|---|---|
| CFR | 31,194 | 51,784 |
| Borrowing | 16,554 | 37,144 |

## 7.5 Limits to Borrowing Activity

7.5.1 The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less

investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2021/22 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent. The Council's Operational Boundary is currently £25m and is proposed to increase to £38m subject to approval.

| Operational Boundary for External debt | 2021/22 Original £'000 | 2021/22 Revised £'000 |
|---|---|---|
| Operational Boundary | 25,000 | 38,000 |
| Borrowing | 16,554 | 37,144 |

7.5.2 The Head of Corporate Services reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

7.5.3 A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Council's Authorisation Limit is £30m and is proposed to increase to £43m subject to approval.

| Authorised Limit for External Debt | 2021/22 Original £'000 | 2021/22 Revised £'000 |
|---|---|---|
| Authorised Limit | 30,000 | 43,000 |
| Borrowing | 16,554 | 37,144 |

## 8. BORROWING

8.1 The Council's capital financing requirement (CFR) for 2021/22 is £51.78m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Table 7.5.3 shows the Council has borrowings of £16.55m and has utilised £14.64m of cash flow funds in lieu of borrowing. This is a prudent and cost-effective approach in the current economic climate but

will require ongoing monitoring in the event that any upside risk to gilt yields prevails.

8.2 Due to the overall financial position and the underlying need to borrow for capital purposes (the CFR), new external borrowing of £6.8m was undertaken. The capital programme is being kept under regular review due to the effects of coronavirus and shortages of materials and labour. Our borrowing strategy will, therefore, also be regularly reviewed and then revised, if necessary, in order to achieve optimum value and risk exposure in the long-term. New £6.8m PWLB borrowing has been undertaken on 10th May 2021 with 50 years term and 1.91%. interest rate.

8.3 It is not anticipated that further external borrowing will be undertaken during this financial year.

**8.4 PWLB maturity certainty rates (gilts plus 80bps) year to date to 30th September 2021**

8.4.1 Gilt yields and PWLB rates were on a falling trend between May and August. However, they rose sharply towards the end of September.

8.4.2 The 50year PWLB target certainty rate for new long-term borrowing started 2021/22 at 1.90%, rose to 2.00% in May, fell to 1.70% in August and returned to 2.00% at the end of September after the MPC meeting of 23rd September.

8.4.3 The current PWLB rates are set as margins over gilt yields as follows:

- PWLB Standard Rate is gilt plus 100 basis points (G+100bps)
- PWLB Certainty Rate is gilt plus 80 basis points (G+80bps)
- PWLB HRA Standard Rate is gilt plus 100 basis points (G+100bps)
- PWLB HRA Certainty Rate is gilt plus 80bps (G+80bps)
- Local Infrastructure Rate is gilt plus 60bps (G+60bps)

## 9. DEBT RESCHEDULING

9.1 Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

## 10. COMPLIANCE WITH TREASURY AND PRUDENTIAL LIMITS

10.1 It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. During the half year ended 30th September 2021, the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement for 2021/22. The

Head of Corporate Services reports that no difficulties are envisaged for the current or future years in complying with these indicators.

10.2 All treasury management operations have also been conducted in full compliance with the Council's Treasury Management Practices.

## 11. ANNUAL INVESTMENT STRATEGY

11.1 The Treasury Management Strategy Statement (TMSS) for 2021/22, which includes the Annual Investment Strategy, was approved by the Council on 19th January 2021. In accordance with the CIPFA Treasury Management Code of Practice, it sets out the Council's investment priorities as being:

- Security of capital
- Liquidity
- Yield

11.2 The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the Council's risk appetite. In the current economic climate, it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with high credit rated financial institutions, using the Link suggested creditworthiness approach, including a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information.

11.3 As shown by the interest rate forecasts in section 5.2, it is now impossible to earn the level of interest rates commonly seen in previous decades as all short-term money market investment rates have only risen weakly since Bank Rate was cut to 0.10% in March 2020 until the MPC meeting on 24th September 2021 when 6- and 12-month rates rose in anticipation of Bank Rate going up in 2022. Given this environment and the fact that Bank Rate may only rise marginally, or not at all, before mid-2023, investment returns are expected to remain low.

### 11.4 Creditworthiness

11.4.1 Significant levels of downgrades to Short- and Long-Term credit ratings have not materialised since the crisis in March 2020. In the main, where they did change, any alterations were limited to Outlooks. However, as economies are beginning to reopen, there have been some instances of previous lowering of Outlooks being reversed.

### 11.5 Investment Counterparty criteria

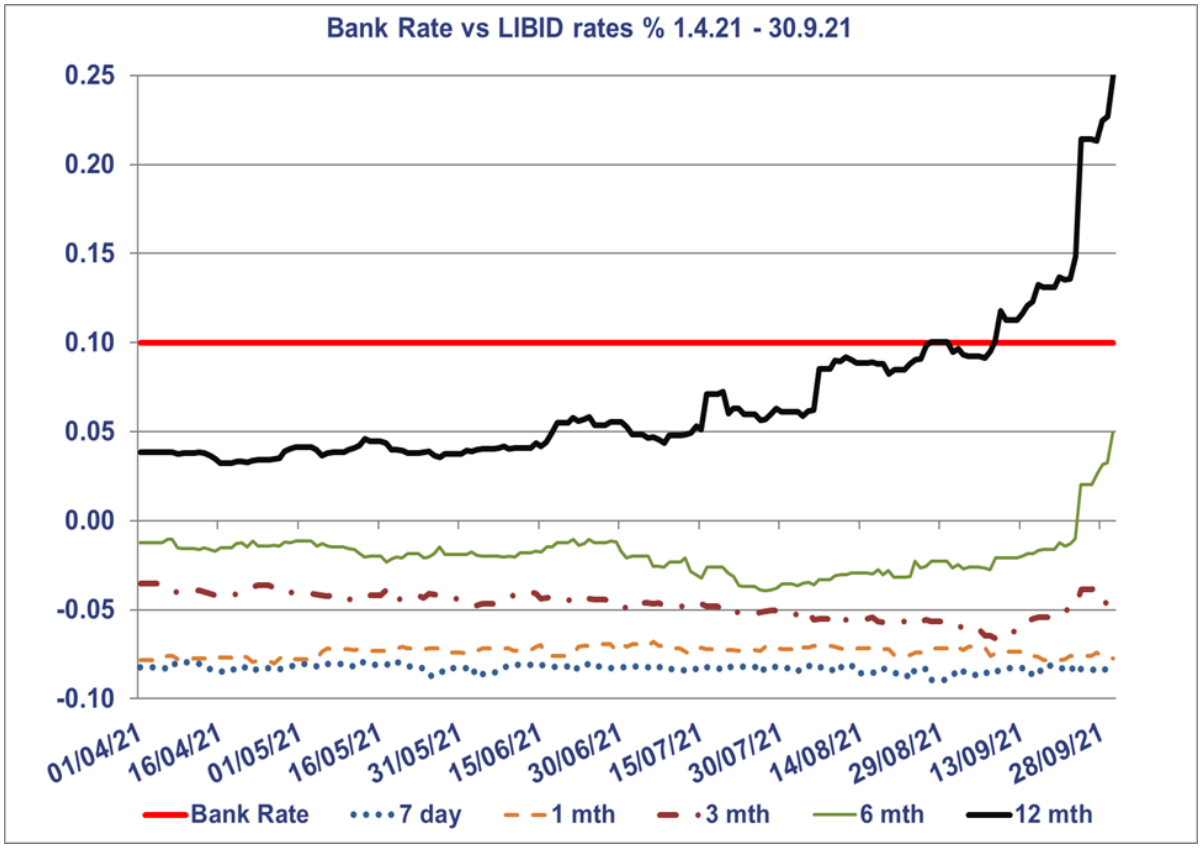
11.5.1 It is requested to amend the Barclays counterparty limit to accommodate the Barclays Green Account; all other counterparty limits should remain the same. During the financial year, temporary extensions of the counterparty limit have been in place as approved by the Portfolio Holder for Finance and assets due to the high levels of grant funding received for Business Rates grants.

## 11.7 Investment balances

11.7.1 The average level of funds available for investment purposes during the quarter was £33m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the capital programme.

## 11.8 Investment rates during half year ended 30th September 2021

11.8.1 As highlighted earlier in this report, the levels shown below use the traditional market method for calculating LIBID rates – i.e., LIBOR – 0.125%. Given the ultra-low LIBOR levels this year, this produces negative rates across some periods.




| | Bank Rate | 7 day | 1 mth | 3 mth | 6 mth | 12 mth |
|---|---|---|---|---|---|---|
| **High** | 0.10 | -0.08 | -0.07 | -0.04 | 0.05 | 0.25 |
| **High Date** | 01/04/2021 | 09/04/2021 | 06/07/2021 | 01/04/2021 | 30/09/2021 | 30/09/2021 |
| **Low** | 0.10 | -0.09 | -0.08 | -0.07 | -0.04 | 0.03 |
| **Low Date** | 01/04/2021 | 27/08/2021 | 26/04/2021 | 08/09/2021 | 27/07/2021 | 16/04/2021 |
| **Average** | 0.10 | -0.08 | -0.07 | -0.05 | -0.02 | 0.07 |
| **Spread** | 0.00 | 0.01 | 0.01 | 0.03 | 0.09 | 0.22 |

### 11.9 Investment performance year to date as of 30th September 2021

| Period | LIBID benchmark return | Council performance |
|---|---|---|
| **7 days** | **-0.08%** | 0.00% - 0.08% |
| **1 month** | **-0.07%** | 0.03%- 0.12% |
| **3 months** | **-0.05%** | 0.30% |
| **6 months** | **-0.02%** | 0.04% - 0.30% |
| **12 months** | **0.07%** | 0.18% |

11.9.1 As illustrated, the Council outperformed the benchmark. The Council's budgeted investment return for 2021/22 is £50k, and performance for the year to date is below the budget. Investment income up to 30th September is £18k.

### 11.9.2 Approved limits

11.9.2.1 The Head of Corporate Services can confirm that the approved limits within the Annual Investment Strategy were not breached during the period ended 30th September 2021.

## 12. OTHER

### 12.1 Changes in risk appetite

12.1.1 There is no change in risk appetite as the security of the Council's funds is paramount and will continue to follow Link Services advice placing funds in line with The Treasury Management Strategy Statement.

### 12.2 Counterparty limits

12.2.1 Approval was sought to implement emergency additional measures to enable the Council to handle the significant additional cash it receives (£14m+) and pay out in Grant Payments during this phase of the Covid19 response. The recommendation was to increase counterparty limits from £5m to £10m from April 2021- October 2021.

## 13. EQUALITIES

All activity will comply with the authority's statutory duties.

## 14. CLIMATE CHANGE

These strategies will work alongside the council's ambition to become a carbon neutral authority by 2035. No direct carbon/environmental impacts arising from the recommendations. We are however, starting to move to a more sensitive and sustainable investment strategy.

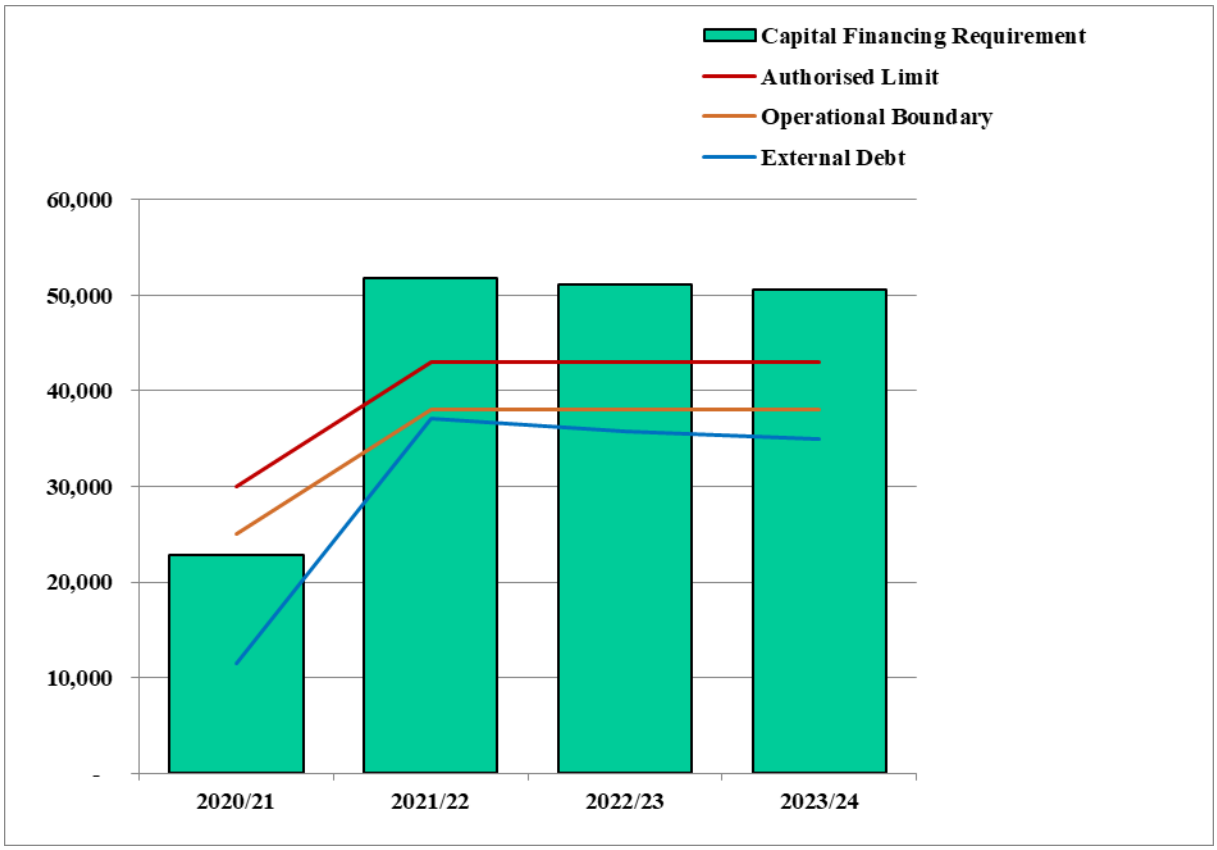
**Contact Details: Emma Foy, email:** Emma.Foy@hart.gov.uk

**Appendices**

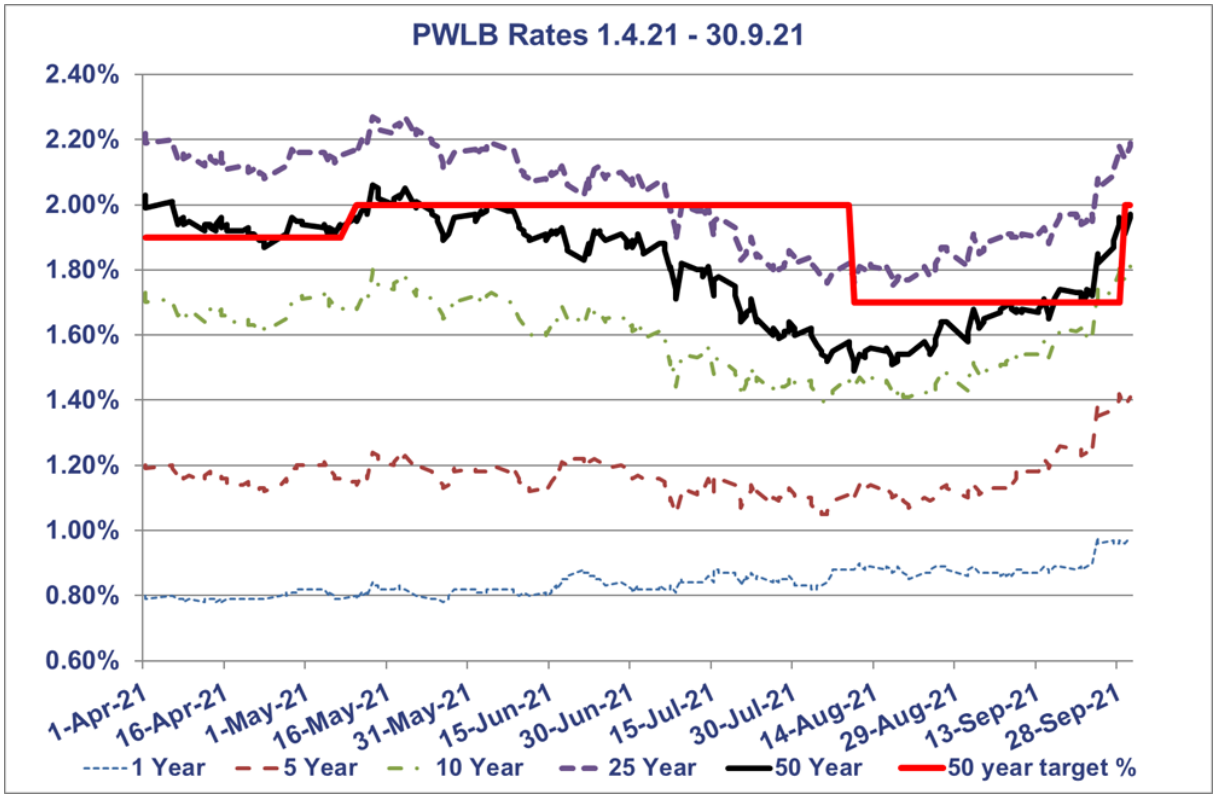
- Appendix 1 – The CFR and Borrowing
- Appendix 2 – Borrowing Rates
- Appendix 3 – Investment Portfolio
- Appendix 4 – Approved countries for investments as at 30 September 2021

## APPENDIX 1: The CFR and Borrowing

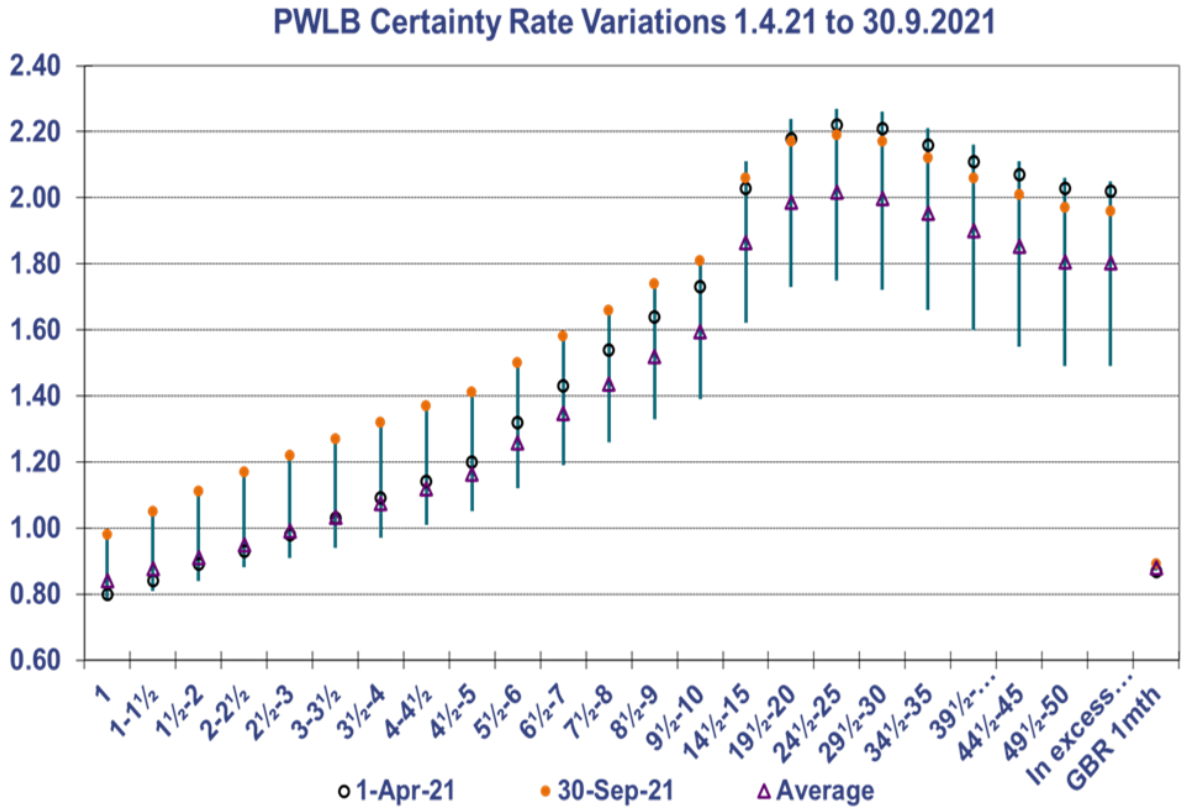
| | 2020/21 £'000 | 2021/22 £'000 | 2022/23 £'000 | 2023/24 £'000 |
|---|---|---|---|---|
| Authorised Limit | 30,000 | 43,000 | 43,000 | 43,000 |
| Operational Boundary | 25,000 | 38,000 | 38,000 | 38,000 |
| | | | | |
| Capital Financing Requirement | 22,889 | 51,784 | 51,175 | 50,565 |
| External Debt | 11,535 | 37,144 | 35,829 | 34,938 |
| | | | | |
| Under/(over) borrowing | 11,354 | 14,640 | 15,346 | 15,627 |
| Change in External Debt | - 850 | 25,609 | - 1,315 | - 891 |



**APPENDIX 2: Borrowing rates**




| | 1 Year | 5 Year | 10 Year | 25 Year | 50 Year |
|---|---|---|---|---|---|
| **Low** | 0.78% | 1.05% | 1.39% | 1.75% | 1.49% |
| **Date** | 08/04/2021 | 08/07/2021 | 05/08/2021 | 17/08/2021 | 10/08/2021 |
| **High** | 0.98% | 1.42% | 1.81% | 2.27% | 2.06% |
| **Date** | 24/09/2021 | 28/09/2021 | 28/09/2021 | 13/05/2021 | 13/05/2021 |
| **Average** | 0.84% | 1.16% | 1.60% | 2.02% | 1.81% |
| **Spread** | 0.20% | 0.37% | 0.42% | 0.52% | 0.57% |



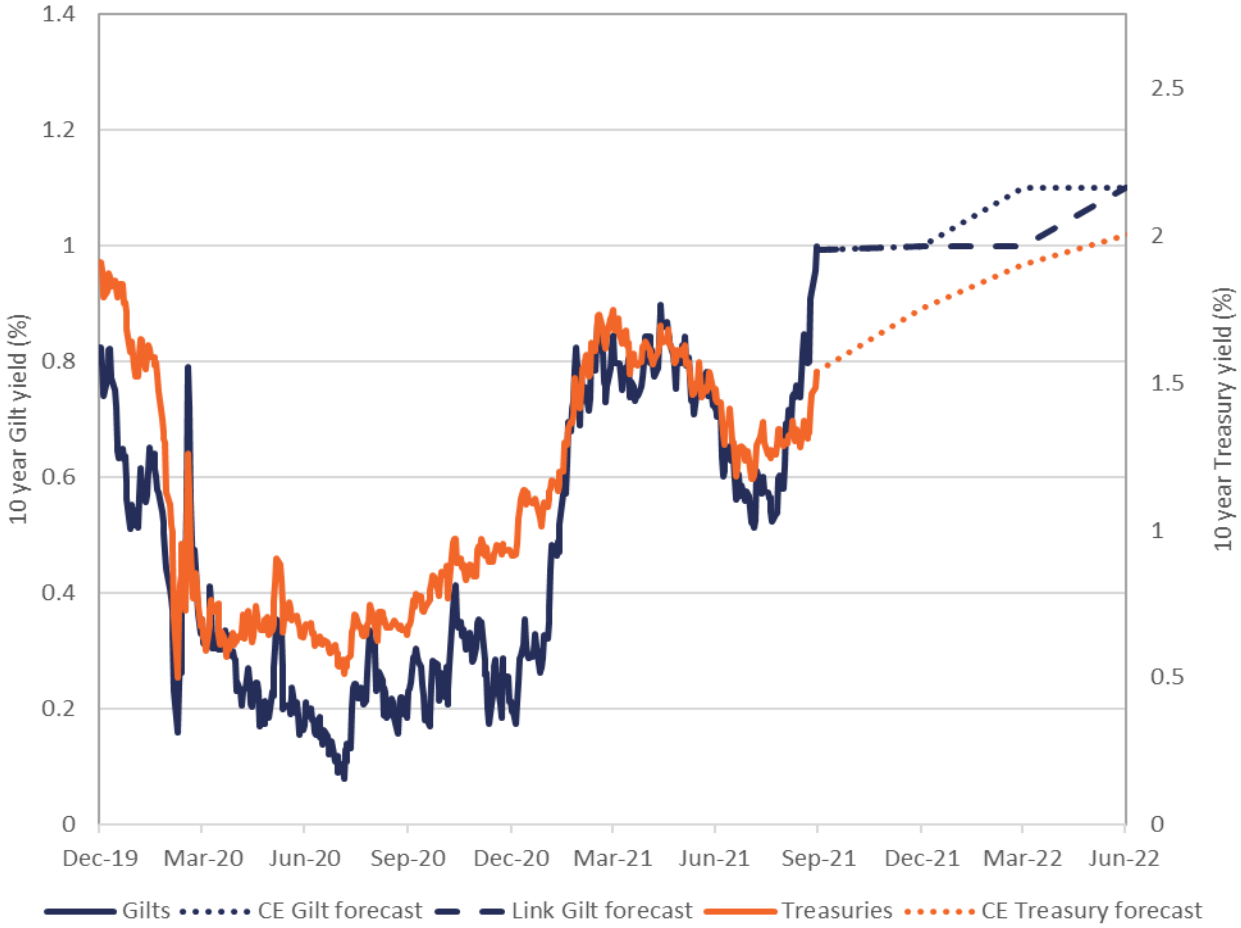

**PWLB RATES**. There was much speculation during the **second half of 2019** that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was heightened expectations that the US could have been heading for a recession in 2020. In addition, there were growing expectations of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued. Combined, these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers. This means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. The consequence of this has been **the gradual lowering of the overall level of interest rates and bond yields in financial markets.** Over the year prior to the coronavirus crisis, this resulted in many bond yields up to 10 years turning negative in the Eurozone. In addition, there was, at times, an inversion of bond yields in the US whereby 10-year yields fell below shorter-term yields. In the past, this has been a precursor of a recession.

**Gilt yields had, therefore, already been on a generally falling trend up until the coronavirus crisis hit western economies during March 2020 which caused gilt yields to spike up**. However, yields then fell sharply in response to major western central banks taking rapid policy action to deal with excessive stress in financial markets during March and starting massive quantitative easing driven purchases of government bonds: these actions also acted to put downward pressure on government bond yields at a time when there was a huge and quick expansion of government expenditure financed by issuing government bonds. Such unprecedented levels of issuance in "normal" times would have caused bond yields to rise sharply.

**At the start of January 2021,** all gilt yields from 1 to 8 years were negative: however, since then all gilt yields have become positive and rose sharply during the spring, especially in medium and longer-term periods, until starting a significant decline since May which was then sharply reversed in August / September. Repeated assurances by the Fed in the US, and by other major world central banks, that inflation would spike up after Covid restrictions were abolished, but would only be transitory, allayed investor fears until August / September when high inflation was again seen as a growing danger and both central banks in the US and UK gave indications that monetary policy tightening was now on the horizon. **There is considerable concern that the US Fed is taking a too laid-back view that inflation pressures in the US are purely transitory and that they will subside without the need for the Fed to take significant action to tighten monetary policy. Lack of spare economic**

**capacity and rising inflationary pressures are viewed as being much greater dangers in the US than in the UK. This could mean that rates will end up rising faster and further in the US than in the UK if inflationary pressures were to escalate; the consequent increases in treasury yields could well spill over to cause (lesser) increases in gilt yields.**

**Correlation between 10-year US treasury yield and 10-year gilt yield**
The Link Group forecasts have included a risk of a 75% correlation between movements in US treasury yields and gilt yields over 10 years since 2011. As US treasury yields are expected to rise faster and further than UK gilt yields, there is an upside risk to forecasts for gilt yields due to this correlation. The graph below shows actual movements in both 10-year yields and forecasts by Link (gilt only) and Capital Economics.




- Yields on 10-year Gilts and Treasuries initially both fell during the first quarter of 2020, as signs emerged that the COVID-19 virus would become a global pandemic which would lead to a sharp downturn in economic growth.
- The correlation between 10-year yields in the UK and the US lessened during the second half of 2020 when US yields displayed an increasing tendency to rise, whilst UK yields remained more range bound. This divergence was consistent with the relatively better economic performance registered by the US during the pandemic, which was aided by historically low US business inventory levels needing to be rebuilt.
- During late 2020 gilt yields rose significantly, reflecting optimism that the fast vaccine roll-out in the UK would support a strong economic recovery during 2021.
- During September 2021, treasury yields rose sharply in response to growing investor concerns around high inflation and indications from the Fed that tapering of quantitative easing purchases of treasuries are likely to occur in the near future. Gilts also rose sharply, as did investor concerns around a sharp increase in inflation in the UK which is now likely to go over 4%. In addition, the MPC meeting on 23rd September flagged up major concerns around the strength of inflation which may require Bank Rate to go up much faster than had previously been expected.

## APPENDIX 3: Investment Portfolio

Investment held as of 30th September 2021.

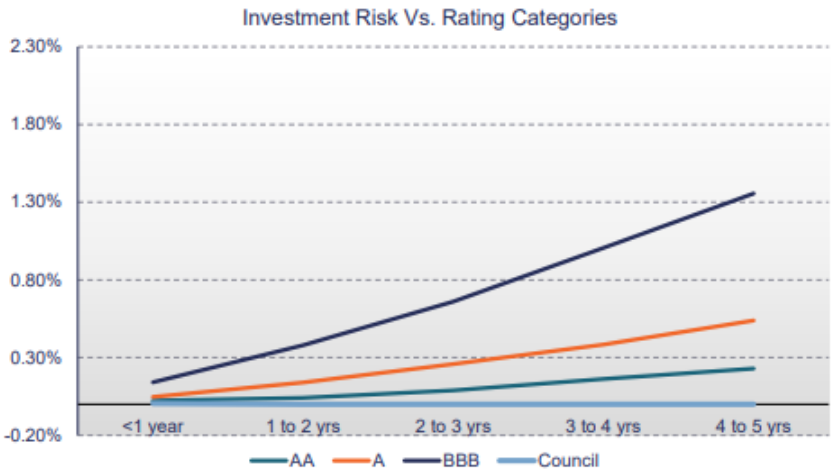
| Counterparty | Amount Invested | Counterparty Limit | Within Limit Y/N | Terms | Rate % |
|---|---|---|---|---|---|
| Barclays - Call account | 1,615,133.24 | | | Instant access-Call | 0.00% |
| Barclays - Green Account | 5,000,000.00 | | | 95 days' notice | 0.30% |
| **Barclays- total** | **6,615,133.24** | **10,000,000.00** | **Y** | | |
| Santander | 4,680,070.05 | 5,000,000.00 | Y | Instant access-Call | 0.02% |
| Bank of New York Mellon - Federated | 4,900,000.00 | 5,000,000.00 | Y | Instant access-MMF | 0.01% |
| Aberdeen Liquidity- Standard Life | 4,000,000.00 | 5,000,000.00 | Y | Instant access-MMF | 0.01% |
| Lloyds Bank | 4,000,194.03 | 5,000,000.00 | Y | 32 days' notice | 0.03% |
| Qatar National Bank | 3,000,000.00 | 5,000,000.00 | Y | Fixed-30 days | 0.12% |
| Fareham Borough Council | 5,000,000.00 | 5,000,000.00 | Y | Fixed-365 days | 0.18% |
| **Total** | **32,195,397** | | | | |

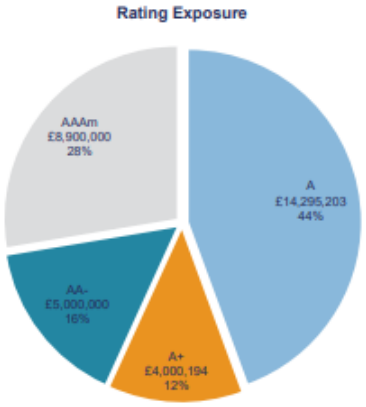
Current Investment List

| Borrower | Principal (£) | Interest Rate | Start Date | Maturity Date | Lowest LT / Fund Rating | Historic Risk of Default |
|---|---|---|---|---|---|---|
| Barclays Bank Plc (NRFB) | 1,615,133 | 0.00% | | Call | A | 0.000% |
| Santander UK PLC | 4,680,070 | 0.02% | | Call | A | 0.000% |
| MMF Aberdeen Standard Investments | 4,000,000 | 0.01% | | MMF | AAAm | |
| MMF BNY Mellon | 4,900,000 | 0.01% | | MMF | AAAm | |
| Qatar National Bank | 3,000,000 | 0.01% | 01/09/2021 | 01/10/2021 | A | 0.000% |
| Lloyds Bank Plc (RFB) | 4,000,194 | 0.03% | | Call32 | A+ | 0.004% |
| Barclays Bank Plc (NRFB) | 5,000,000 | 0.30% | | Call95 | A | 0.012% |
| Fareham Borough Council | 5,000,000 | 0.18% | 14/02/2021 | 14/02/2022 | AA- | 0.009% |
| **Total Investments** | **£32,195,397** | **0.09%** | | | | 0.005% |

Note: An historic risk of default is only provided if a counterparty has a counterparty credit rating and is not provided for an MMF or USDBF, for which the rating agencies provide a fund rating. The portfolio's historic risk of default therefore measures the historic risk of default attached only to those investments for which a counterparty has a counterparty credit rating and also does not include investments which are not rated.

## Investment Risk and Rating Exposure




Historic Risk of Default

| Rating/Years | <1 year | 1 to 2 yrs | 2 to 3 yrs | 3 to 4 yrs | 4 to 5 yrs |
|---|---|---|---|---|---|
| AA | 0.02% | 0.04% | 0.09% | 0.16% | 0.23% |
| A | 0.05% | 0.14% | 0.26% | 0.38% | 0.54% |
| BBB | 0.14% | 0.38% | 0.66% | 1.01% | 1.36% |
| Council | 0.01% | 0.00% | 0.00% | 0.00% | 0.00% |

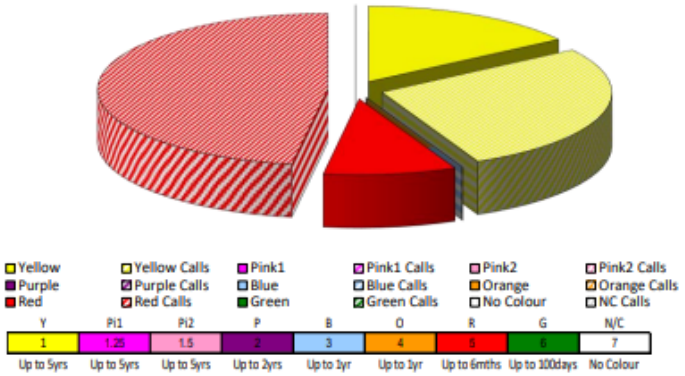
**Historic Risk of Default**
This is a proxy for the average % risk for each investment based on over 30 years of data provided by Fitch, Moody's and S&P. It simply provides a calculation of the possibility of average default against the historical default rates, adjusted for the time period within each year according to the maturity of the investment.

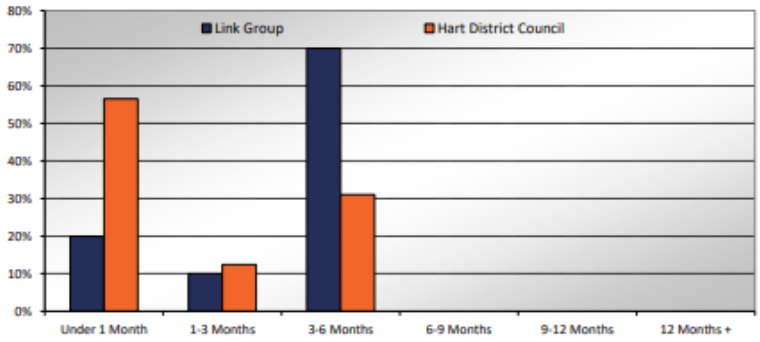
**Chart Relative Risk**
This is the authority's risk weightings compared to the average % risk of default for "AA", "A" and "BBB" rated investments.

**Rating Exposures**
This pie chart provides a clear view of your investment exposures to particular ratings.

Note: An historic risk of default is only provided if a counterparty has a counterparty credit rating and is not provided for an MMF or USDBF, for which the rating agencies provide a fund rating. The portfolio's historic risk of default therefore measures the historic risk of default attached only to those investments for which a counterparty has a counterparty credit rating and also does not include investments which are not rated.

# Portfolio Composition by Link Group's Suggested Lending Criteria



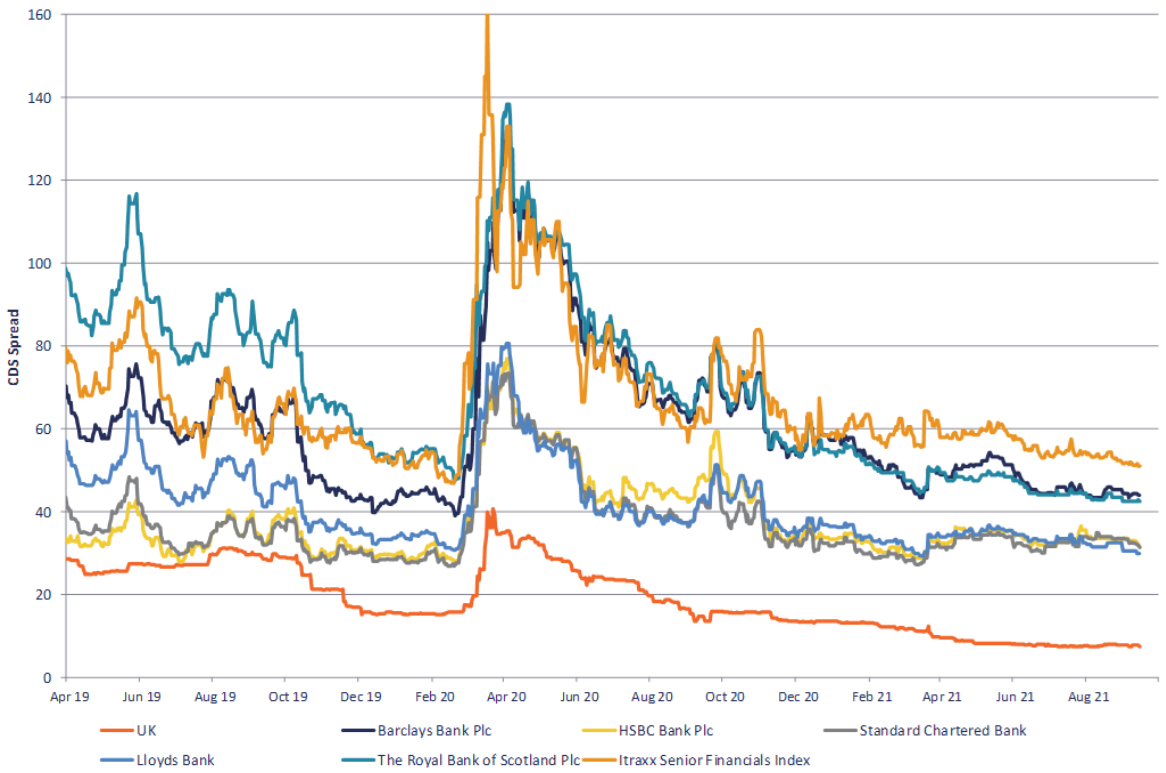




**Portfolios weighted average risk number = 3.27**

WARoR = Weighted Average Rate of Return
WAM = Weighted Average Time to Maturity

| | % of Portfolio | Amount | % of Colour in Calls | Amount of Colour in Calls | % of Call in Portfolio | WARoR | WAM | WAM at Execution | Excluding Calls/MMFs/USDBFs WAM | Excluding Calls/MMFs/USDBFs WAM at Execution |
|---|---|---|---|---|---|---|---|---|---|---|
| Yellow | 43.17% | £13,900,000 | 64.03% | £8,900,000 | 27.64% | 0.07% | 49 | 131 | 137 | 365 |
| Pink1 | 0.00% | £0 | 0.00% | £0 | 0.00% | 0.00% | 0 | 0 | 0 | 0 |
| Pink2 | 0.00% | £0 | 0.00% | £0 | 0.00% | 0.00% | 0 | 0 | 0 | 0 |
| Purple | 0.00% | £0 | 0.00% | £0 | 0.00% | 0.00% | 0 | 0 | 0 | 0 |
| Blue | 0.00% | £0 | 0.00% | £0 | 0.00% | 0.00% | 0 | 0 | 0 | 0 |
| Orange | 0.00% | £0 | 0.00% | £0 | 0.00% | 0.00% | 0 | 0 | 0 | 0 |
| Red | 56.83% | £18,295,397 | 83.60% | £15,295,397 | 47.51% | 0.10% | 33 | 38 | 1 | 30 |
| Green | 0.00% | £0 | 0.00% | £0 | 0.00% | 0.00% | 0 | 0 | 0 | 0 |
| No Colour | 0.00% | £0 | 0.00% | £0 | 0.00% | 0.00% | 0 | 0 | 0 | 0 |
| | **100.00%** | **£32,195,397** | **75.15%** | **£24,195,397** | **75.15%** | **0.09%** | **40** | **78** | **86** | **239** |

## UK Banks 5 Year Senior Debt CDS Spreads



## APPENDIX 4: Approved countries for investments as at 30 September 2021

*Based on lowest available rating*

*AAA*

- *Australia*
- *Denmark*
- *Germany*
- *Luxembourg*
- *Netherlands*
- *Norway*
- *Singapore*
- *Sweden*
- *Switzerland*

*AA+*

- *Canada*
- *Finland*
- *U.S.A.*

*AA*

- *Abu Dhabi (UAE)*
- *France*

*AA-*

- *Belgium*
- *Hong Kong*
- *Qatar*
- *U.K.*