SWANAGE TOWN COUNCIL

Annual Treasury Report 2021/22

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1. Background

The Council's Treasury Management Strategy for 2021/22 is underpinned by having due regard to the Chartered Institute of Public Finance and Accountancy's Guidance for Smaller Public Organisations on the Application of the CIPFA Code of Practice for Treasury Management *in the Public Services: Code of Practice (2014 Edition) and Cross-Sectoral Guidance Notes 2017 Edition* (the CIPFA Code) and the Ministry for Housing, Communities and Local Government (MHCLG) *Guidance on Local Authority Investments,* updated February 2018. The Code recommends that members approve a treasury management annual report after the end of each financial year. This report fulfils the Authority's obligation to have regard to the CIPFA Code and any other appropriate guidance.

The Authority's Treasury Management and Investment Strategy for 2021/22 was approved by full Council on 18/01/2021 which can be accessed on https://www.swanage.gov.uk/Publications-Finance.aspx

The Authority has invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

2. External Context

Economic background: The continuing economic recovery from the coronavirus pandemic, together with the war in Ukraine, higher inflation, and higher interest rates were major issues over the period. Bank Rate was 0.1% at the beginning of the reporting period. April and May saw the economy gathering momentum as the shackles of the pandemic restrictions were eased. Despite the improving outlook, market expectations were that the Bank of England would delay rate rises until 2022. Rising, persistent inflation changed that.

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

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

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

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

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

GDP growth in the euro zone increased by 0.3% in calendar Q4 2021 following a gain of 2.3% in the third quarter and 2.2% in the second. Headline inflation remains high, with CPI registering a record 7.5% year-on-year in March, the ninth successive month of rising inflation. Core CPI inflation was 3.0% y/y in March, was well above the European Central Bank’s target of ‘below, but close to 2%’, putting further pressure on its long-term stance of holding its main interest rate of 0%.

The US economy expanded at a downwardly revised annualised rate of 6.9% in Q4 2021, a sharp increase from a gain of 2.3% in the previous quarter. In its March 2022 interest rate announcement, the Federal Reserve raised the Fed Funds rate to between 0.25% and 0.50% and outlined further increases should be expected in the coming months. The Fed also repeated it plan to reduce its asset purchase programme which could start by May 2022.

Financial markets: The conflict in Ukraine added further volatility to the already uncertain inflation and interest rate outlook over the period. The Dow Jones started to decline in January but remained above its pre-pandemic level by the end of the period while the FTSE 250 and FTSE 100 also fell and ended the quarter below their pre-March 2020 levels.

Bond yields were similarly volatile as the tension between higher inflation and flight to quality from the war pushed and pulled yields, but with a general upward trend from higher interest rates dominating as yields generally climbed.

The 5-year UK benchmark gilt yield began the quarter at 0.82% before rising to 1.41%. Over the same period the 10-year gilt yield rose from 0.97% to 1.61% and the 20-year yield from 1.20% to 1.82%. The Sterling Overnight Rate (SONIA) averaged 0.39% over the quarter.

Credit review: In the first half of FY 2021-22 credit default swap (CDS) spreads were flat over most of the period and were broadly in line with their pre-pandemic levels. In September spreads rose by a few basis points due to concerns around Chinese property developer Evergrande defaulting but then fell back. Fitch and Moody's revised upward the outlook on a number of UK banks and building societies on the Authority's counterparty to 'stable', recognising their improved capital positions compared to 2020 and better economic growth prospects in the UK.

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

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

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

Revised CIPFA Codes, Updated PWLB Lending Facility Guidance

In August 2021 HM Treasury significantly revised guidance for the PWLB lending facility with more detail and 12 examples of permitted and prohibited use of PWLB loans. Authorities that are purchasing or intending to purchase investment assets primarily for yield will not be able to access the PWLB except to refinance existing loans or externalise internal borrowing. Acceptable use of PWLB borrowing includes service delivery, housing, regeneration, preventative action, refinancing and treasury management.

To comply with the Prudential Code, authorities must not borrow to invest primarily for financial return. Existing commercial investments are not required to be sold; however, authorities with existing commercial investments who expect the need to borrow should review the options for exiting these investments.

Borrowing is permitted for cashflow management, interest rate risk management, to refinance current borrowing and to adjust levels of internal borrowing. Borrowing to refinance capital expenditure primarily related to the delivery of a local authority's function but where a financial return is also expected is allowed, provided that financial return is not the primary reason for the expenditure. The changes align the CIPFA Prudential Code with the PWLB lending rules.

3. Local Context

On 31st March 2021 the Authority held investments valued at £6.22m, with usable reserves and working capital being the underlying resources available for investment. On 31st March 2022, the Authority held investments valued at £6.70m. These year-end values include unrealised gains from the Council's strategic investments, being £0.51m in 2021 and £0.96m in 2022.

4. Borrowing Strategy and Debt Management

The Authority is debt free. The 2021/22 capital expenditure plans and treasury strategy did not imply a need to borrow over the 3-year forecast period. Usable reserves are forecast to fall to £2.61m by March 2025, as capital receipts and earmarked reserves are used to finance the Council's extensive capital programme.

5. Treasury Investment Activity

CIPFA published a revised Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes on 20th December 2021. These define treasury management investments as investments that arise from the organisation's cash flows or treasury risk management activity that ultimately represents balances that need to be invested until the cash is required for use in the course of business.

The Authority holds significant invested funds, representing balances and reserves held. During the year the Authority's cash investment balances remained relatively stable, with fluctuations in the value of its long-term strategic investments. The investment position is shown in table 1 below.

Table 1: Treasury Investment Position

Investment Portfolio	**31.03.21 Balance £**	**Net Movement £**	**31.03.22 Balance £**	**31.03.22 Income Return %**
Banks and building societies (unsecured)	512,973	21,454	534,427	
Money Market Funds	750,000	0	750,000	
UK Govt – DMO Deposit/Gilts	450,000	2,108	452,108	
Total Internal Investments	**1,712,973**	**23,562**	**1,736,535**	**0.22%**
*Investments in Pooled Funds:				
Property	3,045,533	534,559	3,580,092	
Multi-Asset	965,700	(46,401)	919,299	
Bonds	503,174	(33,645)	469,529	
Total External Funds	**4,514,407**	**454,513**	**4,968,920**	**3.78%**
TOTAL INVESTMENTS	**6,227,380**	**474,859**	**6,705,455**	**2.86%**

*Funds stated at Fair Value-Issued by Arlingclose

Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

Ultra low short-dated cash rates, which were a feature since March 2020 when Bank Rate was cut to 0.1%, prevailed for much of the 12-month reporting period which resulted in the return on sterling low volatility net asset value (LVNAV) Money Market Funds being close to zero even after some managers have temporarily waived or lowered their fees. However, higher returns on cash instruments followed the increases in Bank Rate in December, February and March.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 2 below, which only includes the Council's internally managed investments.

Table 2: Investment Benchmarking-Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return
31.03.2021	4.42	AA-	74%	13	0.01%
31.03.2022	4.44	AA-	74%	42	0.22%
Similar LAs	4.42	AA-	49%	63	0.27%
All LAs	4.39	AA-	60%	14	0.46%

Externally Managed Pooled Funds

£4.9m (£4m book value) of the Authority's investments are held in externally managed strategic pooled funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. In terms of measuring the performance of these funds, the current value is used.

In the nine months to December, improved market sentiment was reflected in equity, property and multi-asset fund valuations and, in turn, in the capital values of the Authority's property and multi-asset income funds in the Authority's portfolio. The prospect of higher inflation and rising bond yields did however result in muted bond fund performance. In the January- March quarter the two dominant themes were tighter UK and US monetary policy and higher interest rates, and the military invasion of Ukraine by Russia in February, the latter triggering significant volatility and uncertainty in financial markets.

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

The change in the Authority's funds' capital values and income earned over the 12-month period is shown in Table 3 below.

Table 3: Strategic Investment Returns – 12 months to 31st March 2022

Fund Name	Book Value £m	Current Value £	Capital Growth £	Dividends Earned £	Capital Return %	Income Return %	Total Return %
CCLA-LAMIT Property Fund	2.50	3,580,092	534,559	118,189	17.55	3.88	21.43
M & G Strategic Corporate Bond Fund	0.50	469,529	(46,401)	12,282	(3.69)	2.44	(4.25)
Ninety-One Diversified Income Fund	1.00	919,299	(33,645)	34,584	(4.80)	4.10	(0.70)
Total	4.00	4,968,920	454,513	165,055	10.07	3.77	13.83

Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's medium- to long-term investment objectives are regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three- to five-year period total returns will exceed cash interest rates.

Due to accounting practices, these funds are currently stated at cost price in the Council's Annual Return, £4m in total, and as such these funds have an overall unrealised gain of £0.96m at 31st March 2022. Two of the funds are showing an unrealised loss. Unrealised capital losses, or gains, will not have an impact on the General Fund until such a time as the Council redeems all or part of the units held in the funds.

Treasury Performance

The budget for investment income in 2021/22 was £160,000, with actual income of £165,750.

Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return.

The Council did not invest in non-treasury investments during the year.

6. Compliance & Treasury Management Indicators

This report provides members with a summary report of the treasury management activity during 2021/22, having due regard to both the CIPFA Code of Practice and MHCLG Guidance. A prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

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

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

Credit Risk Indicator	31.3.22 Actual	2021/22 Target	Complied?
Portfolio average credit rating	AA-	A	Yes

Liquidity: The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period.

Liquidity Risk Indicator	31.3.22 Actual	2021/22 Target	Complied?
Total cash available within 3 months	£1.28m	£1m	Yes

The Authority can confirm that during 2021/22 it complied with its **Treasury Management Policy Statement** and **Treasury Management Practices**.