ARGYLL AND BUTE COUNCIL | **COUNCIL**

FINANCIAL SERVICES | **30 JUNE 2022**

ANNUAL TREASURY REPORT 2021-22

1. EXECUTIVE SUMMARY

1.1 This report outlines the Council's Treasury Management position for 2021-22.

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 2021-22.
- During 2021-22 the Council's External Borrowing increased by £9.1m from £168.8M at 31 March 2021 to £177.9m at 31 March 2022. The increase was due to temporary borrowing of £10m taken at the year end for cash flow purposes.
- The Capital Financing Requirement (excluding NPDO and Hub School commitments) was £190.4m this is £12.5m 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 2022 were £107.2m at an average rate of 0.61% compared to £105.3m at an average rate of 0.48% for 31 March 2021. The Council continues to hold high levels of cash balances, a reflection of the increase in its reserves over the last two financial years and slippage in the capital programme.
- The average investment rate of 0.418% for 2021-22 compared favourably to the average 7 day LIBID rate of -0.74% during the period. The investments generated £0.485m of interest in 2021-22.
- The Asset Management Fund was invested with London Borough of Croydon Council to increase the rate of return while future long term investment of the fund is being assessed. The return on the fund was £34,337, a rate of return of 1.65%.

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 0.08% due to a decrease in long term borrowing, this is due to the repayment of high interest loans and no new long term borrowing has been taken during the year.

1.6 The economic and interest rate commentary are provided by the Council's Treasury Advisors, Link Group 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 2021-22.

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 Climate Change - None
3.7 Risk – None
3.8 Customer Service – None

Kirsty Flanagan
Section 95 Officer
6 June 2022

Councillor Gary Mulvaney, Policy Lead for Finance and Commercial Services

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Appendix 1 – Annual Treasury Report 2021-22

Appendix 1

ANNUAL TREASURY REPORT

2021-22

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 2021-22. 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 2021-22 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: 25 February 2021) for the financial year 2021-22
- a mid-year (minimum) treasury update report (Policy and Resources Committee: 09 December 2021)
- an annual review following the end of the year describing the activity compared to the strategy (this report).

In addition, the Policy and Resources Committee received further update reports on 14 October 2021 and 17 February 2022.

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.

2. The Economy and Interest Rates

Link Group 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. Economy. Over the last two years, the coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it left Bank Rate unchanged at its subsequent meetings until raising it to 0.25% at its meeting on 16th December 2021, 0.50% at its meeting of 4th February 2022 and then to 0.75% in March 2022.

The UK economy has endured several false dawns through 2021/22, but with most of the economy now opened up and nearly back to business-as-usual, the GDP numbers have been robust (9% y/y Q1 2022) and sufficient for the MPC to focus on tackling the second-round effects of inflation, now that the CPI measure has already risen to 6.2% and is likely to exceed 8% in April.

Gilt yields fell towards the back end of 2021, but despite the war in Ukraine gilt yields have shot higher in early 2022. At 1.38%, 2-year yields remain close to their recent 11-year high

and 10-year yields of 1.65% are close to their recent six-year high. These rises have been part of a global trend as central banks have suggested they will continue to raise interest rates to contain inflation.

Historically, a further rise in US Treasury yields will probably drag UK gilt yields higher. There is a strong correlation between the two factors. However, the squeeze on real household disposable incomes arising from the 54% leap in April utilities prices as well as rises in council tax, water prices and many phone contract prices, are strong headwinds for any economy to deal with. In addition, from 1st April 2022, employees also pay 1.25% more in National Insurance tax. Consequently, inflation will be a bigger drag on real incomes in 2022 than in any year since records began in 1955.

Average inflation targeting. This was the major change in 2020/21 adopted by the Bank of England in terms of implementing its inflation target of 2%. The key addition to the Bank's forward guidance in August 2020 was a new phrase in the policy statement, namely that "it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and *achieving the 2% target sustainably*". That mantra now seems very dated. Inflation is the "genie" that has escaped the bottle, and a perfect storm of supply side shortages, labour shortages, commodity price inflation, the impact of Russia's invasion of Ukraine and subsequent Western sanctions all point to inflation being at elevated levels until well into 2023.

3. Overall Treasury Position as at 31 March 2022

The table below sets out the Council's treasury position (excluding borrowing by PFI and finance leases) at the beginning and the end of 2021-22.

	31 March 2021 Principal £m	Rate/ Return	Average Life yrs	31 March 2022 Principal £m	Rate/ Return	Average Life yrs
Total debt	***169***	***4.19%***	***26.56***	***178***	***3.97%***	***26.84***
CFR	***175***			***190***		
Over / (under) borrowing	***(6)***			***(12)***		
Total investments	***105.30***	***0.48%***		***107.2***	***0.61%***	
Net debt	**63.7**			**70.8**		

The Council was under borrowed by £12.5m at 31 March 2022, the budgeted position for 2021-22 predicted a year end under borrowed position of £10.1m. The difference of £2.4m is due to profiling movements within the capital programme offset by £10m of temporary borrowing taken to smooth short term cash flow fluctuations at the year end.

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4. The Strategy for 2021-22

Investment returns remained close to zero for much of 2021/22. Most local authority lending managed to avoid negative rates and one feature of the year was the continued growth of inter local authority lending. The expectation for interest rates within the treasury management strategy for 2021/22 was that Bank Rate would remain at 0.1% until it was clear to the Bank of England that the emergency level of rates introduced at the start of the COVID-19 pandemic were no longer necessitated.

The Bank of England and the Government also maintained various monetary and fiscal measures, supplying the banking system and the economy with massive amounts of cheap credit so that banks could help cash-starved businesses to survive the various lockdowns/negative impact on their cash flow. The Government also supplied huge amounts of finance to local authorities to pass on to businesses. This meant that for most of the year there was much more liquidity in financial markets than there was demand to borrow, with the consequent effect that investment earnings rates remained low until towards the turn of the year when inflation concerns indicated central banks, not just the Bank of England, would need to lift interest rates to combat the second-round effects of growing levels of inflation (CPI was 6.2% in February).

While the Council has taken a cautious approach to investing, it is also fully appreciative of changes to regulatory requirements for financial institutions in terms of additional capital and liquidity that came about in the aftermath of the financial crisis. These requirements have provided a far stronger basis for financial institutions, with annual stress tests by regulators evidencing how institutions are now far more able to cope with extreme stressed market and economic conditions.

Investment balances have been kept to a minimum through the agreed strategy of using reserves and balances to support internal borrowing, rather than borrowing externally from the financial markets. External borrowing would have incurred an additional cost, due to the differential between borrowing and investment rates Such an approach has also provided benefits in terms of reducing counterparty risk exposure, by having fewer investments placed in the financial markets.

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 2021 Actuals £M	31st March 2022 Budget £M	31st March 2022 Actuals £M
CFR - General Fund	296	299	307
Less NPDO	121	120	117
Net CFR	175	179	190

6. Borrowing Rates in 2021-22

Public Works Loans Board (PWLB) certainty maturity borrowing rates

The following commentary on PWLB rates during 2021-22 was provided by our treasury advisors, Link Group:

- The yield curve has flattened out considerably and PWLB 5 to 50 years Certainty Rates are, generally, in the range of 2.3% to 3%.
- We view the markets as having built in, already, nearly all the effects on gilt yields of the likely increases in Bank Rate and the poor inflation outlook.
- It is difficult to say currently what effect the Bank of England starting to sell gilts will have on gilt yields now that Bank Rate has hit 1%. Nothing will be decided before August, however, but the Bank is likely to act cautiously as it has already started on not refinancing maturing debt. A pure roll-off of the peak £875bn gilt portfolio by not refinancing bonds as they mature, would see the holdings fall to about £415bn by 2031, which would be about equal to the Bank's pre-pandemic holding.
- Increases in US treasury yields over the next few months could add further upside pressure on gilt yields curve. Temporary borrowing rates are likely, however, to remain near Bank Rate and may also prove attractive as part of a balanced debt portfolio.
- In addition, there are also some cheap alternative sources of long-term borrowing if a client is seeking to avoid a "cost of carry" but also wishes to mitigate future re-financing risk.

7. Borrowing Outturn for 2021-22

Borrowing

Due to high levels of cash balances and slippage in the capital programme, mainly as a result of the COVID-19 pandemic, there was no requirement to take out any new long term borrowing during the year.

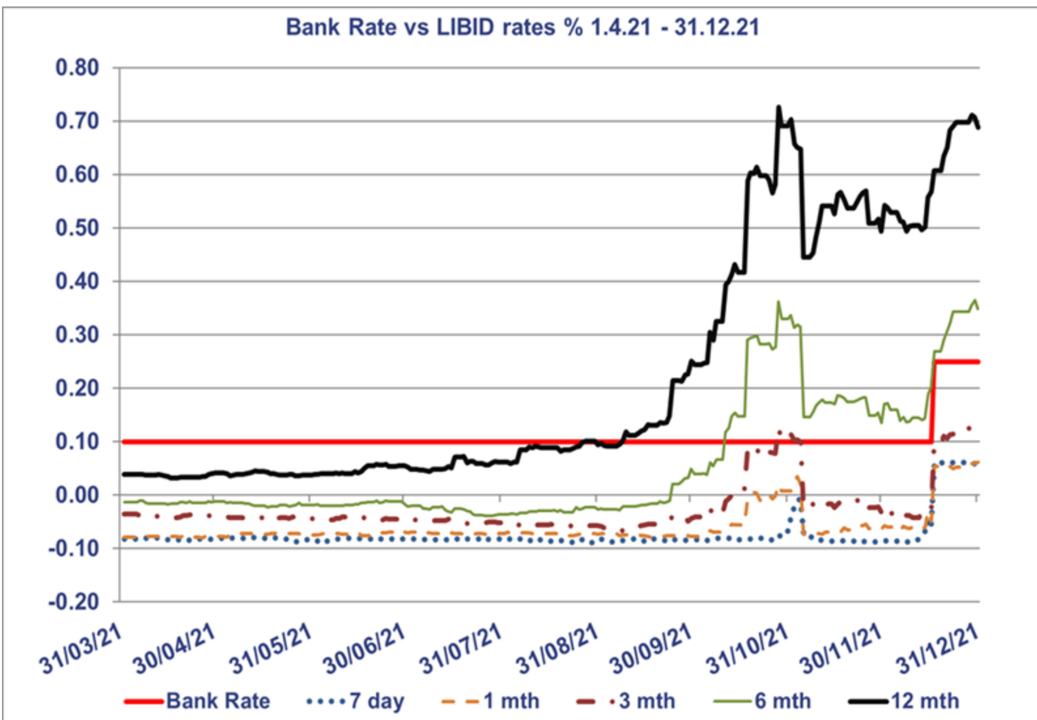
Repayments: The Council repaid the following long term loans during the year using investment balances.

Lender	Principal repaid	Type	Interest rate
PWLB	£0.698 m	Fixed Interest Rate	8.63%

Summary of debt transactions: Management of the debt portfolio resulted in a decrease in the average interest rate of 0.08% due to a decrease in long term borrowing. As can be seen from the table above, a high interest rate loan has been repaid and no new long term borrowing has been taken out during the year.

8. Investment Rates in 2021-22

The expectation for interest rates within the treasury management strategy for 2021-22 was that investment returns would remain low over the course of the year. This has in fact been the reality for most of the year as all short-term money market investment rates were below or little above the Bank Rate at 0.10%. The bank rate increased in December 2021 to 0.25% with a further increase to 0.5% in January 2022.



Note that LIBOR and LIBID rates ceased from the end of 2021 and have now been replaced by SONIA (Sterling Overnight Index Average). This rate will be used for benchmarking from 2022-23 onwards.

9. Investment Outturn 2021-22

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 24 February 2022. 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 £107.2m at 31 March 2022 compared to £105.3m at 31 March 2021. The composition of the investment portfolio is shown in the table below. The internally managed funds earned an average rate of return of 0.418%. The comparable performance indicator is the average 7-day LIBID rate, which was -0.74% (from 01-04-21 to 31-12-21). This generated £0.485m of interest in 2021-22.

TREASURY PORTFOLIO					
		31.03.21	31.03.21	31.03.22	31.03.22
Treasury investments		**£000**	**%**	**£000**	**%**
Banks	Clydesdale Bank	15,518	15%	5,117	5%
	Bank of Scotland	0	0%	0	0%
	Goldman Sachs	0	0%	10,000	9%
	Qatar National Bank	10,000	9%	5,000	5%
	Santander	15,000	14%	5,000	5%
	Totonto Dominion Bank	0	0%	5,000	5%
	First Abu Dhabi Bank	0	0%	10,000	9%
	Al Rayan Bank	5,000	5%	10,000	9%
	National Bank of Kuwait	0	0%	5,000	5%
	Close Bros Bank	5,000	5%	15,000	14%
		50,518	48%	70,117	65%
Building Societies - unrated		0	0%	0	0%
Local Authorities	Cherwell District Council	5,000	5%	0	0%
	Lancashire County Council	10,000	9%	0	0%
	Thurrock Borough Council	0	0%	0	0%
	Cornwall County Council	5,000	5%	0	0%
	Dudley Metropolitan Borough Council	7,500	7%	0	0%
	London Borough of Croydon	7,500	7%	7,500	7%
	Rotherham Metropolitian Borough Council	2,500	2%	7,500	7%
	Cheshire West & Chester Council	0	0%	2,500	2%
		37,500	36%	17,500	16%
DMADF (H.M.Treasury)		0	0%	0	0%
Money Market Funds	BNP	0	0%	10,000	9%
	Federated	2,290	2%	0	0%
	CCLA	15,000	14%	9,600	9%
		17,290	16%	19,600	18%
Certificates of Deposit	National Westminster Bank Plc	0	0%	0	0%
		0	0%	0	0%
Total Treasury Investments		**105,308**	**100%**	**107,217**	**100%**

The Council invested the £2m Asset Management Fund in a deposit with London Borough of Croydon Council during 2021-22 to increase the rate of return while future long term investment of the fund is being assessed. The return on the fund was £34,337 at a rate of return of 1.65%.

10. Prudential and Treasury Indicators

During 2021-22, 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:

	2020/21 Actual £000	2021/22 Original £000	2021/22 Actual £000
Actual Capital Expenditure	7,730	19,189	19,788
Capital Financing Requirement	296,083	309,089	309,092
Gross Borrowing	290,316	300,283	294,645
External Debt	168,805	168,879	177,934
Investments (Under 1 year)	105,308	72,500	107,217
Net Borrowing	63,497	96,379	70,717

In line with the investment strategy, investments held with local authority counterparties were for up to 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 (2020-21) plus the estimates of any additional capital financing requirement for the current (2021-22) 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 2021-22.

	2021/22 £m
Authorised Limit	324
Maximum Gross Borrowing Position	254
Operational Boundary	316
Average Gross Borrowing Position	246
Financing Costs as a proportion of net revenue stream	4.30%

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 2022 Actual £000	2021/22 Original Limits £000	31st March 2021 Actual £000
Under 12 months	£16.3m	£50.6m	£1.4m
12 months and within 24 months	£0.0m	£50.6m	£5.8m
24 months and within 5 years	£0.0m	£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	£40.0m	£168.8m	£30.0m
40 years and within 50 years	£72.5m	£168.8m	£72.5m
50 years +	£31.0m	£168.8m	£31.0m
Total	£177.9m		£168.8m

Appendix A

Commentary from Link Group on the Economy and Interest Rates

USA. The flurry of comments from Fed officials following the mid-March FOMC meeting – including from Chair Jerome Powell himself – hammering home the hawkish message from the mid-March meeting, has had markets pricing in a further 225bps of interest rate increases in 2022 on top of the initial move to an interest rate range of 0.25% - 0.5%.

In addition, the Fed is expected to start to run down its balance sheet. Powell noted that the rundown could come as soon as the next meeting in May.

The upward pressure on inflation from higher oil prices and potential knock-on impacts on supply chains all argue for tighter policy (CPI is estimated at 7.8% across Q1), but the hit to real disposable incomes and the additional uncertainty points in the opposite direction.

More recently, the inversion of the 10y-2y Treasury yield spread at the end of March led to predictable speculation that the Fed's interest rate hikes would quickly push the US economy into recession. Q1 GDP growth is likely to be only between 1.0% and 1.5% annualised (down from 7% in Q4 2021). But, on a positive note, the economy created more than 550,000 jobs per month in Q1, a number unchanged from the post-pandemic 2021 average. Unemployment is only 3.8%.

EU. With euro-zone inflation having jumped to 7.5% in March it seems increasingly likely that the ECB will accelerate its plans to tighten monetary policy. It is likely to end net asset purchases in June – i.e., earlier than the Q3 date which the ECB targeted in March. And the market is now anticipating possibly three 25bp rate hikes later this year followed by more in 2023. Policymakers have also hinted strongly that they would re-start asset purchases if required. In a recent speech, Christine Lagarde said "we can design and deploy new instruments to secure monetary policy transmission as we move along the path of policy normalisation."

While inflation has hit the headlines recently, the risk of recession has also been rising. Among the bigger countries, Germany is most likely to experience a "technical" recession because its GDP contracted in Q4 2021, and its performance has been subdued in Q1 2022. However, overall, Q1 2022 growth for the Eurozone is expected to be 0.3% q/q with the y/y figure posting a healthy 5.2% gain. Finishing on a bright note, unemployment fell to only 6.8% in February.

China. After a concerted effort to get on top of the virus outbreak in Q1 of 2020, economic recovery was strong in the rest of the year; however, 2021 has seen the economy negatively impacted by political policies that have focussed on constraining digital services, restricting individual freedoms, and re-establishing the power of the One-Party state. With the recent outbreak of Covid-19 in large cities, such as Shanghai, near-term economic performance is likely to be subdued. Official GDP numbers suggest growth of c4% y/y, but other data measures suggest this may be an overstatement.

Japan. The Japanese economic performance through 2021/22 is best described as tepid. With a succession of local lockdowns throughout the course of the year, GDP is expected to have risen only 0.5% y/y with Q4 seeing a minor contraction. The policy rate has remained at -0.1%, unemployment is currently only 2.7% and inflation is sub 1%, although cost pressures are mounting.

World growth. World growth is estimated to have expanded 8.9% in 2021/22 following a contraction of 6.6% in 2020/21.

Deglobalisation. Until recent years, world growth has been boosted by increasing globalisation i.e. countries specialising in producing goods and commodities in which they have an economic advantage and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has also depressed inflation. However, the rise of China as an economic superpower over the last 30 years, which now accounts for 18% of total world GDP (the USA accounts for 24%), and Russia's recent invasion of Ukraine, has unbalanced the world economy. In addition, after the pandemic exposed how frail extended supply lines were around the world, both factors are now likely to lead to a sharp retrenchment of economies into two blocs of western democracies v. autocracies. It is, therefore, 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 (and to a much lesser extent Russia) to supply products and vice versa. This is likely to reduce world growth rates.

Central banks' monetary policy. During the pandemic, the governments of western countries have provided massive fiscal support to their economies which has resulted in a big increase in total government debt in each country. It is therefore very important that bond yields stay low while debt to GDP ratios slowly subside under the impact of economic growth. This provides governments with a good reason to amend the mandates given to central banks to allow higher average levels of inflation than we have generally seen over the last couple of decades. Both the Fed and Bank of England have already changed their policy towards implementing their existing mandates on inflation, (and full employment), to hitting an average level of inflation. Greater emphasis could also be placed on hitting subsidiary targets e.g. full employment before raising rates. Higher average rates of inflation would also help to erode the real value of government debt more quickly.