ARGYLL AND BUTE COUNCIL	COUNCIL
FINANCIAL SERVICES	24 JUNE 2021

ANNUAL TREASURY REPORT 2020-21

1. EXECUTIVE SUMMARY

1.1 This report outlines the Council's Treasury Management position for 2020-21.

1.2 The Council is required by regulations issued under the Local Government in Scotland Act 2003 to produce an annual review of treasury management activities and the actual prudential and treasury indicators and submit this to Council. The report at Appendix 1 meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

1.3 The key points to note from the annual report are:

- Reporting requirements under the Code were met during 2020-21.
- During 2020-21 the Council's External Borrowing decreased by £4.8m from £173.6M at 31 March 2020 to £168.8m at 31 March 2021. The decrease was due repayment of borrowing of £3.8m of PWLB loans and £1.0m of market loans.
- The Capital Financing Requirement (excluding NPDO and Hub School commitments) was £172.9m this is £4.1m higher than the Council's external debt. This difference is due to higher than normal levels of cash balances partly due to slippage in the capital programme meaning there was no requirement to borrow at this stage.
- Investments at 31 March 2021 were £105.3m at an average rate of 0.578% compared to £74.8m at an average rate of 0.94% for 31 March 2020. The investment balances are higher than usual due to the COVID-19 funding that has been made available to Councils at the end of 2020-21 which requires to be carried forward into next year.
- The average investment rate of 0.578% for 2020-21 compared favourably to the average 7 day LIBID rate of -0.071% during the period. The investments generated £0.710m of interest in 2020-21.
- The Asset Management Fund was invested with Thurrock Borough Council to increase the rate of return while future long term investment of the fund is being assessed. The return on the fund was £21,624, a rate of return of 1.05%.

1.4 This report meets the Code requirement for a treasury annual report.

1.5 Management of the debt portfolio resulted in a decrease in the average interest rate of 0.16% due to a decrease in long term borrowing, this is due to the repayment of high interest loans and no new borrowing has been taken during the year.

1.6 The economic and interest rate commentary are provided by the Council's Treasury Advisors, Link Asset Services to assist in the consideration of the Council's treasury performance.

2. RECOMMENDATIONS

2.1 It is recommended that the Council note and approve the Annual Treasury Report for 2020-21.

3. IMPLICATIONS

3.1 Policy – None
3.2 Financial – None
3.3 Legal – None
3.4 Human Resources – None
3.5 Fairer Scotland Duty - None
3.5.1 Equalities – None
3.5.2 Socio-Economic Duty – None
3.5.3 Islands Duty - None
3.6 Risk – None

3.7 Customer Service – None

Kirsty Flanagan
Section 95 Officer
1 June 2021

Councillor Gary Mulvaney, Depute Council Leader - Policy Lead for Financial Services and Major Projects

For further information please contact Anne Blue, Finance Manager – Financial Services

Appendix 1 – Annual Treasury Report 2020-21

Appendix 1

ANNUAL TREASURY REPORT

2020-21

1. Introduction

This Council is required by regulations issued under the Local Government in Scotland Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2020-21. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

During 2020-21 the minimum reporting requirements were that the full Council, the Policy and Resources Committee or the Business Continuity Committee should receive the following reports:

- an annual treasury strategy in advance of the year (Council: 27 February 2020) for the financial year 2020-21
- a mid-year (minimum) treasury update report (Policy and Resources Committee: 10 December 2020)
- an annual review following the end of the year describing the activity compared to the strategy (this report).

In addition, the Business Continuity Committee received a treasury management update report on 13 August 2020 and the Policy and Resources Committee received further update reports on 15 October 2020 and 18 February 2021.

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council also confirms that it has complied with the requirement under the Code to give scrutiny to all of the above treasury management reports by the Policy and Resources Committee and Business Continuity Committee.

2. The Economy and Interest Rates

Link Asset Services are the Council's Treasury Advisors and have provided commentary on the current economic position. The UK position is noted below and commentary on other countries is included within Appendix A.

UK. The key quarterly Monetary Policy Report meeting of the Bank of England's Monetary Policy Committee (MPC) kept the Bank Rate and quantitative easing (QE) unchanged on 4th February, However, it revised its economic forecasts to take account of a third national lockdown which started on 5th January 2021, which is going to further delay economic recovery and do further damage to the economy. Although its short-term forecasts were cut for 2021 due to the start of a third lockdown in January 2021, the medium-term forecasts were more optimistic than in November 2020, based on an assumption that the current lockdown will be gradually eased after Q1 as vaccines are gradually rolled out and life can then start to go back to some sort of normality. The Bank's main assumptions were:

- The economy would start to recover strongly from Q3 2021 although it acknowledged there were downside risks from virus mutations etc.
- £125bn of savings made by consumers during the pandemic will give a big boost to the pace of economic recovery once lockdown restrictions are eased and consumers can resume high street shopping, going to pubs and restaurants and taking holidays.
- The economy would still recover to reach its pre-pandemic level by Q1 2022 despite a long lockdown in Q1 2021. Spare capacity in the economy would be eliminated in Q1 2022 and there would be excess demand in the economy by Q4 2022.
- CPI inflation was forecast to rise quite sharply towards the 2% target in the first half of 2021 due to some temporary factors, (e.g. the reduction in VAT for certain services comes to an end) and given developments in energy prices. CPI inflation was projected to be close to 2% in 2022 and 2023.
- The MPC reiterated its previous guidance that the Bank Rate would not rise until inflation was sustainably above 2%. This means it will tolerate inflation running above 2% from time to time to balance out periods during which inflation is below 2%. This is termed average inflation targeting. While financial markets are pricing in the Bank Rate starting to rise by the end of 2022, this policy could mean the Bank Rate does not rise until as late as 2026.
- The Bank of England removed negative interest rates as a possibility for at least six months as financial institutions were not ready to implement them. As in six months' time the economy should be starting to grow strongly, this effectively means that negative rates occurring were unlikely during the current downturn. (Gilt yields and PWLB rates jumped upwards after the removal of negative rates as a key risk in the short-term.)

The Budget on 3 March 2021 increased fiscal support to the economy and employment during 2021 and 2022 followed by substantial tax rises in the following three years to help to pay the cost for the pandemic. This will help further to strengthen the economic recovery from the pandemic and to return the UK Government's finances to a balanced budget on a current expenditure and income basis in 2025/26. This will stop the Debt to GDP ratio rising further from 100%. An area of concern, though, is that the UK Government's debt is now twice as sensitive to interest rate rises as before the pandemic due to QE operations substituting fixed long-term debt for floating rate debt; there is, therefore, much incentive for the UK Government to promote the Bank Rate staying low e.g. by using fiscal policy in conjunction with the monetary policy action by the Bank of England to keep inflation from rising too high, and / or by amending the Bank's policy mandate to allow for a higher target for inflation.

Brexit. The final agreement on 24 December 2020 eliminated a significant downside risk for the UK economy. The initial agreement only covered trade so there is further work to be done on the services sector where temporary equivalence has been granted in both directions between the UK and EU; that now needs to be formalised on a permanent basis. There was much disruption to trade in January as form filling has proved to be a formidable barrier to trade. This appears to have eased somewhat since then but is an area that needs further work to ease difficulties, which are still acute in some areas.

Inflation is likely to rise sharply to around 2% during 2021 for a short period, but as this will be transitory due to one-off factors, it will cause the European Central Bank (ECB) little concern. It is currently unlikely that it will cut its central rate even further into negative territory from -0.5%, although the ECB has stated that it retains this as a possible tool to use. The ECB's December 2020 meeting added a further €500bn to the PEPP scheme, (purchase of government and other bonds), and extended the duration of the programme to March 2022 and re-investing maturities for an additional year until December 2023. Three additional tranches of TLTRO, (cheap loans to banks), were approved, indicating that support will last beyond the impact of the pandemic, implying indirect yield curve control for government bonds for some time ahead. The total PEPP scheme of €1,850bn of QE which started in March 2020 is providing protection to the sovereign bond yields of weaker countries like Italy. There is, therefore, unlikely to be a euro crisis while the ECB is able to maintain this level of support. The March ECB meeting also took action to suppress the rise in long bond yields by stepping up its monthly PEPP purchases.

3. Overall Treasury Position as at 31 March 2021

The table below sets out the Council's treasury position (excluding borrowing by PFI and finance leases) at the beginning and the end of 2020-21.

	31 March 2020 Principal £m	Rate/ Return	Average Life yrs	31 March 2021 Principal £m	Rate/ Return	Average Life yrs
Total debt	***174***	***4.35%***	***26.31***	***169***	***4.19%***	***26.56***
CFR	***172***			***173***		
Over / (under) borrowing	***2***			***(4)***		
Total investments	***74.80***	***0.94%***		***105.3***	***0.48%***	
Net debt	**99.2**			**63.7**		

The Council was under borrowed by £4.1m at 31 March 2021, the budgeted position for 2020-21 predicted a year end under borrowed position of £4.7m. The difference of £0.600m is due to profiling movements within the capital programme.

4. The Strategy for 2020-21

The expectation for interest rates within the treasury management strategy for 2020-21 anticipated that the Bank Rate would remain constant over the course of the financial year at 0.75%. However, due to the COVID-19 pandemic crisis, interest rates fell and currently sit at 0.10%.

With low borrowing rates, the Council's strategy would be to take borrowing to support the capital programme. However, due to high levels of cash balances and significant slippage in the capital programme due to COVID-19 there is no requirement to borrow at present. This position will be kept under review as based on current approved capital expenditure plans, the Council still has a need to borrow in the future and it may be advantageous to secure borrowing at low rate.

5. The Borrowing Requirement and Debt

The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR).

	31st March 2020 Actuals £M	31st March 2021 Budget £M	31st March 2021 Actuals £M
CFR - General Fund	296	305	294
Less NPDO	124	120	121
Net CFR	172	185	173

6. Borrowing Rates in 2020-21

Public Works Loans Board (PWLB) certainty maturity borrowing rates

The following commentary on PWLB rates during 2020-21 was provided by our treasury advisors, Link Asset Services:

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. After gilt yields initially spiked upwards in March, yields 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.

As at 31 December 2020, all gilt yields from 1 to 8 years were still in negative territory: however, since then all gilt yields have now become positive and have risen sharply, especially medium and longer-term yields.

- HM Treasury imposed two changes of margins over gilt yields for PWLB rates in 2019/20 without any prior warning. The first took place on 9 October 2019, adding an additional 1% margin over gilts to all PWLB period rates. That increase was then, at least partially, reversed for some forms of borrowing on 11 March 2020, but not for mainstream non-HRA capital schemes. A consultation was then held with local authorities and on 25 November 2020, the Chancellor announced the conclusion to the review of margins over gilt yields for PWLB rates; the standard and certainty margins were reduced by 1% but a prohibition was introduced to deny access to borrowing from the PWLB for any local authority which had purchase of assets for yield in its three year capital programme. The new margins over gilt yields are as follows: -.

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

As the interest forecast table for PWLB certainty rates, (gilts plus 80bps), above shows, there is likely to be little upward movement in PWLB rates over the next three years as the Bank of England is not expected to raise Bank Rate during that period as inflation is not expected to be sustainably over 2%.

7. Borrowing Outturn for 2020-21

Borrowing

Due to high levels of cash balances and significant slippage in the capital programme, in part due to the COVID-19 pandemic, there was no requirement to take out any new borrowing during the year.

Rescheduling: No rescheduling was carried out during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

Repayments: The Council repaid the following long term loans during the year using investment balances.

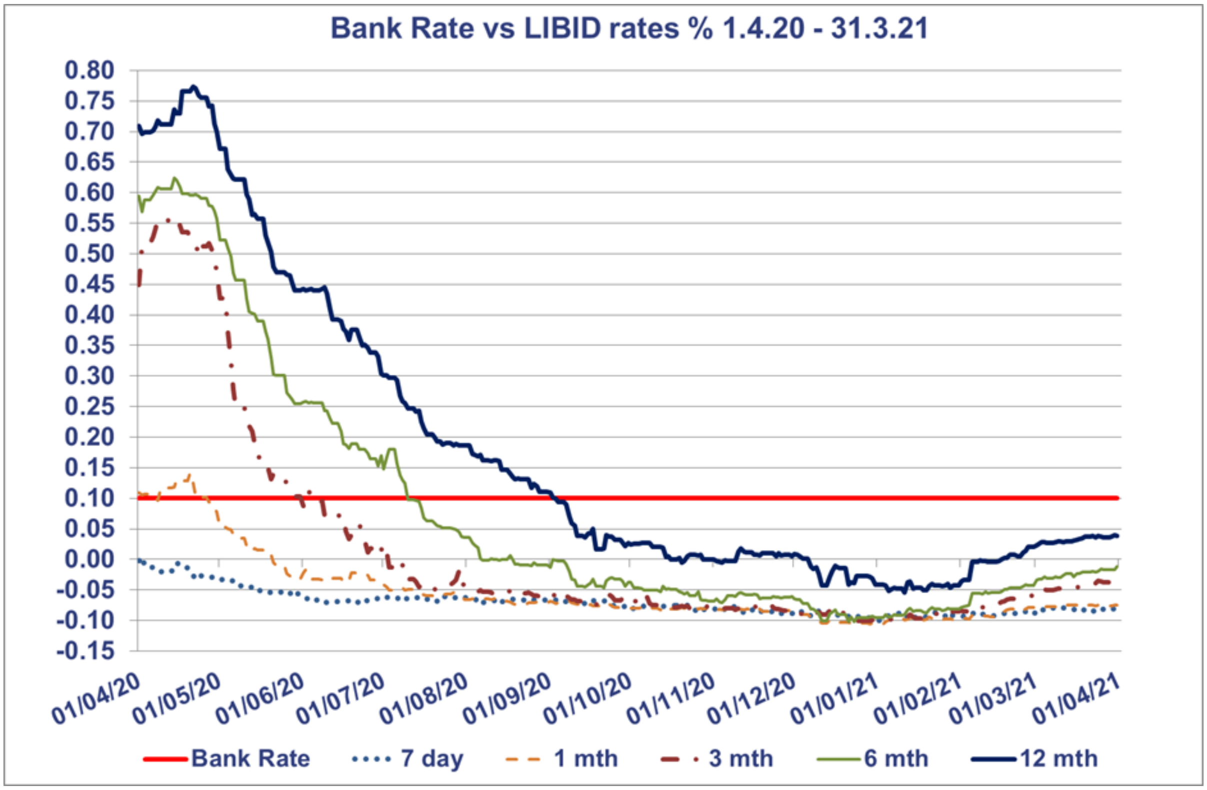
Lender	Principal	Type	Interest rate
PWLB	£0.698 m	Fixed Interest Rate	8.00%
PWLB	£0.331 m	Fixed Interest Rate	10.50%
PWLB	£2.413 m	Fixed Interest Rate	10.125%
PWLB	£0.330 m	Fixed Interest Rate	8.00%

Summary of debt transactions: Management of the debt portfolio resulted in a decrease in the average interest rate of 0.16% due to a decrease in long term borrowing. As can be seen from the table above, high interest rate loans have been repaid and no new borrowing has been taken out during the year.

8. Investment Rates in 2020-21

The expectation for interest rates within the treasury management strategy for 2020-21 was that investment returns would remain low over the course of the year. This has in fact been the reality as all short-term money market investment rates are below or little above the Bank Rate at 0.10%.

At the time the 2020-21 strategy was prepared there was hope that if major progress was made with an agreed UK withdrawal from the EU then there would be potential for earnings to increase, however the impact of the COVID-19 pandemic resulted in further economic downturn.



9. Investment Outturn 2020-21

The Council's investment policy is governed by Scottish Government investment regulations which have been implemented in the annual investment strategy approved by the Council on 27 February 2020. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.). The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

The Council's treasury investment portfolio was £105.3m at 31 March 2021 compared to £74.8m at 31 March 2020. The composition of the investment portfolio is shown in the table below. The internally managed funds earned an average rate of return of 0.578%. The comparable performance indicator is the average 7-day LIBID rate, which was -0.071%. This generated £0.710m of interest in 2020-21.

TREASURY PORTFOLIO					
		Actual	Actual	Actual	Actual
		31.03.20	31.03.20	31.03.21	31.03.21
Treasury investments		**£000**	**%**	**£000**	**%**
Banks	Clydesdale Bank	242	0%	15,518	15%
	Bank of Scotland	5,000	7%	0	0%
	Goldman Sachs	7,500	10%	0	0%
	Qatar National Bank	0	0%	10,000	9%
	Santander	7,500	10%	15,000	14%
	ANZ Banking Group/London	7,500	10%	0	0%
	First Abu Dhabi Bank	5,000	7%	0	0%
	Al Rayan Bank	0	0%	5,000	5%
	Close Bros Bank	0	0%	5,000	5%
		32,742	44%	50,518	48%
Building Societies - unrated		0	0%	0	0%
Local Authorities	Cherwell District Council	5,000	7%	0	0%
	Lancashire County Council	7,000	9%	5,000	5%
	Thurrock Borough Council	5,000	7%	10,000	9%
	Cornwall County Council	5,000	7%	0	0%
	Dudley Metropolitan Borough Council	0	0%	5,000	5%
	London Borough of Croydon	0	0%	7,500	7%
	Rotherham Metropolitian Borough Council	0	0%	7,500	7%
	Cheshire West & Chester Council	0	0%	2,500	2%
		22,000	29%	37,500	36%
DMADF (H.M.Treasury)		0	0%	0	0%
Money Market Funds	Aberdeen Liquidity Sterling Fund Class L1	7,500	10%	0	0%
	Federated	7,550	10%	2,290	2%
	CCLA	0	0%	15,000	14%
		15,050	20%	17,290	16%
Certificates of Deposit	National Westminster Bank Plc	5,000	7%	0	0%
		5,000	7%	0	0%
Total Treasury Investments		**74,792**	**100%**	**105,308**	**100%**

The Council invested the £2m Asset Management Fund in a deposit with Thurrock Borough Council during 2020-21 to increase the rate of return while future long term investment of the fund is being assessed. The return on the fund was £21,624 a rate of return of 1.05%.

10. Prudential and Treasury Indicators

During 2020-21, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

	2019/20 Actual £000	2020/21 Original £000	2020/21 Actual £000
Actual Capital Expenditure	3,043	19,189	7,730
Capital Financing Requirement	296,187	305,014	294,468
Gross Borrowing	283,814	300,283	290,316
External Debt	159,702	168,879	168,805
Investments (Under 1 year)	74,792	72,500	105,308
Net Borrowing	84,910	96,379	63,497

In line with the investment strategy, investments held with local authority counterparties were for less than two years. All other investments were for less than one year, again per the investment strategy.

In order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2019-20) plus the estimates of any additional capital financing requirement for the current (2020-21) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2020-21.

	2020/21 £m
Authorised Limit	332
Maximum Gross Borrowing Position	305
Operational Boundary	324
Average Gross Borrowing Position	294
Financing Costs as a proportion of net revenue stream	5.83%

The authorised limit – this Council has kept within its authorised external borrowing limit as shown by the table above.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

The maturity structure of the debt portfolio , as per the Treasury Management Strategy, was an upper limit of 30% on borrowing up to 5 years, 40% between 5 and 10 years and 100% of borrowing above 10 years. This is shown in the table below:

	31st March 2020 Actual	2020/21 Original Limits	31st March 2021 Actual
Under 12 months	£5.4m	£50.6m	£1.4m
12 months and within 24 months	£0.8m	£50.6m	£5.8m
24 months and within 5 years	£5.8m	£50.6m	£0.0m
5 years and within 10 years	£0.0m	£67.5m	£0.0m
10 years and within 20 years	£10.9m	£168.8m	£10.9m
20 years and within 30 years	£7.2m	£168.8m	£7.2m
30 years and within 40 years	£30.0m	£168.8m	£30.0m
40 years and within 50 years	£82.5m	£168.8m	£72.5m
50 years +	£31.0m	£168.8m	£31.0m
Total	£173.6m		£168.8m

Appendix A

Commentary from Link Asset Services on the Economy and Interest Rates

USA. The Democrats won the presidential election in November 2020 and have control of both Congress and the Senate, although power is more limited in the latter. This enabled the Democrats to pass a $1.9trn (8.8% of GDP) stimulus package in March on top of the $900bn fiscal stimulus deal passed by Congress in late December. These, together with the vaccine rollout proceeding swiftly to hit the target of giving a first jab to over half of the population within the President's first 100 days, will promote a rapid easing of restrictions and strong economic recovery during 2021. The Democrats are also planning to pass a $2trn fiscal stimulus package aimed at renewing infrastructure over the next decade. Although this package is longer-term, if passed, it would also help economic recovery in the near-term.

After Chair Jerome Powell unveiled the Fed's adoption of a flexible average inflation target in his Jackson Hole speech in late August 2020, the mid-September meeting of the Fed agreed by a majority to a toned down version of the new inflation target. This change was aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary "trap" like Japan.

The Fed expects strong economic growth this year to have only a transitory impact on inflation, which explains why the majority of Fed officials project US interest rates to remain near-zero through to the end of 2023. The key message is still that policy will remain unusually accommodative – with near-zero rates and asset purchases – continuing for several more years. This is likely to result in keeping treasury yields at historically low levels – which will also have an influence on gilt yields in this country.

EUROZONE. Both the roll out and take up of vaccines has been disappointingly slow in the EU, at a time when many countries are experiencing a sharp rise in cases which are threatening to overwhelm hospitals in some major countries; this has led to renewed severe restrictions or lockdowns during March. This will inevitably put back economic recovery after the economy had staged a rapid rebound from the first lockdowns in Q3 but contracted slightly in Q4 to end 2020 only 4.9% below its pre-pandemic level. Recovery will now be delayed until Q3 of 2021 and a return to pre-pandemic levels is expected in the second half of 2022.

Inflation is likely to rise sharply to around 2% during 2021 for a short period, but as this will be transitory due to one-off factors, it will cause the ECB little concern. It is currently unlikely that it will cut its central rate even further into negative territory from -0.5%, although the ECB has stated that it retains this as a possible tool to use. The ECB's December 2020 meeting added a further €500bn to the PEPP scheme, (purchase of government and other bonds), and extended the duration of the programme to March 2022 and re-investing maturities for an additional year until December 2023. Three additional tranches of TLTRO, (cheap loans to banks), were approved, indicating that support will last beyond the impact of the pandemic, implying indirect yield curve control for government bonds for some time ahead. The total PEPP scheme of €1,850bn of QE which started in March 2020 is providing protection to the sovereign bond yields of weaker countries like Italy. There is, therefore, unlikely to be a euro crisis while the ECB is able to maintain this level of support. The March ECB meeting also took action to suppress the rise in long bond yields by stepping up its monthly PEPP purchases.

CHINA. After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and then into Q3 and Q4; this has enabled China to recover all of the contraction in Q1. Policy makers have both quashed the virus and implemented a programme of monetary and fiscal support that has been particularly effective at stimulating short-term growth. After making a rapid recovery in 20/21, growth is likely to be tepid in 21/22.

JAPAN. A third round of fiscal stimulus in early December took total fresh fiscal spending in 2020 in response to the virus close to 12% of pre-virus GDP. That is huge by past standards, and one of the largest national fiscal responses. The budget deficit is now likely to reach 16% of GDP in 2020/21. Coupled with Japan's relative success in containing the virus without draconian measures so far, and the roll out of vaccines gathering momentum, the government's latest fiscal effort should help to ensure a strong recovery and to get back to pre-virus levels by Q3 2021 – around the same time as the US and much sooner than the Eurozone.

WORLD GROWTH. World growth was in recession in 2020. Inflation is unlikely to be a problem in most countries for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.