Item: 8

Policy and Resources Committee: 21 September 2021.

Treasury Management – Annual Report.

Report by Head of Finance.

1. Purpose of Report

To report on the performance of the treasury management function for financial year ended 31 March 2021.

2. Recommendations

The Committee is invited to note:

2.1.

That the Bank of England Base Rate decreased from 0.75% to 0.25% on 11 March 2020 and then reduced further to 0.10% on 19 March 2020 in order to counter the hugely negative impact the COVID-19 national lockdown was having on the economy.

2.2.

That the reduction in the Bank of England Base Rate led to the Public Works Loans Board borrowing rates reducing correspondingly, with shorter term rates decreasing more than longer term rates.

2.3.

That the Central Government and the Bank of England also introduced new programmes of supplying the banking system and the economy with significant amounts of cheap credit in order that banks could assist cash-starved businesses to survive the lockdown.

2.4.

That significant amounts of finance were also passed to local authorities to pass onto businesses, which meant that, for most of the year, there was much more liquidity in financial markets than demand to borrow, meaning investment earning rates plummeted.

2.5.

That, although there remains much uncertainty over interest rates, with the long-term trend prediction for rates to rise, the Council should be well placed to benefit from savings on loan charges over the longer term.

The Committee is invited to scrutinise:

2.6.

The Annual Treasury Management Review for financial year 2020/21, attached as Appendix 1 to this report, in order to obtain assurance that the Treasury Management Practices operated effectively.

3. Background

3.1.

Section 21 of the Financial Regulations confirms that the Council has adopted the key recommendations of Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Sector Code of Practice (the Code).

3.2.

The revised Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management in the Public Services (2011) further expands the definition of treasury management to include investment activities.

3.3.

The Council's investment priorities can be summarised as maintaining:

- The security of capital.
- The liquidity of its investments.

3.4.

The Council aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of the Council is low in order to give priority to security of its investments. This is in keeping with the nature of the Strategic Reserve Fund, which is to provide for the benefit of Orkney and its inhabitants, whilst having regard to the Fund's long term obligations in terms of the decommissioning of the Flotta Oil Terminal in the future.

3.5.

The Financial Regulations refer to maintenance of the Treasury Management Policy Statement and Treasury Management Practices as the cornerstone for effective treasury management and the requirement to report annually on the Treasury Management function.

4. Treasury Management Performance

4.1.

A detailed analysis of the Treasury Management Performance for financial year 2020/21 is attached as Appendix 1 to this report, and refers to the following activities:

- Capital Expenditure and Financing.
- The Council's Overall Borrowing Need.
- Treasury Position as at 31 March 2021.
- The Strategy for financial year 2020/21.
- Borrowing Outturn.
- Investment Outturn.
- Other Issues.

4.2.

The conclusion of the analysis of performance is that existing treasury management practices have operated effectively over the previous financial year.

4.3.

Re-profiling and slippage on the approved capital programme for financial year 2019/20 resulted in £14,356,000 being moved into financial year 2020/21 and beyond. Further slippage of £8,577,000 is being recommended for financial year 2020/21, with budgets being reprofiled into financial year 2021/22 and beyond. All slippage on delivery of the approved capital programme delays the timescale over which the capital finance is required, and results in the Council holding higher than predicted cash balances.

4.4.

The Council has established an authorised limit for external debt of £75,000,000 for the two-year period 2020 to 2022, together with an operational boundary of £60,000,000, rising to £65,000,000 during the same period, as part of its Treasury Management Strategy for 2020/21.

4.5.

The Council supports its capital financing requirement through a combination of borrowings and use of internal reserves. In determining this combination, the cost of raising additional finance or borrowing is compared against the opportunity cost of using internal reserves and balances, in that these funds could otherwise be generating an investment return for the Council. On the basis the capital financing requirement can be externalised through borrowings, and investment returns generated in excess of the cost of any borrowings to meet the requirements of the capital programme, the potential exists for a net saving to be realised by the treasury management function over the longer term.

4.6.

As at 31 March 2021, the Council's debt portfolio stood at £35,114,100, with loan maturities ranging over periods from one to 50 years. Overall, this represents an average cost of borrowing of 2.61% per annum, with an average duration of 37.69 years.

4.7.

The cost of this debt is managed as part of the loan charges associated with the capital programme and has been offset in the short term with surplus funds placed on deposit for periods of up to one year at an average rate of 0.53% for financial year 2020/21.

4.8.

The Bank of England Base Rate decreased from 0.75% to 0.25% on 11 March 2020 and then reduced further to 0.10% on 19 March 2020 in order to counter the hugely negative impact the COVID-19 national lockdown was having on the economy. This led to the Public Works Loans Board borrowing rates reducing correspondingly, with shorter term rates decreasing more than longer term rates.

4.9.

The Central Government and the Bank of England also introduced new programmes of supplying the banking system and the economy with massive amounts of cheap credit so that banks could help cash-starved businesses to survive the lockdown. Huge amounts of finance were also passed to Local Authorities to pass onto businesses. This meant for most of the year there was much more liquidity in financial markets than demand to borrow, meaning investment earning rates plummeted.

4.10.

Although there remains much uncertainty over interest rates, with the long-term trend prediction for rates to rise, the Council should be well placed to benefit from savings on loan charges over the longer term.

4.11.

The prime objective for the managed funds remains to maintain or increase their real value over time, while at the same time generating an annual return which meets the targets set by the Council. These objectives normally require to be measured over a number of years while acknowledging that abnormal fluctuations in the short term do create a cause for concern.

4.12.

In February 2019, a review of the Strategic Reserve Fund managed fund investments concluded that an investment strategy with an income bias, i.e. a weighting in favour of income generation, better suited the Council’s needs than a strategy focused towards capital growth.

4.13.

During 2019/20, in consultation with Hymans Robertson, implementation of the new strategy progressed with interviews with potential fund managers taking place in August and October 2019 after which fund managers were appointed to three new mandates. A fourth manager was then appointed in March 2020 through the National Framework Agreement for Passive Bond mandates.

4.14.

The process to onboard the fund managers to the new mandates commenced during financial year 2019/20 and continued during 2020/21, albeit at a slower pace than originally envisaged due to COVID-19 related volatility being experienced in the markets. The diversification process will continue in 2021/22.

5. Corporate Governance

This report relates to the Council complying with its governance and financial processes and procedures and therefore does not directly support and contribute to improved outcomes for communities as outlined in the Council Plan and the Local Outcomes Improvement Plan.

6. Financial Implications

The financial implications are contained within the body of the report.

7. Legal Aspects

7.1.

Treasury Management arrangements help the Council meet its statutory obligation to secure best value.

7.2.

Section 40 of the Local Government in Scotland Act 2003 provides local authorities with the power to invest money. This power may be exercised in accordance with regulations made by Scottish Ministers under this section.

7.3.

Section 95 of the Local Government (Scotland) Act 1973 states that every local authority shall make arrangements for the proper administration of their financial affairs and shall secure that the proper officer has responsibility for the administration of those affairs.

8. Contact Officers

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9. Appendix

Appendix 1: Annual Treasury Management Review for financial year 2020/21.

Annual Treasury Management Review 2020/21

Orkney Islands Council

ABBREVIATIONS USED IN THIS REPORT

CE: Capital Economics - is the economics consultancy that provides Link Group, Treasury solutions, with independent economic forecasts, briefings and research.

CFR: capital financing requirement - the council's annual underlying borrowing need to finance capital expenditure and a measure of the council's total outstanding indebtedness.

CIPFA: Chartered Institute of Public Finance and Accountancy – the professional accounting body that oversees and sets standards in local authority finance and treasury management.

CPI: consumer price index – the official measure of inflation adopted as a common standard by countries in the EU. It is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

ECB: European Central Bank - the central bank for the Eurozone
EU: European Union
EZ: Eurozone -those countries in the EU which use the euro as their currency

Fed: the Federal Reserve System, often referred to simply as "the Fed," is the central bank of the United States. It was created by the Congress to provide the nation with a stable monetary and financial system.

FOMC: the Federal Open Market Committee – this is the branch of the Federal Reserve Board which determines monetary policy in the USA by setting interest rates and determining quantitative easing policy. It is composed of 12 members--the seven members of the Board of Governors and five of the 12 Reserve Bank presidents.

GDP: gross domestic product – a measure of the growth and total size of the economy.

G7: the group of seven countries that form an informal bloc of industrialised democracies--the United States, Canada, France, Germany, Italy, Japan, and the United Kingdom--that meets annually to discuss issues such as global economic governance, international security, and energy policy.

Gilts: gilts are bonds issued by the UK Government to borrow money on the financial markets. Interest paid by the Government on gilts is called a coupon and is at a rate that is fixed for the duration until maturity of the gilt, (unless a gilt is index linked to inflation); while the coupon rate is fixed, the yields will change inversely to the price of gilts i.e. a rise in the price of a gilt will mean that its yield will fall.

HRA: housing revenue account.

IMF: International Monetary Fund - the lender of last resort for national governments which get into financial difficulties.

LIBID: the London Interbank Bid Rate is the rate bid by banks on deposits i.e., the rate at which a bank is willing to borrow from other banks. It is the "other end" of the LIBOR (an offered, hence "ask" rate, the rate at which a bank will lend).

MPC: the Monetary Policy Committee is a committee of the Bank of England, which meets for one and a half days, eight times a year, to determine monetary policy by setting the official interest rate in the United Kingdom, (the Bank of England Base Rate, commonly called Bank Rate), and by making decisions on quantitative easing.

PFI: Private Finance Initiative – capital expenditure financed by the private sector i.e. not by direct borrowing by a local authority.

PWLB: Public Works Loan Board – this is the part of H.M. Treasury which provides loans to local authorities to finance capital expenditure.

QE: quantitative easing – is an unconventional form of monetary policy where a central bank creates new money electronically to buy financial assets, such as government bonds, (but may also include corporate bonds). This process aims to stimulate economic growth through increased private sector spending in the economy and also aims to return inflation to target. These purchases increase the supply of liquidity to the economy; this policy is employed when lowering interest rates has failed to stimulate economic growth to an acceptable level and to lift inflation to target. Once QE has achieved its objectives of stimulating growth and inflation, QE will be reversed by selling the bonds the central bank had previously purchased, or by not replacing debt that it held which matures. The aim of this reversal is to ensure that inflation does not exceed its target once the economy recovers from a sustained period of depressed growth and inflation. Economic growth, and increases in inflation, may threaten to gather too much momentum if action is not taken to 'cool' the economy.

RPI: the Retail Price Index is a measure of inflation that measures the change in the cost of a representative sample of retail goods and services. It was the UK standard for measurement of inflation until the UK changed to using the EU standard measure of inflation – CPI. The main differences between RPI and CPI is in the way that housing costs are treated and that the former is an arithmetical mean whereas the latter is a geometric mean. RPI is often higher than CPI for these reasons.

TMSS: the annual treasury management strategy statement reports that all local authorities are required to submit for approval by the full council before the start of each financial year.

Annual Treasury Management Review 2020/21

1. Introduction

This Council is required by regulations issued under the Local Government in Scotland Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2020/21. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management, (the Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities, (the Prudential Code).

During 2020/21 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Policy and Resources Committee 18/02/2020)
- a mid-year (minimum) treasury update report (Policy and Resources Committee 03/12/2020)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is, therefore, important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Policy and Resources Committee before they were reported to the full Council.

2. The Council's Capital Expenditure and Financing

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

£m	31.3.20 Actual	2020/21 Budget	31.3.21 Actual
Capital expenditure	**19.920**	**27.059**	**16.458**
Financed in year	12.637	14.092	8.845
Unfinanced capital expenditure	**7.283**	**12.967**	**7.613**

3. The Council's Overall Borrowing Need

The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR).

Gross borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2020/21) plus the estimates of any additional capital financing requirement for the current (2021/22) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allowed the Council some flexibility to borrow in advance of its immediate capital needs in 2020/21. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31.3.20 Actual	2020/21 Budget	31.3.21 Actual
CFR (£m)	50.625	63.958	51.832
Gross borrowing position	35.143	35.114	35.114
Under / (over) funding of CFR	15.482	28.844	16.718

The authorised limit - this Council has kept within its authorised external borrowing limit as shown by the table below.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary are acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital, (borrowing and other long term obligation costs net of investment income), against the net revenue stream.

	2020/21
Authorised limit	£75.000m
Maximum gross borrowing position during the year	£51.832m
Operational boundary	£65.000m
Financing costs, including accelerated debt repayment, as a proportion of net revenue stream:	
General Fund	4.0%
Harbours	10.0%
Housing Revenue Account	42.2%

4. Treasury Position as at 31st March 2021

At the beginning and the end of 2020/21, the Councils' treasury position was as follows:

DEBT PORTFOLIO	31.3.20 Principal	Rate/ Return	Average Life years	31.3.21 Principal	Rate/ Return	Average Life years
Fixed rate funding:						
-PWLB	£35.000m			£35.000m		
-Salix Finance Ltd	£0.143m			£0.114m		
Total debt	**£35.143m**	**2.61%**	**38.68**	**£35.114m**	**2.61%**	**37.69**
CFR	**£50.625m**			**£51.832m**		
(Over)/under borrowing	**£15.482m**			**£16.718m**		
Total investments	**£29.625m**			**£34.982m**		
Net debt	**£5.518m**			**£0.186m**		

The maturity structure of the debt portfolio was as follows:

	31.3.20 actual	31.3.21 actual
Under 12 months	£0.029m	£0.029m
12 months and within 24 months	£0.029m	£5.029m
24 months and within 5 years	£5.085m	£0.056m
5 years and within 10 years	£0.000m	£0.000m
10 years and within 40 years	£0.000m	£0.000m
40 years and within 50 years	£30.000m	£30.000m

INVESTMENT PORTFOLIO	31.3.20 Actual £000	31.3.20 Actual %	31.3.21 Actual £000	31.3.21 Actual %
Treasury investments				
Banks	8.425	3.50	19.682	6.71
Building Societies - rated	0.000	0.00	0.000	0.00
Local authorities	14.000	5.83	5.000	1.70
Money Market Funds	7.200	3.00	4.300	1.46
Certificate of Deposit – UK banks	0.000	0.00	6.000	2.05
Total managed in house	**29.625**	**12.33**	**34.982**	**11.92**
Equity Fund	76.695	31.92	106.361	36.24
Bond funds	51.802	21.56	55.212	18.81
Property funds	22.072	9.19	23.046	7.85
Diversified Growth Funds	39.378	16.39	44.061	15.01
Credit Strategies Funds	20.692	8.61	29.850	10.17
Total managed externally	**210.639**	**87.67**	**258.530**	**88.08**
TOTAL TREASURY INVESTMENTS	**240.264**	**100%**	**293.512**	**100%**

Non-Treasury investments				
Fishing Quota	2.769	38.37	3.035	34.74
Private Companies	4.435	61.45	5.689	65.11
Other	0.013	0.18	0.013	0.15
TOTAL NON-TREASURY INVESTMENTS	**7.217**	**100%**	**8.737**	**100%**

Treasury investments (in house)	29.625	11.97	34.982	11.57
Managed Funds investments (external)	210.639	85.11	258.530	85.54
Non-Treasury investments	7.217	2.92	8.737	2.89
TOTAL OF ALL INVESTMENTS	**247.481**	**100%**	**302.249**	**100%**

5. The Strategy for 2020/21

In-house funds. Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e., rates for investments up to 12 months). Greater returns are usually obtainable by investing for longer periods. While most cash balances are required in order to manage the ups and downs of cash flow, where cash sums can be identified that could be invested for longer periods, the value to be obtained from longer term investments will be carefully assessed.

- If it is thought that Bank Rate is likely to rise significantly within the time horizon being considered, then consideration will be given to keeping most investments as being short term or variable.
- Conversely, if it is thought that Bank Rate is likely to fall within that time period, consideration will be given to locking in higher rates currently obtainable, for longer periods.

Investment returns expectations.
When the 2020/21 strategy was approved it was on the assumption that the UK and EU would agree a Brexit deal including the terms of trade by the end of 2020, or soon after. At that time the Bank Rate was forecast to increase only slowly over the next few years to reach 1.00% by quarter 1 2023. Bank Rate forecasts for financial year ends (March) at that time were as follows:

- Q1 2021 0.75%
- Q1 2022 1.00%
- Q1 2023 1.00%

The suggested budgeted investment earnings rates for returns on investments placed for periods up to about three months during each financial year are as follows:

2019/20	0.75%
2020/21	0.75%
2021/22	1.00%
2022/23	1.25%
2023/24	1.50%
2024/25	1.75%
Later years	2.25%

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit, as well as a softening global economic picture.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.
- In the event that a Brexit deal is agreed with the EU and approved by Parliament, the balance of risks to economic growth and to increases in Bank Rate is likely to change to the upside.

Investment treasury indicator and limit - total principal funds invested for greater than 365 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment and, are based on the availability of funds after each year-end.
The Council approved the following treasury indicator and limit:

Upper limit for principal sums invested for longer than 365 days			
£m	**2020/21**	**2021/22**	**2022/23**
Principal sums invested for longer than 365 days	£35m	£35m	£35m
Current investments as at 31 March 2021 in excess of 1 year maturing in each year	Nil	Nil	Nil

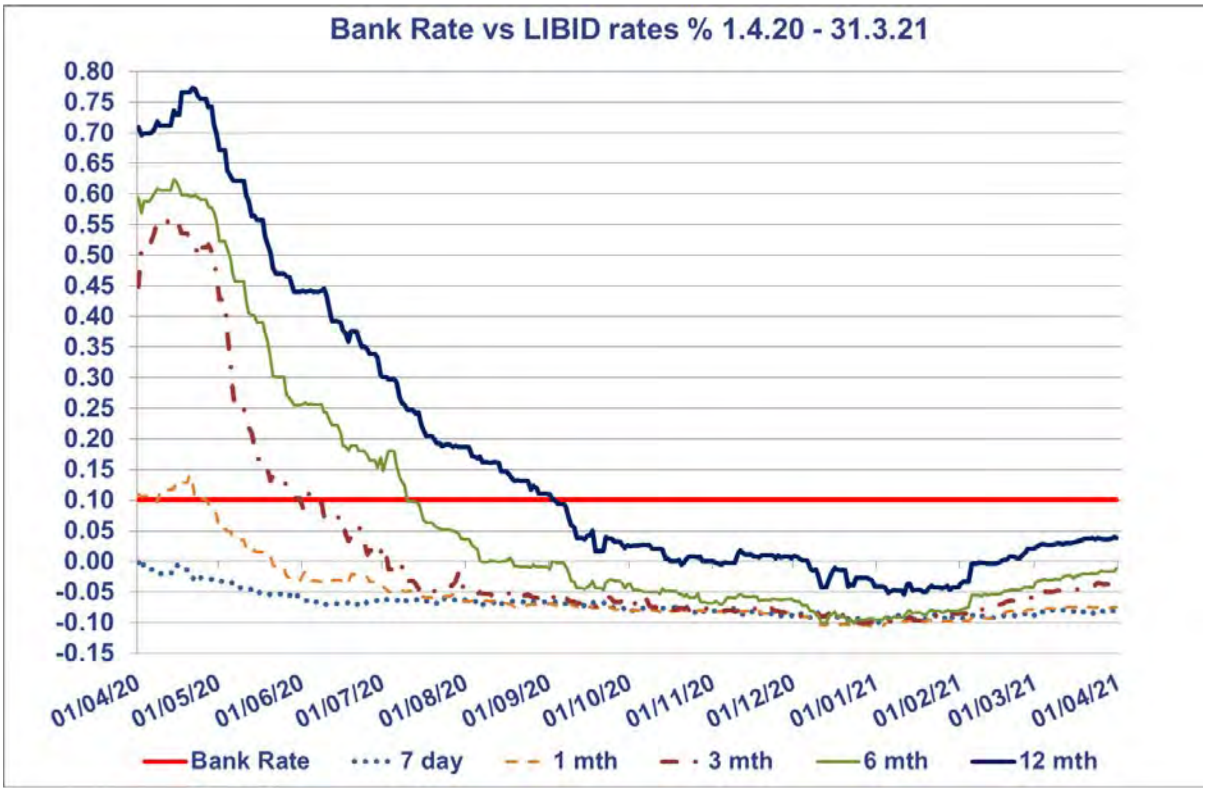
The budgeted investment earnings rates for returns on the Council's strategic reserve fund investments is derived from the approved investment strategy for the portfolio of investments that are managed by appointed external fund managers.

A revised investment strategy was implemented in 2017, introducing a new allocation to Enhanced Yield Debt as an alternative to Government Bonds which should marginally improve investment returns going forward. Since then, a further review has taken place which has resulted in the adoption of an income focused strategy in 2019. Both these changes in strategy are reflected in the forecast for the next three years as follows:

- 2019/2020 5.60%.
- 2020/2021 5.60%.
- 2021/2022 5.60%.

For its cash flow generated balances, the Council will seek to utilise its business reserve instant access and notice accounts, money market funds and short-dated deposits, (overnight to 365 days) in order to benefit from the compounding of interest.

5.1 Investment strategy and control of interest rate risk



	Bank Rate	7 day	1 month	3 months	6 months	12 months
High	0.10	0.00	0.14	0.56	0.62	0.77
High Date	01/04/2020	02/04/2020	20/04/2020	08/04/2020	14/04/2020	21/04/2020
Low	0.10	-0.10	-0.11	-0.10	-0.10	-0.05
Low Date	01/04/2020	31/12/2020	29/12/2020	23/12/2020	21/12/2020	11/01/2021
Average	0.10	-0.07	-0.05	0.01	0.07	0.17
Spread	0.00	0.10	0.25	0.66	0.73	0.83

Investment returns which had been low during 2019/20, plunged during 2020/21 to near zero or even into negative territory. Most local authority lending managed to avoid negative rates and one feature of the year was the growth of inter local authority lending. The expectation for interest rates within the treasury management strategy for 2020/21 was that Bank Rate would continue at the start of the year at 0.75 % before rising to end 2022/23 at 1.25%. This forecast was invalidated by the Covid-19 pandemic bursting onto the scene in March 2020 which caused the Monetary Policy Committee to cut Bank Rate in March, first to 0.25% and then to 0.10%, in order to counter the hugely negative impact of the national lockdown on large swathes of the economy. The Bank of England and the Government also introduced new programmes of supplying the banking system and the economy with massive amounts of cheap credit so that banks could help cash-starved businesses to survive the lockdown. The Government also supplied huge amounts of finance to local authorities to pass on to businesses. This meant that for most of the year there was much more liquidity in financial markets than there was a demand to borrow, with the consequent effect that investment earnings rates plummeted.

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

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

5.2 Borrowing strategy and control of interest rate risk

During 2019/20, the Council maintained an under-borrowed position. This meant that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as investment returns were very low and minimising counterparty risk on placing investments also needed to be considered.

A cost of carry remained during the year on any new long-term borrowing that was not immediately used to finance capital expenditure, as it would have caused a temporary increase in cash balances; this would have incurred a revenue cost – the difference between (higher) borrowing costs and (lower) investment returns.

The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this was kept under review to avoid incurring higher borrowing costs in the future when this authority may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.

Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. The Head of Finance therefore monitored interest rates in financial markets and adopted a pragmatic strategy based upon the following principles to manage interest rate risks*:*

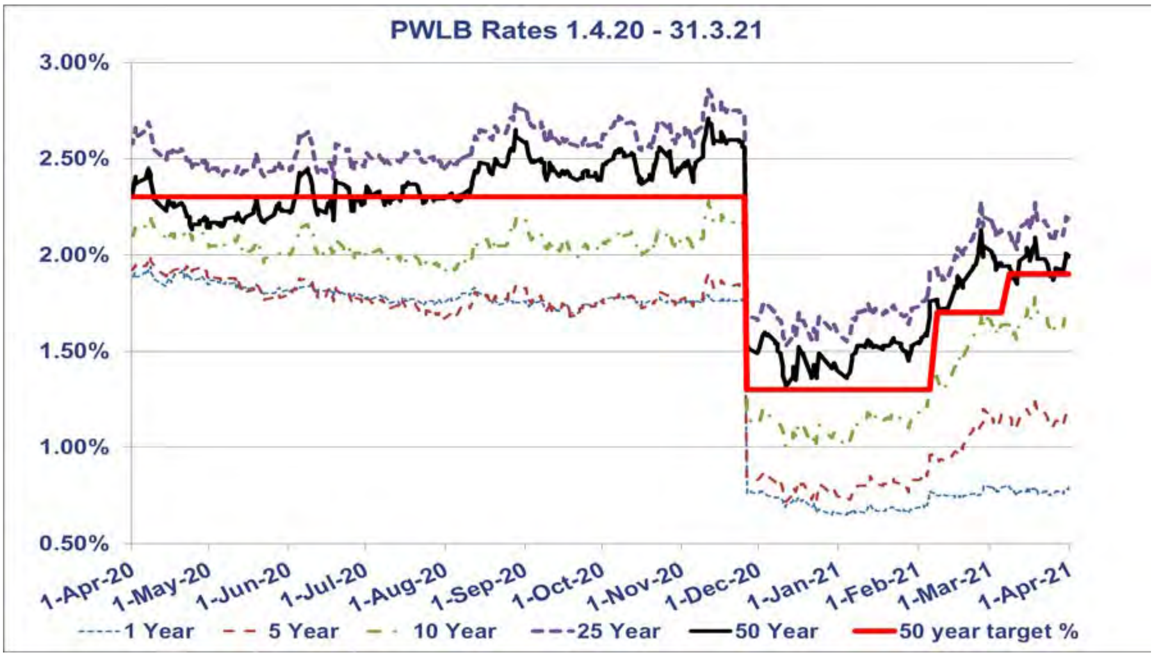
- if it had been felt that there was a significant risk of a sharp FALL in long and short-term rates, (e.g., due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings would have been postponed, and potential rescheduling from fixed rate funding into short term borrowing would have been considered.

- if it had been felt that there was a significant risk of a much sharper RISE in long and short-term rates than initially expected, perhaps arising from an acceleration in the start date and in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position would have been re-appraised. Most likely, fixed rate funding would have been drawn whilst interest rates were lower than they were projected to be in the next few years.

Interest rate forecasts expected only gradual rises in medium and longer-term fixed borrowing rates during 2020/21 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period.

The rates forecast in January 2020 by Link and used when preparing the strategy are shown below:

Link Asset Services Interest Rate View	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Bank Rate View	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25	1.25	1.25	1.25
3 Month LIBID	0.70	0.70	0.80	0.80	0.90	1.00	1.00	1.10	1.20	1.30	1.30	1.30	1.30
6 Month LIBID	0.80	0.80	0.90	1.00	1.00	1.10	1.20	1.30	1.40	1.50	1.50	1.50	1.50
12 Month LIBID	0.90	0.90	1.00	1.10	1.20	1.30	1.40	1.50	1.60	1.70	1.70	1.70	1.70
5yr PWLB Rate	2.30	2.30	2.40	2.40	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.00	3.10
10yr PWLB Rate	2.50	2.50	2.60	2.60	2.70	2.80	2.90	3.00	3.10	3.10	3.20	3.20	3.30
25yr PWLB Rate	3.00	3.00	3.10	3.20	3.30	3.40	3.50	3.60	3.70	3.80	3.80	3.90	3.90
50yr PWLB Rate	2.90	2.90	3.00	3.10	3.20	3.30	3.40	3.50	3.60	3.70	3.70	3.80	3.80



PWLB rates are based on, and are determined by, gilt (UK Government bonds) yields through H.M. Treasury determining a specified margin to add to gilt yields. The main influences on gilt yields are Bank Rate, inflation expectations and movements in US treasury yields. Inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation and the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers: this means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. This has pulled down the overall level of interest rates and bond yields in financial markets over the last 30 years. We have seen over the last two years, many bond yields up to 10 years in the Eurozone turn negative on expectations that the EU would struggle to get growth rates and inflation up from low levels. In addition, there has, at times, been an inversion of bond yields in the US whereby 10-year yields have fallen below shorter-term yields. In the past, this has been a precursor of a recession.

Graph of UK gilt yields v. US treasury yields

Gilt yields fell sharply from the start of 2020 and then spiked up during a financial market meltdown in March caused by the pandemic hitting western countries; this was rapidly countered by central banks flooding the markets with liquidity. While US treasury yields do exert influence on UK gilt yields so that the two often move in tandem, they have diverged during the first three quarters of 2020/21 but then converged in the final quarter. Expectations of economic recovery started earlier in the US than the UK but once the UK vaccination programme started making rapid progress in the new year of 2021, gilt yields and gilt yields and PWLB rates started rising sharply as confidence in economic recovery rebounded. Financial markets also expected Bank Rate to rise quicker than in the forecast tables in this report.

At the close of the day on 31 March 2021, all gilt yields from 1 to 5 years were between 0.19 – 0.58% while the 10-year and 25-year yields were at 1.11% and 1.59%.

HM Treasury imposed **two changes of margins over gilt yields for PWLB rates in 2019/20** without any prior warning. The first took place on 9 October 2019, adding an additional 1% margin over gilts to all PWLB period rates. That increase was then, at least partially, reversed for some forms of borrowing on 11 March 2020, but not for mainstream non-HRA capital schemes. A consultation was then held with local authorities and **on 25 November 2020, the Chancellor announced the conclusion to the review of margins over gilt yields for PWLB rates;** the standard and certainty margins were reduced by 1% but a prohibition was introduced to deny access to borrowing from the PWLB for any local authority which had purchase of assets for yield in its three year capital programme. The new margins over gilt yields are as follows: -.

- **PWLB Standard Rate** is gilt plus 100 basis points (G+100bps)
- **PWLB Certainty Rate** is gilt plus 80 basis points (G+80bps)
- **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
- **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
- **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

There is likely to be only a gentle rise in gilt yields and PWLB rates over the next three years as Bank Rate is not forecast to rise from 0.10% by March 2024 as the Bank of England has clearly stated that it will not raise rates until inflation is sustainably above its target of 2%; this sets a high bar for Bank Rate to start rising.

6. Borrowing Outturn

Borrowing – no loans were drawn to fund the net unfinanced capital expenditure and naturally maturing debt in financial year 2020/21.

Borrowing in advance of need
The Council has not borrowed more than, or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed.

Rescheduling
No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

Repayments
No PWLB loans became due for repayment in 2020/21 but the Council repaid a further £0.029m towards the 8-year interest free loan with Salix Finance Ltd, which was borrowed for LED Street Lighting replacement.

The loans outstanding as at 31 March 2021 were:

Lender	Principal	Type	Interest Rate	Maturity
PWLB	£5.000m	Fixed interest rate	3.93%	26/05/2022
PWLB	£10.000m	Fixed interest rate	4.28%	26/05/2060
PWLB	£10.000m	Fixed interest rate	3.54%	10/10/2064
Salix Finance Ltd	£0.114m	Interest free	0.00%	Equal Instalment of Principal – 4 years remaining
PWLB	£10.000m	Fixed interest rate	1.28%	26/03/2070
TOTAL	£35.114m	Average rate	2.61%	

7. Investment Outturn

Investment Policy – the Council's investment policy is governed by Scottish Government investment regulations which have been implemented in the annual investment strategy approved by the Council on 18 February 2020. This policy sets out the approach for choosing investment counterparties and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data, (such as rating outlooks, credit default swaps, bank share prices etc.).

The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

Resources – the Council's cash balances comprise revenue and capital resources and cash flow monies. The Council's core cash resources comprised as follows:

Balance Sheet Resources (£m)	31.3.20	31.3.21
Fund balances/reserves – managed in-house	**7.942**	**11.100**
Strategic Reserve Fund – externally managed	**210.639**	**258.530**
Capital Receipts	**3.067**	**2.539**
Provisions	**30.590**	**31.004**
Other – Repairs and Renewals Fund and Capital Fund	**7.973**	**10.743**
Total	**260.211**	**313.916**

Investments held by the Council

- The Council maintained an average balance of £30.877m of internally managed funds.
- The internally managed funds earned an average rate of return of 0.53%.
- The comparable performance indicator is the 90-day LIBOR, which was 0.09%.
- Total investment income was £0.165m.

Investments held by fund managers

The Council employs specialist external fund managers to invest the Strategic Reserve Fund cash balances across 7 separate mandates. The performance of the managers compared against the benchmark returns for the 12 months ending 31 March 2021 was:

Fund	Investments Held	Return	Benchmark
Equity Portfolio	£52.5m	41.7%	40.9%
Global Equity Portfolio	£53.9m	**	**
Dynamic Diversified Growth Fund	£44.0m	18.2%	3.2%
Global High Yield Credit Strategies Fund	£22.2m	27.6%	5.1%
Global Private Loan Fund 3	£7.7m	*	*
UK Property Fund	£23.0m	4.1%	2.4%
Passive Bonds Fund	£55.2m	**	**
Total	£258.5m	23.0%	15.0%

This compares to a budget assumption of 5.6% investment return and although very good in absolute terms it should be noted that this 12-month return includes the bounce-back of the large losses incurred by the financial markets at 31 March 2020 as a result of the impact of the Covid-19 pandemic.

*The Global Private Loan fund 2 is a new mandate that has only been partly drawn down. Measuring returns in percentages will become more appropriate when the committed investment has been fully drawn down and held for a full reporting period.

**The Global Equity Fund and the Passive Bonds Fund were only established in June 2020 and November 2020 respectively, so no 12-month performance figures are available at 31 March 2021.

The performance of investment mandates, including the Fund Managers, is measured against targets to out-perform the respective benchmarks over rolling 3-year periods and in some cases this has not been met, as follows:

Mandate	Benchmark	Target	Target Return	Actual Return
Equities Portfolio	MSCI AC World	+1.5% p.a. over rolling 3 years	13.5%	7.9%
UK Property Fund	MSCI All Balanced Property	Outperform benchmark	2.4%	2.6%
Dynamic Diversified Growth Fund	3-month LIBOR	+3% net of fees	6.6%	5.8%
Global High Yield Credit Strategies Fund	3-month LIBOR	+ 5% gross	10.6%	3.2%
Global Equity	MSCI AC World	+2.0% net of fees	**	**
Passive Bonds Fund	Markit iBoxx Sterlin Non-Gilts ex BBB	Match benchmark	**	**

**The Global Equity Fund and the Passive Bonds Fund were only established in June 2020 and November 2020 respectively, so no 3-year performance figures are yet available.

8. Other Issues

The Authority's activities expose it to a variety of financial risks:

- Credit risk – the possibility that other parties might fail to pay amounts due to the Authority.
- Liquidity risk – the possibility that the Authority might not have funds available to meet its commitments to make payments.
- Market risk – the possibility that financial loss might arise for the Authority as a result of changes in such measure as interest rates and stock market movements.

The Council's management of treasury risks actively works to minimise the Council's exposure to the unpredictability of financial markets and to protect the financial resources available to fund services. The Council has fully adopted CIPFA's Code of Treasury Management Practices and has written principles for overall risk management as well as written policies and procedures covering specific areas such as credit risk, liquidity risk and market risk.

Credit Risk
Credit risk arises from the short-term lending of surplus funds to financial institutions and local authorities, as well as credit exposures to the council's customers.

The risk is minimised through the Annual Investment Strategy.

Credit Risk Management Practices
The Council's credit risk management practices are set out in the Annual Investment Strategy. It is the policy of the council to place deposits only with a limited number of high-quality banks, building societies and money market funds whose credit rating is independently assessed as sufficiently secure by the Council's treasury advisers and to restrict lending to a prudent maximum amount for each entity.

Deposits are not made with banks and financial institutions unless they are rated independently with minimum score of A1/P1/F1 short term debt ratings with Moodys, Standard & Poors or Fitch. The authority has a policy of not lending more than 25% of its surplus balances to individual institutions at any one time.

No credit limits were exceeded during the financial year 2020/21 and the Council expects full repayment on the due date of deposits placed with its counterparties.

Liquidity risk
The authority has a cash flow management system that seeks to ensure that cash is available as needed. If unexpected movements happen, the authority has ready access to borrowings from the money markets and the Public Works Loans Board. There is no significant risk that it will be unable to raise finance to meet its commitments under financial instruments. Instead, the risk is that the authority will be bound to replenish a significant proportion of its borrowings at a time of unfavourable interest rates. The authority sets limits on the proportion of its fixed rate borrowing during specified periods.

Market risk: interest rate risk
The Authority is exposed to risk in terms of its exposure to interest rate movements on its borrowings and investments. Movements in interest rates have a complex impact on the authority. For instance, a rise in interest rates would have the following effects:

- Borrowings at variable rates – the interest expense charged to the Surplus or Deficit on the Provision of Services will rise.
- Borrowings at fixed rates – the fair value of the liabilities borrowings will fall.
- Investments at variable rates – the interest income credited to the Surplus or Deficit on the Provision of Services will rise.
- Investments at fixed rates – the fair value of the assets will fall.

The authority's investment strategy aims to manage interest rate risk by maintaining a number of discrete investment mandates or portfolios which are managed by specialist external fund managers. The diversification across equities, multi-asset pooled funds and bond investments in this way effectively minimises the Council's exposure to interest rate movements. The risk of loss remains with the authority.

Market risk: price risk

The authority held £267.267m of investments as at 31 March 2021 in the form of equities, multi-asset pooled funds and bonds, including £3.089m in a local wind energy company and £3.035m in fishing quota. The authority is consequently exposed to losses arising from movement in the price of the shares.

The authority's investment strategy limits its exposure to price movements by diversifying its investment portfolio through the use of external fund managers, investment guidelines, benchmarks and targets.

These clearly defined shares are mainly classified as Fair Value through Profit or Loss with the investment in the local wind energy company and fishing quota classified as Fair Value Other Comprehensive Income, meaning that all movements in price will impact directly on the Surplus or Deficit in the Provision of Services.