Item: 6.1

Policy and Resources Committee: 22 November 2022.

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 2022.

2. Recommendations

The Committee is invited to note:

2.1.

That, following emergency action to counter the hugely negative impact the COVID-19 national lockdown was having on the economy, the Bank of England took emergency action in March 2020 to cut Base Rate to 0.10%.

2.2.

That the Base Rate was left unchanged until it was raised to 0.25% on 16 December 2021, 0.50% on 4 February 2022 and then 0.75% in March 2022.

2.3.

That the increase in the Bank of England Base Rate led to the Public Works Loans Board borrowing rates increasing correspondingly.

2.4.

That Bank of England Base Rate increases will impact on future borrowing requirements, although the Council is well placed to benefit from savings on existing loans, with an average interest rate of 2.61%.

The Committee is invited to scrutinise:

2.5.

The Annual Treasury Management Review for financial year 2021/22, attached as Appendix 1 to this report, in order to obtain assurance that the Treasury Management Practices operated effectively.

3. Background

3.1.

Regulation 21 of the Council’s Financial Regulations confirms that the Council has adopted the key recommendations of the Chartered Institute of Public Finance and Accountancy’s Code of Practice for Treasury Management in the Public Services (the Code).

3.2.

The Code defines 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 2021/22 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 2022.
- The Strategy for financial year 2021/22.
- 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 2020/21 resulted in £8,551,000 being moved into financial year 2021/22 and beyond. Further slippage of £235,000 has been approved for financial year 2021/22, with budgets being reprofiled into financial year 2022/23 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 2021 to 2023, together with an operational boundary of £65,000,000 during the same period, as part of its Treasury Management Strategy for 2021/22.

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 2022, the Council's debt portfolio stood at £35,085,600, with loan maturities ranging over periods from one to 50 years. Overall, this represents an average cost of borrowing of 3.26% per annum, with an average duration of 38.81 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 0.24% for financial year 2021/22.

4.8.

In order to counter the huge economic damage caused by the coronavirus outbreak, the Bank of England Base Rate was raised from 0.10% to 0.25% on 16 December 2021 and then increased further to 0.50% on 4 February 2022 and 0.75% in March 2022. This led to the Public Works Loans Board borrowing rates increasing correspondingly.

4.9.

Although there remains much uncertainty over interest rates, with the long-term trend prediction for rates to rise, which will impact on future borrowing requirements, the Council should be well placed to benefit from savings on existing loan debt with an average interest rate of 2.61%.

4.10.

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.

4.11.

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.

4.12.

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.

4.13.

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 continued in financial year 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. Appendices

Appendix 1: Annual Treasury Management Review for financial year 2021/22.

Annual Treasury Management Review 2021/22

Orkney Islands Council

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ABBREVIATIONS USED IN THIS REPORT

ALMO: an Arm's Length Management Organisation is a not-for-profit company that provides housing services on behalf of a local authority. Usually an ALMO is set up by the authority to manage and improve all or part of its housing stock.

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). These benchmarks ceased on 31st December 2021 and have, generally, been replaced by SONIA, the Sterling Overnight Index Average.

DLUHC: Department for Levelling Up, Housing & Communities – set up 18th September 2021 to replace MHCLG.

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 – Consumer Price Index. 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.

SONIA: the Sterling Overnight Index Average. Generally, a replacement set of indices (for LIBID) for those benchmarking their investments. The benchmarking options include using a forward-looking (term) set of reference rates and/or a backward-looking set of reference rates that reflect the investment yield curve at the time an investment decision was taken.

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.

VRP: a voluntary revenue provision to repay debt, in the annual budget, which is additional to the annual MRP charge, (see above definition).

Annual Treasury Management Review 2021/22

Purpose

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 2021/22. 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 2021/22 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 16.02.2021)
- a mid-year, (minimum), treasury update report (Policy and Resources Committee 21.09.2021)
- 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.

Introduction and Background

This report summarises the following:-

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness, (the Capital Financing Requirement);
- The actual prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity.

1. 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 General Fund	31.3.21 Actual	2021/22 Budget	31.3.22 Actual
Capital expenditure	**14.099**	**12.516**	**11.684**
Financed in year	6.486	9.143	9.468
Unfinanced capital expenditure	**7.613**	**3.373**	**2.216**

£m HRA	31.3.21 Actual	2021/22 Budget	31.3.22 Actual
Capital expenditure	**2.359**	**2.537**	**2.200**
Financed in year	2.359	0.000	0.959
Unfinanced capital expenditure	**0.000**	**2.537**	**1.241**

2. The Council's Overall Borrowing Need

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2021/22 unfinanced capital expenditure (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies, (such as the Government, through the Public Works Loan Board [PWLB], or the money markets), or utilising temporary cash resources within the Council.

Reducing the CFR – the Council's (non HRA) underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called scheduled debt amortisation (or loans fund repayment), to reduce the CFR. This is effectively a repayment of the borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources, (such as unapplied capital receipts); or
- charging more than the scheduled debt amortisation.

The Council's CFR for the year is shown below, and represents a key prudential indicator.

CFR (£m): General Fund	31.3.21 Actual	2021/22 Budget	31.3.22 Actual
Opening balance	39.540	42.095	42.095
Add unfinanced capital expenditure (as above)	7.613	1.838	2.216
Less scheduled debt amortisation for loans repayments	1.470	1.634	1.384
Less principle accelerated	3.588	0.000	0.000
Closing balance	**42.095**	**42.299**	**42.927**

CFR (£m): HRA	31.3.21 Actual	2021/22 Budget	31.3.22 Actual
Opening balance	11.016	9.737	9.737
Add unfinanced capital expenditure (as above)	0.000	1.535	1.241
Less scheduled debt amortisation for loans repayments	0.465	0.410	0.418
Less principle accelerated	0.814	0.000	0.466
Closing balance	**9.737**	**10.862**	**10.094**

Borrowing activity is constrained by prudential indicators for gross borrowing and the CFR, and by the authorised limit.

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 (2021/22) plus the estimates of any additional capital financing requirement for the current (2022/23) 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 2021/22. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31.3.21 Actual	2021/22 Budget	31.3.22 Actual
Gross borrowing position	£35.114m	£35.085m	£35.085m
CFR	£51.832m	£53.161m	£53.021m
Under / over funding of CFR	£16.718m	£18.076m	£17.936m

The authorised limit - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2021/22 the Council has maintained gross borrowing within its authorised limit.

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.

	2021/22
Authorised limit	£75.000m
Maximum gross borrowing position during the year	£53.021m
Operational boundary	£65.000m
Average gross borrowing position	£39.756m
Financing costs as a proportion of net revenue stream: General Fund	2.2%
Financing costs as a proportion of net revenue stream: HRA	31.3%

3. Treasury Position as at 31st March 2022

The Council's treasury management debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the end of 2021/22 the Council's treasury, (excluding borrowing by PFI and finance leases), position was as follows:

DEBT PORTFOLIO	31.3.21 Principal	Rate/ Return	Average Life yrs	31.3.22 Principal	Rate/ Return	Average Life yrs
Fixed rate funding:						
-PWLB	£35.000m			£35.000m		
-Salix Finance Ltd	£0.114m			£0.086m		
Total debt	**£35.114m**	**2.61%**	**27.69**	**£35.086m**	**2.61%**	***38.81***
CFR	**£51.832m**			**£53.021m**		
Over / (under) borrowing	**£16.718m**			**£17.935m**		
Total investments	**£34.982m**			**£22.619m**		
Net debt	**£0.132m**			**£12.467m**		

The maturity structure of the debt portfolio was as follows:

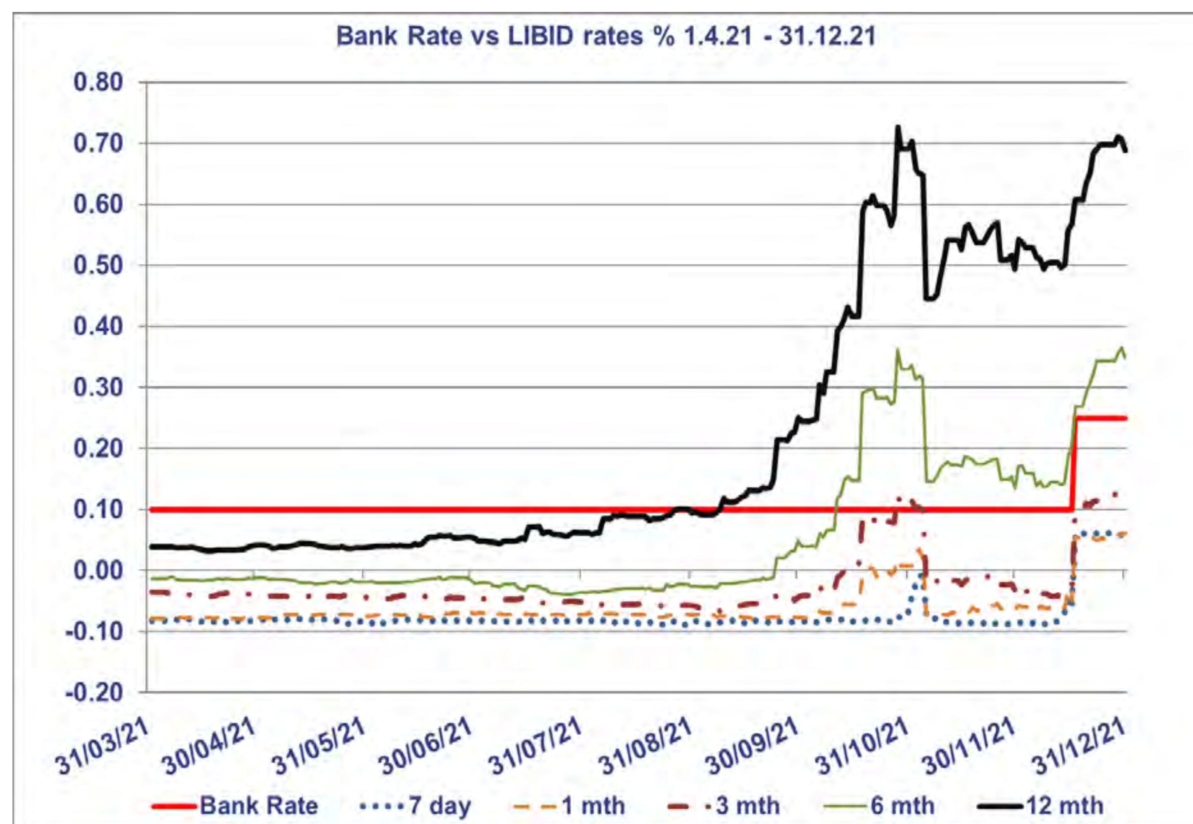
	31.3.21 actual	31.3.22 actual
Under 12 months	£0.029m	£5.029m
12 months and within 24 months	£5.029m	£0.029m
24 months and within 5 years	£0.056m	£0.028m
5 years and within 10 years	£0.000m	£0.000m
10 years and within 20 years	£0.000m	£0.000m
20 years and within 30 years	£0.000m	£0.000m
30 years and within 40 years	£0.000m	£0.000m
40 years and within 50 years	£30.000m	£30.000m

INVESTMENT PORTFOLIO	31.3.21 Actual £000	31.3.21 Actual %	31.3.22 Actual £000	31.3.22 Actual %
Treasury investments				
Banks	19.682	6.71	6.319	2.15
Building Societies - rated	0.000	0.00	0.000	0.00
Local authorities	5.000	1.70	3.000	1.02
Money Market Funds	4.300	1.46	4.300	1.46
Certificate of Deposits – UK Banks	6.000	2.05	9.000	3.07
Total managed in house	**34.982**	**11.92**	**22.619**	**7.71**
Equity Fund	106.361	36.24	106.917	36.43
Bond Funds	55.212	18.81	44.078	15.02
Property Funds	23.046	7.85	27.941	9.52
Diversified Growth Funds	44.061	15.01	43.752	14.91
Credit Strategies Funds	29.850	10.17	30.973	10.55
Alternative Income Funds	0.000	0.00	17.237	5.87
Total managed externally	**258.530**	**88.08**	**270.898**	**92.29**
TOTAL TREASURY INVESTMENTS	**293.512**	**100%**	**293.517**	**100%**

Non Treasury investments				
Fishing Quota	3.035	34.74	3.333	36.15
Private Companies	5.689	65.11	5.874	63.71
Other	0.013	0.15	0.013	0.14
TOTAL NON TREASURY INVESTMENTS	**8.737**	**100%**	**9.220**	**100%**
Treasury investments (in house)	34.982	11.57	22.619	7.47
Managed Funds investments (external)	258.530	85.54	270.898	89.48
Non-Treasury investments	8.737	2.89	9.220	3.05
TOTAL OF ALL INVESTMENTS	**302.249**	**100%**	**302.737**	**100%**

4. The Strategy for 2021/22

4.1 Investment strategy and control of interest rate risk



	Bank Rate	7 day	1 mth	3 mth	6 mth	12 mth
High	0.25	0.06	0.06	0.14	0.36	0.73
High Date	17/12/2021	29/12/2021	31/12/2021	31/12/2021	30/12/2021	28/10/2021
Low	0.10	-0.09	-0.08	-0.07	-0.04	0.04
Low Date	01/07/2021	27/08/2021	17/09/2021	08/09/2021	27/07/2021	08/07/2021
Average	0.11	-0.07	-0.05	-0.01	0.09	0.31
Spread	0.15	0.15	0.14	0.20	0.40	0.68

Investment returns remained close to zero for much of 2021/22. Most local authority lending managed to avoid negative rates and one feature of the year was the continued growth of inter local authority lending. The expectation for interest rates within the treasury management strategy for 2021/22 was that Bank Rate would remain at 0.1% until it was clear to the Bank of England that the emergency level of rates introduced at the start of the Covid-19 pandemic were no longer necessitated.

The Bank of England and the Government also maintained various monetary and fiscal measures, supplying the banking system and the economy with massive amounts of cheap credit so that banks could help cash-starved businesses to survive the various

lockdowns/negative impact on their cashflow. 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 demand to borrow, with the consequent effect that investment earnings rates remained low until towards the turn of the year when inflation concerns indicated central banks, not just the Bank of England, would need to lift interest rates to combat the second-round effects of growing levels of inflation (CPI was 6.2% in February).

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 counterparty risk exposure, by having fewer investments placed in the financial markets.

4.2 Borrowing strategy and control of interest rate risk

During 2021/22, 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.

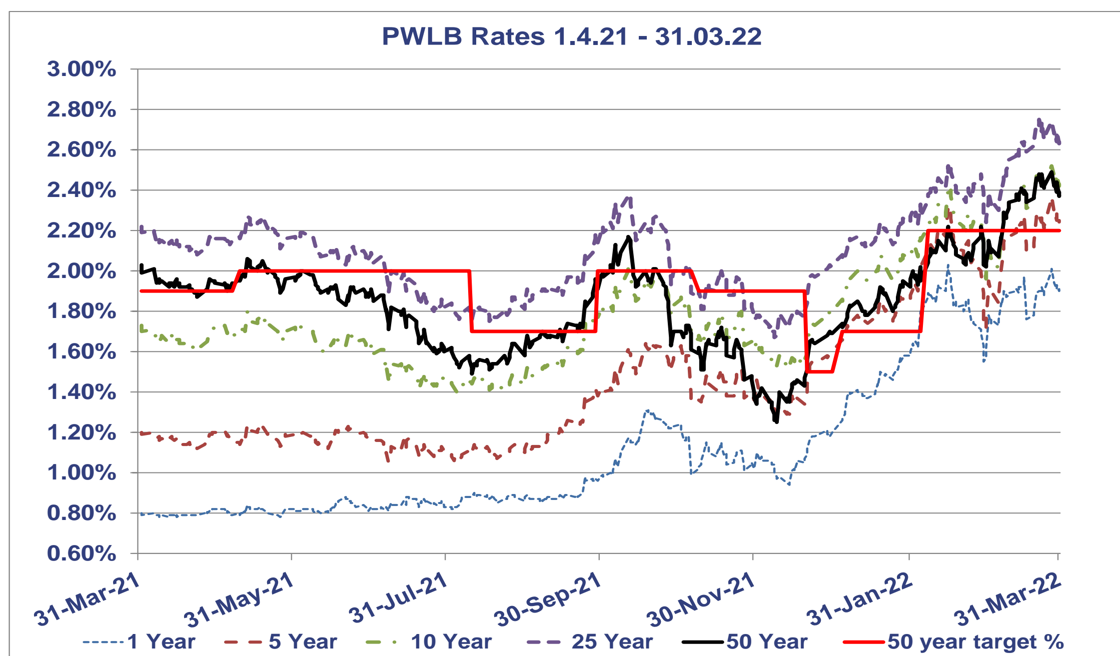
- if it had been felt that there was a significant risk of a much sharper RISE in long and short term rates than initially expected, perhaps arising from an acceleration in the start date and in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden 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 2021/22 and the two subsequent financial years until the turn of the year, when inflation concerns increased significantly. Internal, variable, or short-term rates, were expected to be the cheaper form of borrowing until well in to the second half of 2021/22.

Forecasts at the time of approval of the treasury management strategy report for 2021/22 were as follows:

Link Group Interest Rate View	9.11.20													
	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
BANK RATE	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
12 month ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
5 yr PWLB	1.80	1.80	1.80	1.80	1.80	1.90	1.90	1.90	1.90	1.90	2.00	2.00	2.00	2.00
10 yr PWLB	2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30	2.30	2.30	2.30	2.30
25 yr PWLB	2.50	2.50	2.60	2.60	2.60	2.60	2.70	2.70	2.70	2.70	2.80	2.80	2.80	2.80
50 yr PWLB	2.30	2.30	2.40	2.40	2.40	2.40	2.50	2.50	2.50	2.50	2.60	2.60	2.60	2.60

PWLB RATES 2021/22



PWLB rates are based on 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. Recently, yields have risen since the turn of the year on the back of global inflation concerns.

Graph of UK gilt yields v. US treasury yields

Gilt yields fell sharply from the spring of 2021 through to September and then spiked back up before falling again through December. However, by January sentiment had well and truly changed, as markets became focussed on the embedded nature of inflation, spurred on by a broader opening of economies post the pandemic, and rising commodity and food prices resulting from the Russian invasion of Ukraine.

At the close of the day on 31 March 2022, all gilt yields from 1 to 5 years were between 1.11% – 1.45% while the 10-year and 25-year yields were at 1.63% and 1.84%.

Regarding PWLB borrowing rates, the various margins attributed to their pricing 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)

5. Borrowing Outturn

Borrowing – no loans were drawn to fund the net unfinanced capital expenditure and naturally maturing debt in financial year 2021/22.

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 2021/22 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.

6. 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 16 February 2021. 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:

Housing authorities should consider whether this table should be split between General Fund and HRA

Balance Sheet Resources (£m)	31.3.21	31.3.22
Fund Balances/Reserves – managed in-house	**11.100**	**3.129**
Strategic Reserve Fund – externally managed	**258.530**	**270.898**
Capital Receipts	**2.539**	**1,961**
Provisions	**31.004**	**32,168**
Other – Repairs and Renewals Fund and Capital Fund	**10.743**	**9,658**
Total	**313.916**	**317.814**

Investments held by the Council

- The Council maintained an average balance of £30.219M of internally managed funds.
- The internally managed funds earned an average rate of return of 0.24%.
- The comparable performance indicator is the average 90-day LIbor rate, which was 0.26%.
- Total investment income was £0.071M.

Investments held by fund managers

The Council employs specialist external fund managers to invest the Strategic Reserve Fund cash balances across 8 separate mandates. The performance of the managers compared against the benchmark returns for the 12 months ending 31 March 2022 was:

Fund	Investments Held	Return	Benchmark*
Equity Portfolio	£59.5m	13.0%	16.7 %
Global Equity Portfolio	£47.4m	-7.2%	15.2%
Dynamic Diversified Growth Fund	£43.8m	-0.8%	3.2%
Global High Yield Credit Strategies Fund	£22.1m	-0.5%	5.1%
Global Private Loan Fund 3	£8.9m	*	*
UK Property Fund	£27.9m	21.4%	23.1%
Secured Income Fund	£17.2m	*	*
Passive Bonds Fund	£44.1m	-5.3%	-5.1%
Total	£270.9m	2.4%	9.1 %

This compares with a budget assumption of 5.2% investment return. Although performance during the year has been positive in absolute terms it should be noted that against benchmark this is considered very poor.

*The Global Private Loan Fund 3 and Secured Income Fund are still in investment phase so no 12-month performance figures are available at 31 March 2022.

7. 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 2021/22 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 £280.118m of investments as at 31 March 2022 in the form of equities, multi-asset pooled funds and bonds, including £3.034m in a local wind energy company and £3.333m 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.