Audit and Governance Committee
Monday, 14 November 2022
Treasury Management Annual Report

For Decision

Portfolio Holder: Cllr G Suttle, Finance, Commerical & Capital Strategy

Local Councillor(s): All

Executive Director: A Dunn, Executive Director, Corporate Development

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Report Status: Public

Brief Summary

This report summarises the treasury management performance and position information for Dorset Council for the year ended 31 March 2022. It was originally intended that this report would be considered at the meeting of the Committee 26 September 2022 which was postponed due to the period of national mourning.

Treasury management at the Council is conducted within the framework of CIPFA's Treasury Management Code of Practice. In adopting the code, recommended best practice is for members to approve an annual treasury management strategy report, and to then receive a mid-year update on progress against the strategy and a year-end review of actual performance against the strategy (this report).

The Council's Capital Financing Requirement (CFR) (or underlying need to borrow) at 31 March 2022 was £345m, compared to £335m at the start of the year and an estimated closing position of £369m when the treasury management strategy was approved in February 2021. The borrowing need has not increased as much as was expected due to slippage in the capital programme.

Total external borrowing and other capital financing liabilities of the Council at 31 March 2022 was £204m and the total interest paid servicing external debt for the year was £7.6m.

The difference between the CFR and external borrowing was approximately £140m, financed temporarily by 'internal borrowing' (the use of reserves and working capital that could otherwise have been invested to offset the need to borrow externally).

As at 31 March 2022 the Council held cash and cash equivalents of £46m and treasury investments valued at £149m – in total £195m. The total interest receivable and investment income for the Council for the year was approximately £3.1m.

Recommendation:

That the Committee note and comment upon the report.

Reason for Recommendation:

To better inform members of treasury management activity, in accordance with the corporate requirement to ensure money and resources are used wisely.

1. Introduction

1.1 The Council's treasury management strategy for 2021/22 was approved by a meeting of Dorset Council on 16 February 2021.

1.2 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.

1.3 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 2021 Edition (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.

1.4 The Council employs professionally qualified and experienced staff with responsibility for making borrowing and investment decisions. Officers are supported by external advisers who are specialists in their fields. The Council currently employs Arlingclose Limited as treasury management advisers.

1.5 This approach ensures that the Council has access to a wide pool of relevant market intelligence, knowledge and skills that would be very difficult and costly to replicate internally. However, whilst advisers provide support to the internal treasury function, final decisions on treasury matters always remain with the Council.

2. External Context

2.1 Treasury management decisions made by the Council must take into consideration external factors, particularly the wider economic backdrop and the outlook for financial markets and interest rates, and the wider regulatory framework.

2.2 The continuing economic recovery from coronavirus pandemic, together with the war in Ukraine, higher inflation, and higher interest rates were the major external factors issues over the year. In response to concerns regarding rising and persistent inflation, the Bank of England increased the Bank Rate from 0.10% to 0.25% in December 2021, and then to 0.50% in February 2022 and 0.75% in March 2022.

2.3 The financial year also saw updated guidance from DMO and CIPFA attempting to make clearer the permitted and prohibited uses of borrowing by local authorities.

2.4 A detailed commentary on the external context provided by Arlingclose is included in Appendix 1.

3. Local Context

3.1 The Council's balance sheet is summarised in table 1 below.

Table 1: Balance Sheet Summary

	31-Mar 2021 Actual £m	31-Mar 2022 Budget £m	31-Mar 2022 Actual £m
Capital Financing Requirement	**335**	**369**	**345**
External Debt (incl. PFI & leases):			
External borrowing	220	240	181
Long Term PFI Liabilities	22	25	21
Obligations under Finance Leases	3	5	2
Total External Debt	**245**	**270**	**204**
Internal Borrowing	90	99	141
Cash and Investments	**169**	**100**	**195**

3.2 All capital expenditure must be financed, either from external sources (government grants and other contributions), the Council's own resources (revenue, reserves and capital receipts) or debt (borrowing, leasing and Private Finance Initiative). The Council's cumulative outstanding amount of debt finance is measured by the Capital Financing Requirement (CFR).

3.3 Debt is only a temporary source of finance, since loans and leases must be repaid, and this is therefore replaced over time by other financing, usually from revenue which is known as Minimum Revenue Provision (MRP). Alternatively, proceeds from selling capital assets (known as capital receipts) may be used to replace debt finance. The CFR increases with new debt-financed capital expenditure and reduces with MRP and capital receipts used to replace debt.

3.4 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

	31.03.21 Balance £m	Net Movement £m	31.03.22 Balance £m
Long-term borrowing	179.0	-1.0	178.0
Short-term borrowing	41.0	-37.9	3.1
Total Borrowing	**220.0**	**-38.9**	**181.1**
Investments	85.3	64.0	149.3
Cash and cash equivalents	83.6	-37.7	45.9
Total Cash and Investments	**168.9**	**26.3**	**195.2**
Net Borrowing / (Investments)	**51.1**	**-65.2**	**-14.1**

4. Borrowing

4.1 At 31 March 2022 the Council held £181m of loans, (a net decrease of £39m from 31 March 2021), as part of its strategy for funding previous and current years' capital programmes. Outstanding loans as at 31 March 2022 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 Average Rate %	31.03.22 Average Maturity (years)
Public Works Loan Board	83.9	-21.1	62.9	4.1	21.9
Banks (fixed-term)	25.6	0.0	25.6	4.7	55.0
Banks (LOBO)	11.0	0.0	11.0	4.6	54.6
Local authorities (long-term)	15.0	0.0	15.0	4.4	37.7
Local authorities (short-term)	10.0	-10.0	0.0	0.0	0.0
Other lenders (fixed-term)	55.0	-7.9	47.1	3.7	42.5
Other lenders (LOBO)	19.5	0.0	19.5	2.6	10.6
Total Borrowing	**220.0**	**-38.9**	**181.1**	**4.0**	**34.0**

4.2 The chief objective of Dorset Council and its predecessors 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 long-term plans change being a secondary objective.

4.3 The Council's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short and long-term borrowing has been maintained.

4.4 The Council held £30.5m of Lender's Option Borrower's Option (LOBO) at 31 March 2022. These are loans where the lender has the option to propose an increase in the interest rate at set dates (lender's option), following which the Council has the option to either accept the new rate or to repay the loan at no additional cost (borrower's option). No lenders exercised options in 2021/22.

4.5 In addition, capital finance may be raised by the following methods that are not borrowing but are classed as other debt liabilities: leasing, hire purchase, Private Finance Initiative (PFI) and sale and leaseback. Total debt other than borrowing at 31 March 2022 was £22.8m.

5. Cash and Treasury Investments

5.1 CIPFA 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.

5.2 Cash, cash equivalents and treasury investments held on 31 March 2022 are summarised in Table 4 below.

Table 4: Cash and Treasury Investments Position

	31.03.21 Balance £m	Net Movement £m	31.03.22 Balance £m
Cash and Cash Equivalents	**83.6**	**-37.7**	**45.9**
Investments:			
UK Debt Management Office deposits	0.0	60.0	60.0
Short-dated bond funds	12.0	-0.2	11.8
Strategic bond funds	11.2	-0.6	10.6
Equity income funds	35.4	1.7	37.1
Property funds	20.4	3.3	23.7
Multi asset income funds	6.3	-0.3	6.0
Total Investments	**85.3**	**64.0**	**149.3**
Total Cash and Investments	**168.9**	**26.3**	**195.2**

5.3 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.

5.4 Very low short-dated cash rates prevailed for much of the year which resulted in the return on cash and cash equivalents such as Low Volatility Net Asset Value (LVNAV) Money Market Funds being close to zero. However, higher returns on cash instruments followed the increases in Bank Rate in December 2021, February and March 2022.

5.5 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 increases to Bank Rate increased to between 0.55% and 0.85% depending on the deposit maturity.

5.7 The Council held investments in bond, equity, multi-asset and property funds valued at £90m in total as at 31 March 2022, compared to £85m as at 31 March 2021. Such investments are held for the longer term with the acceptance that capital values will fluctuate over the short term but with the expectation that over a three to five-year period total returns will exceed cash interest rates.

5.8 In the period to December 2021 improved market sentiment was reflected in equity, property and multi-asset fund valuations and, in turn, in the

capital values of the Council's holdings in property, equity and multi-asset income funds. 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.

6. Treasury Performance

6.1 The Council measures the financial performance of its treasury management in terms of its impact on the revenue budget as shown in table 5 below.

Table 5: Treasury Performance

	Budget £m	Actual £m	Variance £m	
Interest Payable	9.9	7.6	2.3	F
Interest and Investment Income	-4.0	-3.1	-0.9	A
Net Payable / (Receivable)	**5.9**	**4.5**	**1.4**	**F**
Unrealised (Gains) / Losses in Fair Value	0.0	-4.2	4.2	F
Net (Surplus) / Deficit	**5.9**	**0.3**	**5.6**	**F**

6.2 The unrealised gains of £4.2m in the fair value of investments relate to the Council's investments in strategic pooled investment vehicles. Unrealised gains or losses in the fair value of these investments are accounted for through reserves and do not have an impact on the general fund.

7. Compliance

7.1 All treasury management activities undertaken during the year complied with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

7.2 Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 6 below.

Table 6: Debt Limits

	Maximum 2021-22 £m	31.03.22 Actual £m	Operational Boundary £m	Authorised Limit £m	Complied Yes/No
Borrowing	220.0	181.0	401.0	421.0	Yes
PFI & Finance Leases	25.0	23.0	31.0	36.0	Yes
Total Capital Financing	**245.0**	**204.0**	**432.0**	**457.0**	

8. Treasury Management Indicators

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

8.2 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 average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Table 7: Security

	31.03.22 Actual	2021/22 Target	Complied Yes/No
Portfolio average credit rating or score	3.7	< 6	Yes

8.3 Liquidity: The Council 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 without additional borrowing. In addition, the Council aims to hold a minimum of £10m readily available in same day access bank accounts and Money Market Funds.

Table 8: Liquidity

	31.03.22 Actual	2021/22 Target	Complied Yes/No
Total cash available within 100 days	53%	> 30%	Yes

8.4 Interest Rate Exposure: 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 were:

Table 9: Interest Rate Exposure

	31.03.22 Actual £000s	2021/22 Target £000s	Complied Yes/No
Upper limit on one-year revenue impact of a 1% rise in interest rates	-125	500	Yes
Upper limit on one-year revenue impact of a 1% fall in interest rates	125	500	Yes

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

8.6 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 at the period end were:

Table 10: Investments longer than one year

	2021/22 £m
Actual principal invested beyond one year	0.0
Limit on principal invested beyond one year	20.0
Complied (Yes/No)	Yes

8.7 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 borrowing were:

Table 11: Maturity Structure of Borrowing

	31.03.22 Actual £m	% of Total Borrowing	Upper Limit	Lower Limit	Complied Yes/No
Under 12 months	3.1	1.7%	25%	0%	Yes
12 Months to 2 Years	0.0	0.0%	25%	0%	Yes
2 Years to 5 Years	10.0	5.5%	25%	0%	Yes
5 Years to 10 Years	9.5	5.2%	35%	0%	Yes
10 Years to 15 Years	20.0	11.0%	35%	0%	Yes
15 Years to 20 Years	0.0	0.0%	35%	0%	Yes
20 Years to 25 Years	0.0	0.0%	45%	0%	Yes
25 Years to 30 Years	9.0	5.0%	45%	0%	Yes
30 Years to 35 Years	33.0	18.2%	45%	0%	Yes
35 Years to 40 Years	15.0	8.3%	45%	0%	Yes
40 Years to 45 Years	25.0	13.8%	45%	0%	Yes
45 Years and above	56.5	31.2%	75%	0%	Yes
Total	**181.1**	**100.0%**			

9. Financial Implications

This report summarises the performance of the Council's treasury management activity in 2021/22. There are no other financial implications arising from this report.

10. Climate implications

There are no direct climate implications arising from this report. However, Dorset Council owns units in a number of pooled investment funds which will have holdings in companies in all sectors of the economy, including the extraction, refinement and supply of fossil fuels.

11. Well-being and Health Implications

There are no well-being and health implications arising from this report.

12. Other Implications

There are no other implications arising from this report.

13. Risk Assessment

Having considered the risks associated with this decision, the level of risk has been identified as:
Current Risk: HIGH

Residual Risk: Medium

Treasury management is an inherently risky area of activity and a number of controls are embedded in its operation. The key treasury management risks are highlighted as part of the treasury management strategy approved by Council as part of the budget setting process. This report highlights any variances from this strategy and draws out any specific risks which have arisen

14. Equalities Impact Assessment

There are no equalities implications arising from this report.

15. Appendices

Appendix 1: External Context (Arlingclose April 2022)

16. Background Papers

Treasury Management Strategy 2021/22

Footnote:
Issues relating to financial, legal, environmental, economic and equalities implications have been considered and any information relevant to the decision is included within the report.

Appendix 1: External Context (Arlingclose 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 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 2021, the Bank of England hiked it further to 0.50% in February 2022 and 0.75% in March 2022. 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 2022 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 MPC 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.

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 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.

In the nine months to December 2022 improved market sentiment was reflected in equity, property and multi-asset fund valuations. The prospect of higher inflation and rising bond yields did however result in muted bond fund

performance. In the January to March 2022 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.

Updated PWLB Lending Facility Guidance and revised CIPFA Codes

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 and 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 authority. 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 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.