

Background for TM report as at 31 March 2022

1. Spelthorne Borough Council's Context

- 1.1. Treasury Management is the management of the Council's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.
- 1.2. The Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code), which requires the Council to report on performance of the treasury management function at least twice yearly (mid-year and at year end).
- 1.3. The Council's Treasury Management Strategy for 2021/22 was reviewed and approved by Cabinet on 27 January 2021, and approved by Council on 25 February 2021, and has been consistently applied since the beginning of the financial year.
- 1.4. The 2021 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Council's Capital Strategy for 2021/22, complying with CIPFA's requirement, was approved by Council on 25 February 2021.
- 1.5. The following sections are based on advice from Spelthorne's treasury adviser Arlingclose.

2. External Context

- 2.1. **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.
- 2.2. 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.
- 2.3. 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%.
- 2.4. 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

- 2.5. With the fading of lockdown 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.
- 2.6. Having increased Bank Rate from 0.10% to 0.25% in December, the Bank of England hiked it further to 0.50% in February and 0.75% in March. At the meeting in February, the Monetary Policy Committee (MPC) voted unanimously to start reducing the stock of its asset purchase scheme by ceasing to reinvest the proceeds from maturing bonds as well as starting a programme of selling its corporate bonds.
- 2.7. In its March interest rate announcement, the MPC noted that the invasion of Ukraine had caused further large increases in energy and other commodity prices, with the expectation that the conflict will worsen supply chain disruptions around the world and push CPI inflation to around 8% later in 2022, even higher than forecast only a month before in the February Monetary Policy Report. The Committee also noted that although GDP in January was stronger than expected with business confidence holding up and the labour market remaining robust, consumer confidence had fallen due to the squeeze in real household incomes.
- 2.8. 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%.
- 2.9. The US economy expanded at a downwardly revised annualised rate of 6.9% in Q4 2021, a sharp 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 its plan to reduce its asset purchase programme which could start by May 2022.
- 2.10. **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.
- 2.11. 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.
- 2.12. 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%.
- 2.13. The Sterling Overnight Rate (SONIA) averaged 0.39% over the quarter.

- 2.14. **Credit review:** In the first half of FY 2021-22 credit default swap (CDS) spreads were flat over most of period and are broadly in line with their pre-pandemic levels. In September spreads rose by a few basis points due to concerns around Chinese property developer Evergrande defaulting but then fell back. Fitch and Moody's revised upward the outlook on a number of UK banks and building societies on the Council's counterparty to 'stable', recognising their improved capital positions compared to 2020 and better economic growth prospects in the UK.
- 2.15. 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.
- 2.16. 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.
- 2.17. Having completed its full review of its credit advice on unsecured deposits, in September Arlingclose extended the maximum duration limit for UK bank entities on its recommended lending list from 35 days to 100 days; a similar extension was advised in December for the non-UK banks on this list. As ever, the institutions and durations on the Council's counterparty list recommended by Arlingclose remains under constant review.

3. Revised CIPFA Codes, and Updated PWLB Lending Facility Guidance

- 3.1. In August 2021, HM Treasury significantly revised guidance for the PWLB lending facility with more detail and twelve 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.
- 3.2. CIPFA published its revised Prudential Code for Capital Finance and Treasury Management Code on 20 December 2021. The key changes in the two codes are around permitted reasons to borrow, knowledge and skills, and the management of non-treasury investments.
- 3.3. The principles of the Prudential Code took immediate effect although local authorities can defer introducing the revised reporting requirements until the 2023/24 financial year if they wish. The Council is reviewing reporting during 2022/23 with a view to implementation of the revised reporting by 2023/24.
- 3.4. 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.

- 3.5. 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.
- 3.6. Unlike the Prudential Code, there is no mention of the date of initial application in the Treasury Management Code. The TM Code now includes extensive additional requirements for service and commercial investments, far beyond those in the 2017 version. As with the Prudential Code, the Council is reviewing reporting during 2022/23 with a view to implementation of revised reporting by 2023/24.

4. Treasury Investment

- 4.1. CIPFA published a revised Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes on 20 December 2021. These define treasury management investments as investments that arise from the organisation's cash flows or treasury risk management activity that ultimately represents balances that need to be invested until the cash is required for use in the course of business.
- 4.2. 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 optimal 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.
- 4.3. Ultra-low short-dated cash rates, which were a feature since March 2020 when Bank Rate was cut to 0.1%, prevailed for much of the 12-month reporting period resulting in the return on sterling low volatility net asset value (LVNAV) Money Market Funds being close to zero even after some managers had temporarily waived or lowered their fees. However, higher returns on cash instruments followed the increases in Bank Rate in December, February and March. At 31 March, the 1-day return on the Council's MMFs was 0.06% and 0.09%.
- 4.4. **Externally Managed Pooled Funds:** In the nine months to December improved market sentiment was reflected in equity, property and multi-asset fund valuations and, in turn, in the capital values of the property, equity and multi-asset income funds in the Council's portfolio. 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.
- 4.5. In light of Russia's invasion, Arlingclose contacted the fund managers of their MMF, cash plus and strategic funds and confirmed no direct exposure to Russian or Belarusian assets had been identified. Indirect exposures were immaterial. It should be noted that any assets held by banks and financial institutions (e.g. from loans to companies with links to those countries) within MMFs and other pooled funds cannot be identified easily or with any certainty as that level of granular detail is unlikely to be available to the fund managers or Arlingclose in the short-term, if at all.

- 4.6. **Treasury Management Indicators:** The Council measures and manages its exposures to treasury management risks using the indicators shown at Appendices A. Appendix B shows benchmarking details that Arlingclose provides shortly after year end. The indicators are slightly different from the detail in the Council's own results which are produced later after the year end, including for example accruing adjustments.