Colchester	**Governance and Audit Committee**		**Item 7**
	23 November 2021		
Report of	**Assistant of Director of Corporate and Improvement**	**Author**	**Paul Cook** ☏ **505861** **Mark Jarvis** **282794**
Title	**Treasury Management Strategy - Mid Year Review Report 2021/22**		
Wards affected	Not applicable		

1 Executive Summary

1.1 The 2021/22 Treasury Management Strategy Statement (TMSS) was approved by Council on 24 February 2021. This report is a mid-year review of the Council's treasury management.

1.2 Complying with CIPFA's Code of Practice on Treasury Management the update includes:

- an economic update
- whether key elements of the TMSS and annual investment strategy require changes
- performance against prudential indicators
- a review of borrowing strategy
- highlights areas to be taken into consideration in preparing the 2021/22 TMSS

2 Recommended Decision

2.1 To approve the Treasury Mid-Year report.

3 Reason for Recommended Decision

3.1 Treasury Management governance arrangements require Governance and Audit to approve a mid-year Treasury Management report.

4 Alternative Options

4.1 Alternative options regarding treasury management activities are considered on an ongoing basis, in consultation with the Council's Treasury Advisors, Link Asset Services.

5 Introduction

5.1 The Council operates a balanced budget in line with statutory requirements. This broadly means that in year income meets the Council's spending requirements.

5.2 Treasury Management operations ensure:

- that cashflow is adequately planned, with surplus monies being invested in line with the Council's Treasury Management Policies and Practices and the Council's risk appetite for investments and borrowing

- that the Council's capital plans are fully funded, treasury management practices supporting the requirement for long term cashflow planning and supporting the Council's need to borrow.

- Local Authorities are required under statute to self-regulate on the affordability, prudence and sustainability of its capital investment plans and borrowing through a process of setting estimates, indicators and the Council's overall risk appetite; and reporting on these on a regular basis.

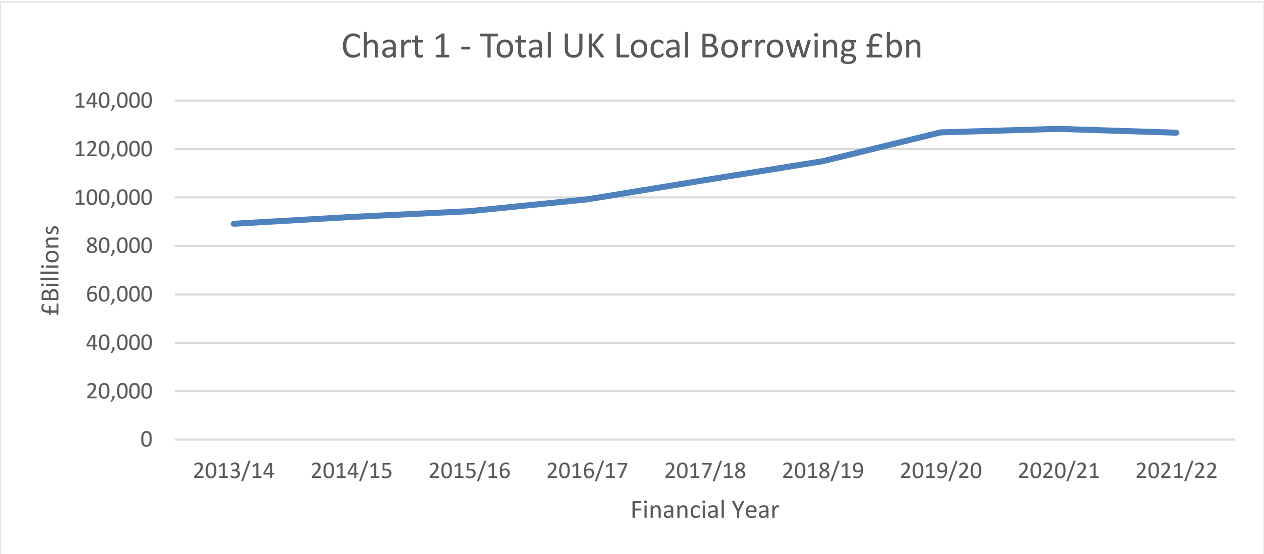
5.3 Treasury Management is defined as 'the management of the Council's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of risks associated with these activities; and the pursuit of optimum performance consistent with those risks.'

5.4 The management of the Council's treasury management processes is supported by Treasury Management Practices and the Council employs Link Asset Services to provide specialist consultancy in respect of treasury management, especially with regards to investments and debt, as well as capital accounting arrangements and asset finance.

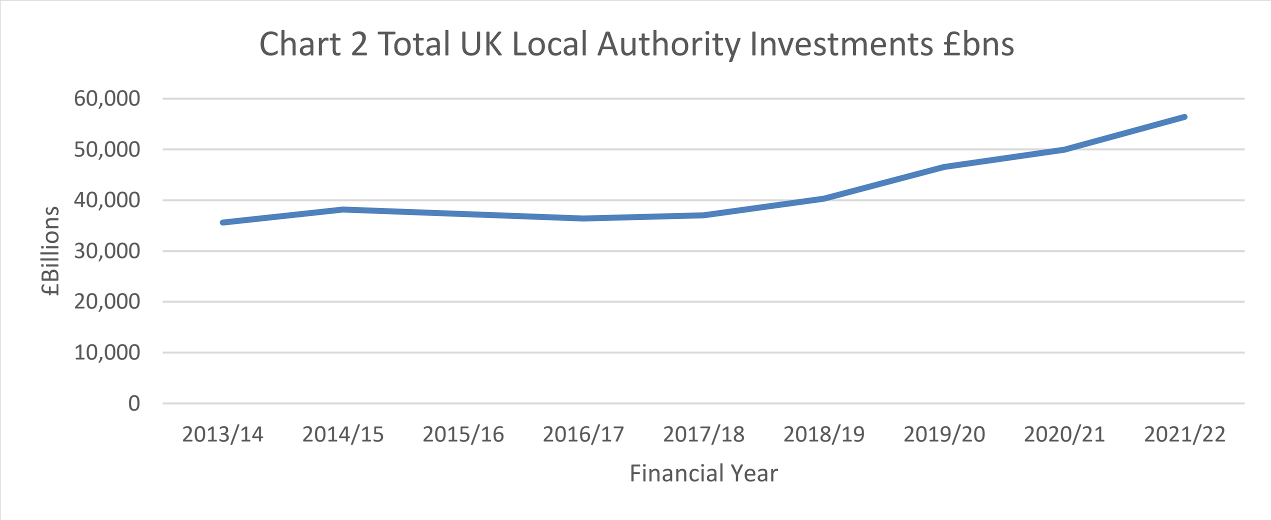
5.6 In line with statutory requirements the Council has adopted the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017). This mid-year position report complies with the Code.

6 Economic Update

6.1 Total local authority borrowing has gradually increased over the last few financial years. This reflects the funding of local authority capital programmes. Given the impact of global pandemic, the amount of borrowing has remained stable during 2020/21 and even reduced given the large amount of funding provided to Local government that improves the cash position as well as a slowdown nationally in regard to Council's respective capital programme



6.2 Over the same period there has been an increase in the Council's short term investment due to the additional funding and economic slowdown.



6.3 There has been a considerable rise in the use of money market funds and other managed funds reflecting the low rates on offer from banks directly to local authorities. The table shows Colchester's comparative position as at September 2021.

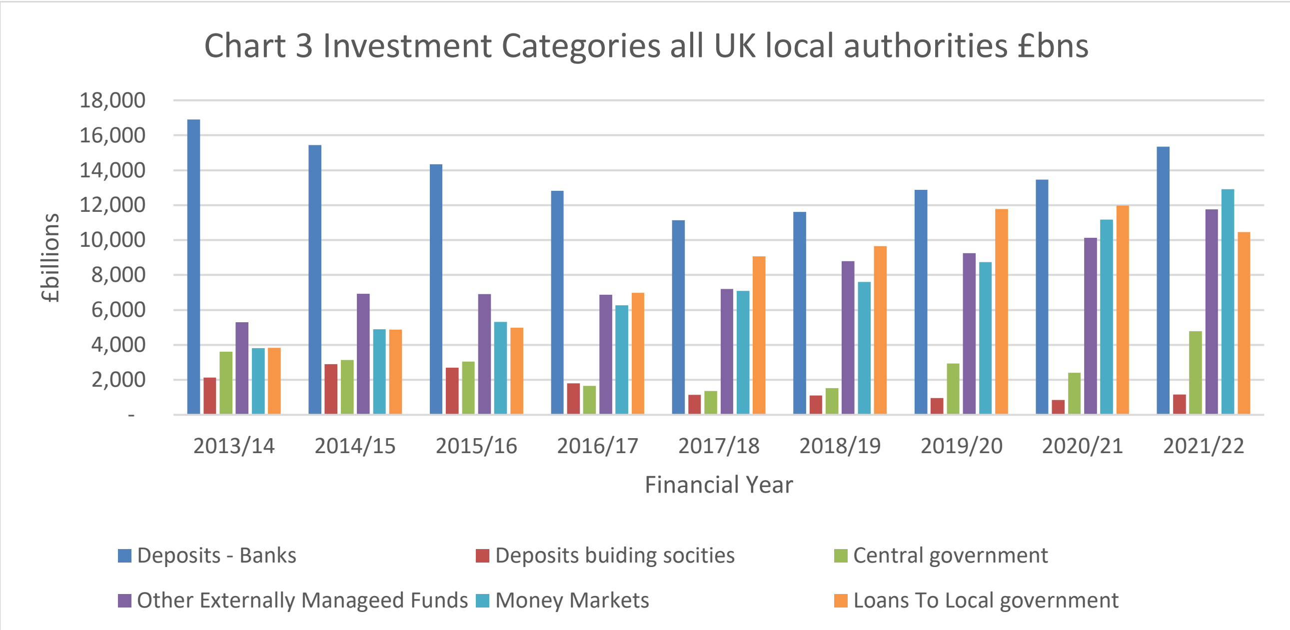


Table 1 – Investment distribution 30 September 2021		UK local authorities	Colchester
1	Bank	27%	52%
2	Building society	2%	3%
3	Money market funds	23%	37%
4	Externally managed funds	21%	Nil
5	Local government	19%	8%
6	Other including DMO	8%	Nil
7	Total	100%	100%

6.4 The economic forecast remains difficult given the impact of the global pandemic. A recent update provided by the Council's Treasury advisors concludes the following over the next few years based on a level risk analysis:

- The Monetary Policy Committee (MPC) voted unanimously to leave 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

- Financial markets are now pricing in a first increase in Bank Rate from 0.10% to 0.25% in February 2022

- The path of CPI inflation is now expected to rise slightly above 4% by the end of 2021. 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.

6.5 Full details of the Council's Treasury Advisors economic analysis are included at Appendix A to this report.

7 Treasury Management Strategy 2020/21

7.1 The TMSS includes the following key elements:

- The Council continues to maintain an under-borrowed position. It will borrow internally, reducing the cost of carry as current investment rates are substantially below long term borrowing rates. This also reduces the Council's exposure to credit risk by reducing the level of investment balances.

- The Council's investment policy reflects a low appetite for risk; emphasising the priorities of security and liquidity over yield.

- The budgeted return on investments placed for periods up to 100 days is 0.5%.

- That the Council complies with the CIPFA Prudential and Treasury Management Codes (Revised 2017); in relation to setting of capital plans, setting and reporting on prudential indicators, evaluation of the General Fund MRP and other related governance guidance.

7.2 No immediate mid-year changes are proposed to the TMSS.

8 **The Council's Capital Position and Prudential Indicators**

8.1 This part of the report updates:

- The Council's capital expenditure plans and their financing
- The impact of changes to the Council's capital plans on prudential Indicators and the underlying need to borrow
- Compliance with the limits on borrowing activity.

Capital Expenditure

8.2 The table below identifies the revised 2021/22 capital programme forecast since the original capital budget was approved by Council in February 2021.

Table 3 Capital Expenditure 2021/22 £k	Original Estimate	Revised Estimate
General Fund capital expenditure	42.106	19,868
HRA capital expenditure	40.292	46,172
Total capital expenditure	**82.398**	**66,040**

8.3 The main variances are as follows:

- On-lending to Colchester Commercial Holdings Limited £26.6m. This relates to the delays in the development of Mill Road site.
- Additional HRA expenditure has been incurred due to delays in the 2020/21 programme which have been reprofiled in 2021/22

Changes to the financing of the capital programme

8.4 Funding of the capital programme is updated for the lower than expected level of expenditure. The Medium Term Financial Forecast provides minimum revenue provision and interest for new debt.

	Table 4 - New Borrowing Requirement 2021/22 All £k	Original Estimate	Revised Estimate
1	General Fund capital expenditure	42.106	19,868
2	HRA capital expenditure	40.292	46,172
3	Total capital expenditure	**82.398**	**66,040**
	Resourced by:		
4	Capital receipts	2,369	1,455
5	Capital grants	25,585	11,784
6	Capital reserves	10,950	6,134
7	Finance leases	0	0
8	Revenue	9,790	10,518
9	New borrowing requirement	33,704	36,149

Capital Financing Requirement (CFR)

8.5 The following table shows the CFR, the Council's total need to borrow for capital purposes including both past and current financial years.

Table 5 - CFR 2021/22 All £k	Original Estimate	Revised Estimate
Opening balance	200,631	187,284
Unfinanced capital expenditure	42,452	36,149
Less MRP	2,248	2,211
Closing balance	240,835	221,222

Limits to borrowing activity

8.6 Councils have a responsibility to ensure that over the medium-term net borrowing is only made for capital purposes. Gross external debt should not - except in the short term - exceed the Capital Financing Requirement in the preceding year plus any additional Capital Financing Requirement for the current and the next two financial years. This allows 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.

Table 6 - Limits to Borrowing activity 2021/22 All £k	Original Estimate	Revised Estimate
Gross Debt 1 April 2021	169,944	169,944
Borrowing 2021/22	42,578	0
Other Long Term Liabilities	0	0
Gross Debt 31 March	212,522	169,944
CFR	240,835	221,222
Under/(Over) Borrowed Position	28,313	51,278

8.7 The Council is expected to be in an under-borrowed position compared to its CFR at the end of 2021/22. This is in line with the Treasury Management Strategy. The Council can demonstrate that its borrowing is for capital investment purposes only.

8.8 The Operational Boundary is the limit which external debt is not normally expected to exceed.

Table 7 – Operational Boundary All £k	Original Estimate	Revised Estimate
Operational Boundary	250,835	250,835

9 Investment Portfolio 2021/22

9.1 In accordance with the Prudential Code, the Council is required to ensure that the security and liquidity of its investments take priority over the level of return. As detailed at paragraph 5, it is a very difficult investment market in terms of returns

9.2 The Council had £79.5m of investments as at 30th September 2021 (£58m as at 30 September 2020) all repayable during 2021/22. These investments are short-term repayable within the current financial year of which £30.000m is currently held in liquid money market funds. This is significantly higher than previous years given the large amount of forward funding the Council has received from Government in the form of Covid grants and section 31 grants in relation to business rate reliefs. It is expected that the level of investments will reduce to normal levels by year end.

9.3 A full list of investments is listed at Appendix B (confidential section of the agenda).

9.4 Given the historic low interest rates, the Council is expected to make return on its investments of approximately £0.050m for the 2021/22 against a budget of £0.278m.

9.5 The Head of Finance confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of the year.

10 Borrowing

10.1 The Council is forecast to have borrowings of £169.944m at the end of the financial year, with the expectation of utilising £51.278m of cash flow funds in lieu of borrowing to fund the capital programme. This is prudent and cost-effective approach in the current economic climate and interest rate structure.

10.2 The majority of borrowing is in relation to the Housing Revenue Account which currently stands at £127.445m and £42.500m in relation to General Fund activity. A breakdown on the type of loans is provided below:

Breakdown of Loans All £k	Loan Value £m
Public Works Loan Board (PWLB)	132,094
Local authorities	23,350
Banks	9,000
LOBOs - Lender Option Borrow Option	5,500

10.3 No additional borrowing has taken place during 2021/22 and given current capital expenditure projections, the strategy is to continue to internally borrow to reduce the cost of borrowing.

11 PWLB interest rate structure

11.1 Changes to PWLB facilities were announced in November 2020 preventing borrowing from PWLB if the Council's capital programme included borrowing for yield as its primary objection. Further announcements have since been made with the anticipation that there will be further changes to the prudential code and Treasury management guidance applying in 2022/23. The Council is awaiting final details and clarification of the changes to the Code.

11.2 At this stage the Council does not have or propose to make borrow for yield investments. However until the guidance and any regulations have been finalised the full impact will not be known.

12. Standard References

11.1 There are no particular references to the Strategic Plan; consultation; or publicity consideration; community safety; health and safety implications.

13. Financial implications

12.1 As set out in the body of this report.

13. Risk Management Implications

13.1 The Council's Treasury Management Strategy supported by the Treasury Management Practices, reflects the council's low risk appetite for treasury management investments, in line with the current economic outlook. The mid-year review provides the opportunity to report and review on the practices for the first six months of the financial year against the Council's strategy and take remedial action as required.

Appendices

Appendix A – Economic Update from Link Asset Services
Appendix B – Confidential paper

Appendix A

Economics and interest rates

MPC meeting 24.9.21

- The Monetary Policy Committee (MPC) voted unanimously to leave 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.

- 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.

- So, in August the country was just 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.

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

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 mis-distribution 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.

3.2 Interest rate forecasts

The Council's treasury advisor, Link Group, 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

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.
As shown in the forecast table above, one increase in 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.

GILT YIELDS / PWLB RATES.

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: -

1. A fast vaccination programme has enabled a rapid opening up of the economy.
2. The economy had already been growing strongly during 2021.
3. 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.
4. And the Fed was still providing monetary stimulus through monthly QE purchases.

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. It is notable that some Fed members have moved forward their expectation of when the first increases in the Fed rate will occur in recent Fed meetings. In addition, more recently, shortages of workers appear to be stoking underlying wage inflationary pressures which are likely to feed through into CPI inflation. A run of strong monthly jobs growth figures could be enough to meet the threshold set by the Fed of "substantial further progress towards the goal of reaching full employment". However, the weak growth in August, (announced 3.9.21), has spiked anticipation that tapering of monthly QE purchases could start by the end of 2021. These purchases are currently acting as downward pressure on treasury yields. As the US financial markets are, by far, the biggest financial markets in the world, any trend upwards in the US will invariably impact and influence financial markets in other countries. However, during June and July, longer term yields fell sharply; even the large non-farm payroll increase in the first week of August seemed to cause the markets little concern, which is somewhat puzzling, particularly in the context of the concerns of many commentators that inflation may not be as transitory as the Fed is expecting it to be. Indeed, inflation pressures and erosion of surplus economic capacity look much stronger in the US than in the UK. As an average since 2011, there has been a 75% correlation between movements in 10 year treasury yields and 10 year gilt yields. This is a significant UPWARD RISK exposure to our forecasts for longer term PWLB rates. However, gilt yields and treasury yields do not always move in unison.

There are also possible DOWNSIDE RISKS from the huge sums of cash that the UK populace 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. How this will interplay with the Bank of England eventually getting round to not reinvesting maturing gilts and then later selling gilts, will be interesting to keep an eye on.

The balance of risks to medium to long term PWLB rates: -

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

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

One of the key results of the pandemic has been a fundamental rethinking and shift in monetary policy by major central banks like the Fed, the Bank of England and the ECB, 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 <u>above</u> 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.

- The Fed in America has gone furthest in adopting a monetary policy based on a clear goal of allowing the inflation target to be symmetrical, (rather than a ceiling to keep under), so that inflation averages out the dips down and surges above the target rate, over an unspecified period of time.
- The Bank of England has also amended its target for monetary policy so that inflation should be 'sustainably over 2%' and the ECB now has a similar policy.
- For local authorities, this means that investment interest rates and very short term PWLB rates will not be rising as quickly or as high as in previous decades when the economy recovers from a downturn and the recovery eventually runs out of spare capacity to fuel continuing expansion.
- Labour market liberalisation since the 1970s has helped to break the wage-price spirals that fuelled high levels of inflation and has now set inflation on a lower path which makes this shift in monetary policy practicable. In addition, recent changes in flexible employment practices, the rise of the gig economy and technological changes, will all help to lower inflationary pressures.

Governments will also be concerned to see interest rates stay lower as every rise in central rates will add to the cost of vastly expanded levels of national debt; (in the UK this is £21bn for each 1% rise in rates). On the other hand, higher levels of inflation will help to erode the real value of total public debt.