Treasury Management Performance Report 2021/22

Introduction

In February 2011 the council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the council to approve treasury management semi-annual and annual reports.

The council's treasury management strategy for 2021/22 was approved at the audit committee meeting on 14 March 2022. The council has borrowed and 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 remains central to the council's treasury management strategy.

Treasury risk management at the council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code) which requires the council to approve a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

The Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full council covering capital expenditure and financing, treasury management and non-treasury investments. The council's Capital Strategy, complying with CIPFA's requirement, was approved by full council on 23 February 2022.

External Context (provided by Arlingclose Limited) (produced 13 April 2022)

Economic background: The continuing economic recovery from 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 Consumer Price Inflation (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 in 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.1-month, 3-month and 12-month SONIA bid rates averaged 0.01%, 0.10% and 0.23% respectively over the financial year.

Credit review: In the first half of FY 2021-22 credit default swap (CDS) spreads were flat over most of period and are 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 council'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 council'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.

CIPFA published its revised Prudential Code for Capital Finance and Treasury Management Code on 20th December 2021. The key changes in the two codes are around permitted reasons to borrow, knowledge and skills, and the management of non-treasury investments.

The principles of the Prudential Code took immediate effect although local authorities could defer introducing the revised reporting requirements until the 2023/24 financial year if they wish. The Isle of Wight Council had decided to instigate the required quarterly reporting from the start of the 2022/23 financial year.

To comply with the Prudential Code, authorities must not borrow to invest primarily for financial return. This Code also states that it is not prudent for local authorities to make investment or spending decision that will increase the CFR unless directly and primarily related to the functions of the council. Existing commercial investments are not required to be sold; however, authorities with existing commercial investments who expect to 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 council'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.

Unlike the Prudential Code, there is no mention of the date of initial application in the Treasury Management Code. The TM Code now includes extensive additional requirements for service and commercial investments, far beyond those in the 2017 version.

Local Context

On 31 March 2022, the council had net borrowing of £150.3 million arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31.03.2022 Actual £m
Total CFR **	407.0
Less Other Debt Liabilities *	(97.0)
Borrowing CFR	**310.0**
External Borrowing	**(200.8)**
Internal borrowing	**109.2**
Less Usable Reserves **	(131.2)
Less Working Capital **	(28.5)
Net Investments	**(50.5)**

* finance leases, PFI liabilities and transferred debt that form part of the council's total debt
** These figures are as per the latest figures as of 24 June and are not the final year end position as the statement of accounts is still being prepared

Lower official interest rates have lowered the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The council pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.
The treasury management position at 31 March 2022 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.03.2021 Balance £m	Movement £m	31.03.2022 Balance £m	31.03.2022 Average Rate %
Long-term borrowing	197.7	(11.9)	185.8	3.15%
Short-term borrowing	45.0	(30.0)	15.0	0.11%
Total borrowing	**242.7**	**(41.9)**	**200.8**	**3.02%**
Short term Investments	(68.3)	17.8	(50.5)	0.20%
Total investments	**(68.3)**	**17.8**	**(50.5)**	**0.20%**
Net borrowing	**174.4**	**(24.1)**	**150.3**	**3.97%**

Borrowing Update

The council was not planning to borrow to invest primarily for commercial return and is so unaffected by the changes in the Prudential Code.

The council currently holds £41.4m in commercial investments that were purchased prior to the change in the CIPFA Prudential Code. Before undertaking further additional borrowing the council will review the options for exiting these investments.

Borrowing strategy

At 31 March 2022 the council held £200.8 million of loans, (a decrease of £41.9 million), as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 31 March are summarised in Table 3 below.

Table 3: Borrowing Position

	31.03.21 Balance £m	Net Movement £m	31.03.22 Balance £m	31.03.22 Weighted Average Rate %	31.03.2022 Weighted Average Maturity (years)
Public Works Loan Board	192.7	(11.9)	180.8	3.23%	14.99
Banks (LOBO)	5.0	-	5.0	4.27%	19.67
Banks (fixed term)	-	-	-		
Local authorities (long-term)	-	-	-		
Local authorities (short-term)	45.0	(30.0)	15.0	0.11%	0.60
Total borrowing	**242.7**	**(41.9)**	**200.8**	**3.02%**	**14.03**

The council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the council's long-term plans change being a secondary objective.

In keeping with these objectives, no new borrowing was undertaken, while £11.9 million of PWLB loans and £15.0 million of local authority short-term loans were allowed to mature without replacement. This strategy enabled the council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

PWLB funding margins have lurched quite substantially and there remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields + 0.80%. The council will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.

The council continues to hold £5m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the council has the option to either accept the new rate or to repay the loan at no additional cost. The bank did not exercise their option during the year.

Other Debt Activity

During the 2021/22 financial year the council did not raise any additional capital finance for Highway Improvements via Private Finance Initiative. Total debt, other than borrowing, stood at £97.1 million on 31 March 2022, taking total debt to £297.9 million

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 council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the council’s investment balances ranged between £50.5 and £94.8 million due to timing differences between income and expenditure. During the year the balances of up to £12 million were maintained in the council’s current bank account, in addition to the amounts invested.

The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.03.2021 Balance £m	Net Movement £m	31.03.2022 Balance £m	31.03.2022 Income Return %	31.03.2022 Weighted Average Maturity days
Banks & Building societies (unsecured)	(10.0)	9.0	(1.0)	0.12%	1
Covered bonds (secured)	-	-	-		
Govt (incl local authorities)	(38.0)	(2.5)	(40.5)	0.13%	153
Isle of Wight Council Pension Fund	(5.5)	5.5	-		
Corporate bonds and loans	-	-	-		
Money Market Funds	(14.8)	5.8	(9.0)	0.51%	1
Other Pooled Funds	-	-	-		
Total Investments	**(68.3)**	**17.8**	**(50.5)**	**0.20%**	**123**

Both the CIPFA Code and government guidance require the council 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 council’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.

Continued 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. At 31 March 2022, the 1-day return on the council's money market funds (MMF) ranged between 0.42% and 0.58%

Similarly, deposit rates with the Debt Management Account Deposit Facility (DMADF) initially remained very low with rates ranging from 0% to 0.1% but following the hikes to policy rates increased to between 0.55% and 0.85% depending on the deposit maturity. The council did not use this facility during the 2022/23 financial year.

Given the risk and low returns from short-term unsecured bank investments, the council has continued in the more secure investment of lending to other local authorities as shown in table 4 above. As a result, investment risk was diversified.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in exposure %	Weighted Average Maturity days	Rate of Return %
31.03.2021	4.71	A+	36%	75	0.14%
30.06.2021	4.74	A+	52%	101	0.09%
30.09.2021	4.76	A+	61%	98	0.06%
31.12.2021	4.71	A+	39%	134	0.11%
31.03.2022	4.62	A+	20%	123	0.20%
Similar LAs	**4.58**	**A+**	**67%**	**43**	**0.46%**
All LAs	**4.39**	**AA-**	**60%**	**14**	**0.46%**

In light of Russia's invasion, Arlingclose contacted the fund managers of our MMFs 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.

Non-Treasury Investments

The definition of investments in CIPFA's revised 2021 Treasury Management Code now covers all the financial assets of the council as well as other non-financial assets which the council holds primarily for financial return. Investments that do not meet the definition of treasury management investments (i.e., management of surplus cash) are categorised as either for service purposes (made explicitly to further service objectives) and or for commercial purposes (made primarily for financial return).

Investment Guidance issued by the Department for Levelling Up Housing and Communities (DLUHC) and Welsh Government also broadens the definition of investments to include all such assets held partially or wholly for financial return.

The council also held £46.7 million of such investments in

- directly owned property £41.4 million
- shared ownership housing £4.0 million
- loans to local businesses £1.3 Million

A full list of the council's non-treasury investments is available in the Isle of Wight Council Statement of Accounts 2021/22

The directly owned property investments generated £0.7 million of income for the council, after taking account of direct costs. This represents a rate of return of 1.69%

Treasury Performance

The council measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in table 6 below.

Table 6: Performance

	Actual £m	Budget £m	Over / Under £m	Actual %	Benchmark %	Over / Under %
Total Investment Income	(0.1)	(0.2)	0.1	0.10%	0.46%	-0.36%
Total Cost of Borrowing	6.4	8.4	(2.0)	2.56%	-	-
GRAND TOTAL	6.3	8.2	(1.9)	n/a	n/a	n/a

Compliance

The Director of Finance and Section 151 Officer reports that all treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the council's approved Treasury Management Strategy.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below.

Table 7: Debt Limits

	2021/22 Maximum	31.3.2022 Actual	2021/22 Operational Boundary	2021/22 Authorised Limit	Complied?
Borrowing	242.7	200.8	357.0	450.0	✓
PFI and Finance Leases	100.8	97.0	107.0	130.0	✓
Total Debt	**343.5**	**297.8**	**464.0**	**580.0**	✓

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Table 8: Investment Limits

	2021/22 Maximum	31.03.2022 Actual	2021/22 Limit	Complied?
Any single organisation, except the UK Government	12.0	10.0	12.0	✓
Any group of organisations under the same ownership	3.0	1.0	12.0	✓
Money Market Funds	40.3	9.0	Unlimited	✓

Treasury Management Indicators

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

Security: The council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score 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.

	31.03.22 Actual	2021/22 Target	Complied ?
Portfolio average credit score	4.62	5.0	✓

The council measures the security of its investments using data provided by Arlingclose. The target figure is the average credit score of all Arlingclose clients that take part in the benchmarking exercise.

Although the portfolio average credit score for the year was slightly higher than the target in numeric terms, the average credit rating of the council's investments was A+ for both actual and target.

Liquidity: The council maintains detailed cash flow forecasts with a view to keeping minimum surplus cash balances. It addresses liquidity issues by restricting a significant proportion of its investment opportunities to short term and instant access deposits.

	31.03.2022 Actual £m	2021/22 Target £m	Complied?
Total cash available within 3 months	44.3	26.5	✓

Interest Rate Exposures: This indicator is set to control the council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interests was:

Interest Rate Risk Indicator	31.03.22 Actual £m	2021/22 Limit £m	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	-0.2	-0.3	✓
Upper limit on one-year revenue impact of a 1% fall in interest rates	0.2	0.3	✓

The impact of a change in interest rates is calculated on the assumption that maturing loans and investment will be replaced at current rates.

Maturity Structure of Borrowing: This indicator is set to control the council's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	31.03.2022 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	11%	50%	0%	✓
12 months and within 24 months	3%	30%	0%	✓
24 months and within 5 years	11%	30%	0%	✓
5 years and within 10 years	16%	75%	0%	✓
10 years and above	59%	95%	0%	✓

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than a year: The purpose of this indicator is to control the council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2021/22 £m	2022/23 £m	2023/24 £m
Actual principal invested beyond year end	-	-	-
Limit on principal invested beyond year end	40	35	30
Complied?	✓	✓	✓

Other

IFRS 16: The implementation of the new IFRS 16 Leases accounting standard was due to come into for force for local authorities from 1st April 2022. Following a consultation CIFPA/LASAAC announced an optional two-year delay to the implementation of this standard a decision which was confirmed by the Financial Reporting Advisory Board in early April 2022. Authorities can now choose to adopt the new standard at the beginning of April 2022, April 2023 or April 2024. The council intends to adopt the new standard before the final deadline as disclosed above