GMCA GREATER MANCHESTER COMBINED AUTHORITY

Date: **30 November 2021**

Subject: **Treasury Management Interim Report 2021-2022**

Report of: **Steve Wilson, Treasurer of the GMCA**

PURPOSE OF REPORT

To report the Treasury Management activities of the Greater Manchester Combined Authority (GMCA) during the first six months of 2021/22.

RECOMMENDATIONS

The Audit Committee is asked to note the contents of the report.

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EQUALITIES IMPACT, CARBON AND SUSTAINABILITY ASSESSMENT
N/A

Risk Management
There are considerable risks to the security of the GMCA's resources if appropriate Treasury Management strategies and policies are not adopted and followed. The GMCA has established good practice in relation to Treasury Management.

Legal Considerations
The Authority has adopted the clauses within the CIPFA Treasury Management Code of Practice, the second of which is that the organisation will receive a mid-year review report. This report therefore meets requirement.

Financial Consequences – Revenue
Financial revenue consequences are contained within the body of the report

Financial Consequences – Capital
Financial capital consequences are contained within the body of the repor

Number of attachments to the report:
None

Comments/recommendations from Overview & Scrutiny Committee
N/A

Background Papers
Audit Committee, 22nd January 2021 - Treasury Management Strategy Statement, Borrowing Limits and Annual Investment Strategy 2021/22

TRACKING/PROCESS		
Does this report relate to a Key Decision, as set out in the GMCA Constitution or in the process agreed by the AGMA Executive Board		No
EXEMPTION FROM CALL IN		
Are there any aspects in this report which means it should be considered to be exempt from call in by the AGMA Scrutiny Pool on the grounds of urgency?	No	
AGMA Commission	**TfGMC**	**Scrutiny Pool**
N/A	N/A	N/A

1. BACKGROUND

1.1 In December 2017, the Chartered Institute of Public Finance and Accountancy (CIPFA), issued revised Prudential and Treasury Management Codes. These require all local authorities to prepare a Capital Strategy which is to provide the following:

a) a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services;
b) an overview of how the associated risk is managed;
c) the implications for future financial sustainability.

1.2 The Authority operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low-risk counterparties, providing adequate liquidity initially before considering optimising investment return.

1.3 The second main function of the treasury management service is the funding of the Authority's capital plans. These capital plans provide a guide to the borrowing need of the Authority, essentially the longer-term cash flow planning to ensure the Authority can meet its capital spending operations. This management of longer-term cash may involve arranging long or short-term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet the Authorities risk or cost objectives.

1.4 Accordingly, treasury management is defined as:

"The management of the local authority's borrowing, investments and 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."

2. INTRODUCTION

2.1 This report has been written in accordance with the requirements of the CIPFA Code of Practice on Treasury Management (revised 2017).

2.2 The primary requirements of the Code are as follows:

a) Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
b) Creation and maintenance of Treasury Management Practices which set out the manner in which the Authority will seek to achieve those policies and objectives.
c) Receipt by the Audit Committee of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report, (stewardship report), covering activities during the previous year.
d) Delegation by the Authority of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
e) Delegation by the Authority of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Authority the delegated body is Audit Committee:

2.3 This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

a) An economic update for the first half of the 2021/22 financial year;
b) A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
c) The Authority's capital expenditure, as set out in the Capital Strategy, and prudential indicators;
d) A review of the Authority's investment portfolio for 2021/22;
e) A review of the Authority's borrowing strategy for 2021/22;
f) A review of any debt rescheduling undertaken during 2021/22;
g) A review of compliance with Treasury and Prudential Limits for 2021/22.

3. ECONOMICS AND INTEREST RATES

Economics update

3.1 **Monetary Policy Committee (MPC) meeting 24 September 2021**

a) The MPC voted unanimously to leave Bank Rate unchanged at 0.10% and made no changes to its programme of quantitative easing purchases due to finish by the end of this year at a total of £895bn; two MPC members voted to stop the last £35bn of purchases as they were concerned that this would add to inflationary pressures.

b) There was a major shift in the tone of the MPC's minutes at this meeting from the previous meeting in August 2021 which had majored on indicating that some tightening in monetary policy was now on the horizon, but also not wanting to stifle economic recovery by too early an increase in Bank Rate. In his press conference after the August 2021 MPC meeting, Governor Andrew Bailey said, "the challenge of avoiding a steep rise in unemployment has been replaced by that of ensuring a flow of labour into jobs" and that "the Committee will be monitoring closely the incoming evidence regarding developments in the labour market, and particularly unemployment, wider measures of slack, and underlying wage pressures." In other words, it was flagging up a potential danger that labour shortages could push up wage growth by more than it expects and that, as a result, Consumer Price Index (CPI) inflation would stay above the 2% target for longer. It also discounted sharp increases in monthly inflation figures in the pipeline in late 2021 which were largely propelled by events a year ago, for example, the cut in Value Added Tax (VAT) in August 2020 for the hospitality industry, and by temporary shortages which would eventually work their way out of the system: in other words, **the MPC had been prepared to look through a temporary spike in inflation.**

c) So, in August 2021 the country was just put on alert. However, this time the MPC's words indicated there had been a marked increase in concern that more recent increases in prices, particularly the increases in gas and electricity prices in October 2021 and due again in April 2022, are, indeed, likely to lead to **faster and higher inflation expectations and underlying wage growth, which would in turn increase the risk that price pressures would prove more persistent next year than previously expected. Indeed, to emphasise its concern about inflationary pressures, the MPC pointedly chose to reaffirm its commitment to the 2% inflation target in its statement;** this suggested that it was now willing to look through the flagging economic recovery during the summer to prioritise bringing inflation down next year. This is a reversal of its priorities in August 2021 and a long way from words at earlier MPC meetings which indicated a willingness to look through inflation overshooting the target for limited periods to ensure that inflation was 'sustainably over 2%'. Indeed, whereas in August 2021 the MPC's focus was on getting through a winter of temporarily high energy prices and supply shortages, believing that inflation would return to just under the 2% target after reaching a high around 4% in late 2021, now its primary concern is that underlying price pressures in the economy are likely to get embedded over the next year and elevate future inflation to stay significantly above its 2% target and for longer.

d) Financial markets are now pricing in a first increase in Bank Rate from 0.10% to 0.25% in February 2022, but this looks ambitious as the MPC has stated that it wants to see what happens to the economy, and particularly to employment once furlough ends at the end of September 2021. At the MPC's meeting in February 2022 it will only have available the employment figures for November 2021: to get a clearer picture of employment trends, it would need to wait until the May 2022 meeting when it would have data up until February 2022. At its May 2022 meeting, it will also have a clearer understanding of the likely peak of inflation.

e) **The MPC's forward guidance on its intended monetary policy** on raising Bank Rate versus selling (quantitative easing) holdings of bonds is as follows:

i. Placing the focus on raising Bank Rate as "the active instrument in most circumstances".
ii. Raising Bank Rate to 0.50% before starting on reducing its holdings.
iii. Once Bank Rate is at 0.50% it would stop reinvesting maturing gilts.

iv. Once Bank Rate had risen to at least 1%, it would start selling its holdings.

3.2 **COVID-19 vaccines.** These have been the game changer which have enormously boosted confidence that **life in the UK could largely return to normal during the summer** after a third wave of the virus threatened to overwhelm hospitals in the spring. With the household saving rate having been exceptionally high since the first lockdown in March 2020, there is plenty of pent-up demand and purchasing power stored up for services in hard hit sectors like restaurants, travel and hotels. The big question is whether mutations of the virus could develop which render current vaccines ineffective, as opposed to how quickly vaccines can be modified to deal with them and enhanced testing programmes be implemented to contain their spread.

3.3 **United States -** see comments below on US treasury yields.

3.4 **European Union -** The slow role out of vaccines initially delayed economic recovery in early 2021 but the vaccination rate has picked up sharply since then. After a contraction in Gross Domestic product (GDP) of -0.3% in Q1, Q2 came in with strong growth of 2%, which is likely to continue into Q3, though some countries more dependent on tourism may struggle. Recent sharp increases in gas and electricity prices have increased overall inflationary pressures but the European Central Bank (ECB) is likely to see these as being only transitory after an initial burst through to around 4%, so is unlikely to be raising rates for a considerable time. German general election. With the Christian Democratic Union (CDU)/Christian Social Union (CSU) and Social Democratic Party (SDP) both having won around 24-26% of the vote in the September 2021 general election, the composition of Germany's next coalition government may not be agreed by the end of 2021. An SDP-led coalition would probably pursue a slightly less restrictive fiscal policy, but any change of direction from a CDU/CSU led coalition government is likely to be small. However, with Angela Merkel standing down as Chancellor as soon as a coalition is formed, there will be a hole in overall European Union (EU) leadership which will be difficult to fill.

3.5 **China.** After a concerted effort to get on top of the virus outbreak in Q1 2020, economic recovery was strong in the rest of the year; this enabled China to recover all the initial contraction. During 2020, policy makers both quashed the virus and implemented a programme of monetary and fiscal support that was particularly effective at stimulating short-term growth. At the same time, China's economy benefited from the shift towards online spending by consumers in developed markets. These factors helped to explain its comparative outperformance compared to western economies during 2020 and earlier in 2021. However, the pace of economic growth has now fallen back after this initial surge of recovery from the pandemic and China is now struggling to contain the spread of the Delta variant through sharp local lockdowns - which will also depress economic growth. There are also questions as to how effective Chinese vaccines are proving. In addition, recent regulatory actions motivated by a political agenda to channel activities into officially approved directions, are also likely to reduce the dynamism and long-term growth of the Chinese economy.

3.6 **Japan.** 2021 has been a patchy year in combating Covid. However, after a slow start, nearly 50% of the population are now vaccinated and Covid case numbers are falling. After a weak Q3 there is likely to be a strong recovery in Q4. The Bank of Japan is continuing its very loose monetary policy but with little prospect of getting inflation back above 1% towards its target of 2%, any time soon: indeed, inflation was negative in July 2021. New Prime Minister Kishida has promised a large fiscal stimulus package after the November 2021 general election – which his party is likely to win.

3.7 **World growth.** World growth was in recession in 2020 but recovered during 2021 until starting to lose momentum more recently. Inflation has been rising due to increases in gas and electricity prices, shipping costs and supply shortages, although these should subside during 2022. It is likely that we are heading into a period where there will be a reversal of **world globalisation** and a decoupling of western countries from dependence on China to supply products, and vice versa. This is likely to reduce world growth rates from those in prior decades.

3.8 **Supply shortages**. The pandemic and extreme weather events have been highly disruptive of extended worldwide supply chains. At the current time there are major queues of ships unable to unload their goods at ports in New York, California and China. Such issues have led to mis-distribution of shipping containers around the world and have contributed to a huge increase in the cost of shipping. Combined with a shortage of semi-conductors, these issues have had a disruptive impact on production in many countries. Many western countries are also hitting up

against a difficulty in filling job vacancies. It is expected that these issues will be gradually sorted out, but they are currently contributing to a spike upwards in inflation and shortages of materials and goods on shelves.

Interest rate forecasts

3.9 The Authority's treasury advisor, Link Group, provided the following forecasts on 29 September 2021 (Public Works Loan Board (PWLB) rates are certainty rates, gilt yields plus 80bps):

Link Group Interest Rate View 29.9.21										
	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	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.75
3 month ave earnings	0.10	0.10	0.20	0.20	0.30	0.40	0.50	0.50	0.60	0.70
6 month ave earnings	0.20	0.20	0.30	0.30	0.40	0.50	0.60	0.60	0.70	0.80
12 month ave earnings	0.30	0.40	0.50	0.50	0.50	0.60	0.70	0.80	0.90	1.00
5 yr PWLB	1.40	1.40	1.50	1.50	1.60	1.60	1.60	1.70	1.70	1.70
10 yr PWLB	1.80	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.10
25 yr PWLB	2.20	2.20	2.30	2.30	2.40	2.40	2.40	2.50	2.50	2.60
50 yr PWLB	2.00	2.00	2.10	2.20	2.20	2.20	2.20	2.30	2.30	2.40

3.10 The coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it left Bank Rate unchanged at its subsequent meetings.

3.11 As shown in the forecast table above, one increase in Bank Rate from 0.10% to 0.25% has now been included in quarter 2 of 2022/23, a second increase to 0.50% in quarter 2 of 23/24 and a third one to 0.75% in quarter 4 of 23/24.

3.12 **Significant risks to the forecasts**

a) COVID vaccines do not work to combat new mutations and/or new vaccines take longer than anticipated to be developed for successful implementation.
b) The pandemic causes major long-term scarring of the economy.
c) The Government implements an austerity programme that supresses GDP growth.
d) The MPC tightens monetary policy too early – by raising Bank Rate or unwinding Quantitative Easing (QE).
e) The MPC tightens monetary policy too late to ward off building inflationary pressures.
f) Major stock markets, for example, in the US, become increasingly judged as being over-valued and susceptible to major price corrections. Central banks become increasingly exposed to the "moral hazard" risks of having to buy shares and corporate bonds to reduce the impact of major financial market sell-offs on the general economy.
g) Geo-political risks are widespread, for example, German general election in September 2021 produces an unstable coalition or minority government and a void in high-profile leadership in the EU when Angela Merkel steps down as Chancellor of Germany; on-going global power influence struggles between Russia/China/US.

3.13 **The balance of risks to the UK economy: -**

a) The overall balance of risks to economic growth in the UK is now to the downside, including residual risks from Covid and its variants - both domestically and their potential effects worldwide.

3.14 **Forecasts for Bank Rate**

Bank Rate is not expected to go up fast after the initial rate rise as the supply potential of the economy has not generally taken a major hit during the pandemic, so should be able to cope well with meeting demand without causing inflation to remain elevated in the medium-term, or to inhibit inflation from falling back towards the MPC's 2% target after the surge to around 4% towards the end of 2021. Three increases in Bank rate are forecast in the period to March 2024, ending at 0.75%. However, these forecasts may well need changing within a relatively short time frame for the following reasons:

a) There are increasing grounds for viewing the economic recovery as running out of steam during the summer and now into the autumn. This could lead into stagflation which would create a dilemma for the MPC as to which way to face.

b) Will some current key supply shortages, for example, petrol and diesel, spill over into causing economic activity in some sectors to take a significant hit?
c) Rising gas and electricity prices in October 2021 and next April 2022 and increases in other prices caused by supply shortages and increases in taxation next April 2022, are already going to deflate consumer spending power without the MPC having to take any action on Bank Rate to cool inflation.
d) On the other hand, consumers are sitting on around £200bn of excess savings left over from the pandemic so when will they spend this sum, in part or in total?
e) There are 1.6 million people coming off furlough at the end of September 2021; how many of those will not have jobs on 1 October 2021 and will, therefore, be available to fill labour shortages in many sectors of the economy? So, supply shortages which have been driving up both wages and costs, could reduce significantly within the next six months or so and alleviate the MPC's current concerns.
f) There is a risk that there could be further nasty surprises on the Covid front, on top of the flu season this winter, which could depress economic activity.

3.15 In summary, with the high level of uncertainty prevailing on several different fronts, it is likely that these forecasts will need to be revised again soon - in line with what the new news is.

3.16 It also needs to be borne in mind that Bank Rate being cut to 0.10% was an emergency measure to deal with the Covid crisis hitting the UK in March 2020. At any time, the MPC could decide to simply take away that final emergency cut from 0.25% to 0.10% on the grounds of it no longer being warranted and as a step forward in the return to normalisation. In addition, any Bank Rate under 1% is both highly unusual and highly supportive of economic growth.

3.17 **Forecasts for PWLB rates and gilt and treasury yields**

As the interest forecast table for PWLB certainty rates above shows, there is likely to be a steady rise over the forecast period, with some degree of uplift due to rising treasury yields in the US.

3.18 There is likely to be **exceptional volatility and unpredictability in respect of gilt yields and PWLB rates** due to the following factors: -

a) How strongly will changes in gilt yields be correlated to changes in US treasury yields?
b) Will the Fed take action to counter increasing treasury yields if they rise beyond a yet unspecified level?
c) Would the MPC act to counter increasing gilt yields if they rise beyond a yet unspecified level?
d) How strong will inflationary pressures turn out to be in both the US and the UK and so impact treasury and gilt yields?
e) How will central banks implement their new average or sustainable level inflation monetary policies?
f) How well will central banks manage the withdrawal of QE purchases of their national bonds i.e., without causing a panic reaction in financial markets as happened in the "taper tantrums" in the US in 2013?
g) Will exceptional volatility be focused on the short or long-end of the yield curve, or both?

3.19 The forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU within our forecasting period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and China / North Korea and Iran, which have a major impact on international trade and world GDP growth.

3.20 **Gilt and treasury yields**

Since the start of 2021, there has been a lot of volatility in gilt yields, and hence PWLB rates. During the first part of the year, US President Biden's, and the Democratic party's determination to push through a $1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a recovery package from the Covid pandemic was what unsettled financial markets. However, this was in addition to the $900bn support package already passed in December 2020 under President Trump. This was then followed by additional Democratic ambition to spend further huge sums on infrastructure and an American families plan over the next decade which are caught up in Democrat / Republican haggling. Financial markets were alarmed that all this

stimulus, which is much bigger than in other western economies, was happening at a time in the US when:

a) A fast vaccination programme has enabled a rapid opening up of the economy.
b) The economy had already been growing strongly during 2021.
c) It started from a position of little spare capacity due to less severe lockdown measures than in many other countries. A combination of shortage of labour and supply bottle necks is likely to stoke inflationary pressures more in the US than in other countries.
d) And the Fed was still providing monetary stimulus through monthly QE purchases.

3.21 These factors could cause an excess of demand in the economy which could then unleash stronger and more sustained inflationary pressures in the US than in other western countries. This could then force the Fed to take much earlier action to start tapering monthly QE purchases and/or increasing the Fed rate from near zero, despite their stated policy being to target average inflation. It is notable that some Fed members have moved forward their expectation of when the first increases in the Fed rate will occur in recent Fed meetings. In addition, more recently, shortages of workers appear to be stoking underlying wage inflationary pressures which are likely to feed through into CPI inflation. A run of strong monthly jobs growth figures could be enough to meet the threshold set by the Fed of "substantial further progress towards the goal of reaching full employment". However, the weak growth in August, (announced 3 September 2021), has spiked anticipation that tapering of monthly QE purchases could start by the end of 2021. These purchases are currently acting as downward pressure on treasury yields. As the US financial markets are, by far, the biggest financial markets in the world, any trend upwards in the US will invariably impact and influence financial markets in other countries. However, during June 2021 and July 2021, longer term yields fell sharply; even the large non-farm payroll increase in the first week of August 2021 seemed to cause the markets little concern, which is somewhat puzzling, particularly in the context of the concerns of many commentators that inflation may not be as transitory as the Fed is expecting it to be. Indeed, inflation pressures and erosion of surplus economic capacity look much stronger in the US than in the UK. **As an average since 2011, there has been a 75% correlation between movements in 10 year treasury yields and 10 year gilt yields. This is a significant UPWARD RISK exposure to our forecasts for longer term PWLB rates. However, gilt yields and treasury yields do not always move in unison.**

3.22 There are also possible **DOWNSIDE RISKS** from the huge sums of cash that the UK populace have saved during the pandemic; when savings accounts earn little interest, it is likely that some of this cash mountain could end up being invested in bonds and so push up demand for bonds and support their prices i.e., this would help to keep their yields down. How this will interplay with the Bank of England eventually getting round to not reinvesting maturing gilts and then later selling gilts, will be interesting to keep an eye on.

3.23 **The balance of risks to medium to long term PWLB rates** There is a balance of upside risks to forecasts for medium to long term PWLB rates.

3.24 **A new era – a fundamental shift in central bank monetary policy**

One of the key results of the pandemic has been a fundamental rethinking and shift in monetary policy by major central banks like the Fed, the Bank of England and the ECB, to tolerate a higher level of inflation than in the previous two decades when inflation was the prime target to bear down on so as to stop it going <u>above</u> a target rate. There is now also a greater emphasis on other targets for monetary policy than just inflation, especially on 'achieving broad and inclusive "maximum" employment in its entirety' in the US before consideration would be given to increasing rates.

a) The Fed in America has gone furthest in adopting a monetary policy based on a clear goal of allowing the inflation target to be symmetrical, (rather than a ceiling to keep under), so that inflation averages out the dips down and surges above the target rate, over an unspecified period of time.
b) The Bank of England has also amended its target for monetary policy so that inflation should be 'sustainably over 2%' and the ECB now has a similar policy.
c) ***<u>For local authorities, this means that investment interest rates and very short term PWLB rates will not be rising as quickly or as high as in previous decades when the economy recovers from a downturn and the recovery eventually runs out of spare capacity to fuel continuing expansion.</u>***

d) Labour market liberalisation since the 1970s has helped to break the wage-price spirals that fuelled high levels of inflation and has now set inflation on a lower path which makes this shift in monetary policy practicable. In addition, recent changes in flexible employment practices, the rise of the gig economy and technological changes, will all help to lower inflationary pressures.
e) Governments will also be concerned to see interest rates stay lower as every rise in central rates will add to the cost of vastly expanded levels of national debt; (in the UK this is £21bn for each 1% rise in rates). On the other hand, higher levels of inflation will help to erode the real value of total public debt.

4 TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY

4.1 The Treasury Management Strategy Statement, (TMSS), for 2021/22 was approved by this Authority on 12 February 2021. There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

5. THE AUTHORITY'S CAPITAL POSITION (PRUDENTIAL INDICATORS)

5.1 This part of the report is structured to update:
a) The Authority's capital expenditure plans;
b) How these plans are being financed;
c) The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
d) Compliance with the limits in place for borrowing activity.

Prudential Indicator for Capital Expenditure

5.2 This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget.

Capital Expenditure by Service	2021/22 Original Estimate £m	2021/22 Revised Estimate £m
Transport	213.950	232.314
Economic Development & Regeneration	188.673	354.846
Fire & Rescue Service	13.277	13.318
Waste & Resources	23.050	25.200
Police	18.119	39.699
Total capital expenditure	**457.069**	**665.377**

5.3 The increase in capital expenditure in Economic Development & Regeneration is largely as a result of the addition of Public Sector Decarbonisation Scheme (£78.2m), Green Homes grant (£27.2m) and increase in Housing Investment Fund (£58m)

5.4 The increase in capital expenditure in Police is largely as a result of capital projects being carried forward from 2020/21.

Changes to the Financing of the Capital Programme

5.5 The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Authority by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure	2021/22 Original Estimate £m	2021/22 Revised Estimate £m
Total capital expenditure	**457.069**	**665.377**
Financed by:		
Capital receipts	(115.392)	(170.912)
Capital grants	(175.904)	(305.340)
Capital reserves		
Revenue	(37.743)	(41.481)
Total financing	**(329.039)**	**(517.733)**
Borrowing requirement	**128.030**	**147.644**

5.6 The increase in financing from Capital Grants reflects the increase in capital expenditure as in 5.2 above.

Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

5.7 The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period, which is termed the Operational Boundary.

5.8 **Prudential Indicator – Capital Financing Requirement**
The Capital Financing Requirement has been updated below to reflect the additions to the Capital Programme.

5.9 **Prudential Indicator – the Operational Boundary for external debt**

	2021/22 Original Estimate £m	2021/22 Revised Estimate £m
Total CFR	2,436.943	2,442.407
Net movement in CFR	**40.389**	**60.003**
Borrowing	1,480.844	1,360.737
Other long-term liabilities	40.759	40.759
Total debt (year-end position)	**1,521.603**	**1,401.496**

Limits to Borrowing Activity

5.10 The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. **Gross external borrowing** should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2021/22 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Authority has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

Operational Boundary for external debt	2021/22 Original Estimate £m	2021/22 Revised Estimate £m
Borrowing	2,516.382	2,501.524
Other long-term liabilities	46.639	46.639
Total debt	**2,563.021**	**2,548.163**
CFR (year-end position)	**2,436.943**	**2,442.407**

5.11 A further prudential indicator controls the overall level of borrowing. This is **the Authorised Limit** which represents the limit beyond which borrowing is prohibited and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Authorised limit for external debt	2021/22 Original Indicator	2021/22 Revised Indicator
Borrowing	2,636.209	2,620.644
Other long-term liabilities	48.860	48.860
Total	**2,685.069**	**2,669.504**

6. BORROWING

6.1 The Authority's revised capital financing requirement (CFR) for 2021/22 is £2,442.407m. The CFR denotes the Authority's underlying need to borrow for capital purposes. If the CFR is positive the Authority may borrow from the PWLB or the market (external borrowing), or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. The table 5.9 shows the Authority has forecast borrowings of £1,401.496m and forecasts to utilise £1,040.911m of cash flow funds in lieu of borrowing. This is a prudent and cost-effective approach in the current economic climate but will require ongoing monitoring in the event that any upside risk to gilt yields prevails.

6.2 The capital programme is being kept under regular review due to the effects of coronavirus and shortages of materials and labour. Our borrowing strategy will, therefore, also be regularly reviewed and then revised, if necessary, in order to achieve optimum value and risk exposure in the long-term. It is anticipated that borrowing will not be undertaken during this financial year.

6.3 **PWLB maturity certainty rates (gilts plus 80bps) year to date to 30 September 2021**

Gilt yields and PWLB rates were on a falling trend between May 2021 and August 2021. However, they rose sharply towards the end of September 2021.

6.4 The 50 year PWLB target certainty rate for new long-term borrowing started 2021/22 at 1.90%, rose to 2.00% in May 2021, fell to 1.70% in August 2021 and returned to 2.00% at the end of September 2021 after the MPC meeting of 23 September 2021.

6.5 The current PWLB rates are set as margins over gilt yields as follows:

a) **PWLB Standard Rate** is gilt plus 100 basis points (G+100bps)
b) **PWLB Certainty Rate** is gilt plus 80 basis points (G+80bps)
c) **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
d) **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
e) **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

6.6 Within the debt portfolio there were originally two Lender Option Borrower Option (LOBO) loans with Barclays which were taken out in 2005 and 2006 for a period of 60 years. At Barclays' initiative in 2018 these were converted to standard vanilla loans. In August 2021 Barclays Bank was the first UK bank to confirm conversion of LOBOs into fixed-rate loans.

7 DEBT RESCHEDULING

7.1 Debt rescheduling opportunities have been very limited in the current economic climate and following the various increases in the margins added to gilt yields which have impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

8. COMPLIANCE WITH TREASURY AND PRUDENTIAL LIMITS

8.1 It is a statutory duty for the Authority to determine and keep under review the affordable borrowing limits. During the half year ended 30th September 2021, the Authority has operated

within the treasury and prudential indicators set out in the Authority's Treasury Management Strategy Statement for 2021/22. The Treasurer reports that no difficulties are envisaged for the current or future years in complying with these indicators.

8.2 All treasury management operations have also been conducted in full compliance with the Authority's Treasury Management Practices.

9. ANNUAL INVESTMENT STRATEGY

9.1 The Treasury Management Strategy Statement (TMSS) for 2021/22, which includes the Annual Investment Strategy, was approved by the Authority on **12 February 2021**. In accordance with the CIPFA Treasury Management Code of Practice, it sets out the Authority's investment priorities as being:

- Security of capital
- Liquidity
- Yield

9.2 The Authority will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the Authority's risk appetite. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with high credit rated financial institutions, using the Link suggested creditworthiness approach, including a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information.

9.3 As shown by the interest rate graphs in section 9.7, it is now impossible to earn the level of interest rates commonly seen in previous decades as all short-term money market investment rates have only risen weakly since Bank Rate was cut to 0.10% in March 2020 until the MPC meeting on 24 September 2021 when 6 and 12 month rates rose in anticipation of Bank Rate going up in 2022. Given this environment and the fact that Bank Rate may only rise marginally, or not at all, before mid-2023, investment returns are expected to remain low.

Creditworthiness

9.4 Significant levels of downgrades to Short and Long Term credit ratings have not materialised since the crisis in March 2020. In the main, where they did change, any alterations were limited to Outlooks. However, as economies are beginning to reopen, there have been some instances of previous lowering of Outlooks being reversed.

Investment Counterparty criteria

9.5 The current investment counterparty criteria selection approved in the TMSS is not meeting the requirement of the treasury management function and the Treasurer has approved extensions as below as per the delegation granted in the TMSS approved by the Authority on 12 February 2021.

	Limit Contained in TMSS	Revised Limit
Total Government (includes Debt Management Office)	£250m	£500m
Total Banks, Building Societies and Money Market Funds	£150m	£300m
Individual Banks & Building Societies/MMFs - Fitch AA+ and above / AAAM	£25m	£100m

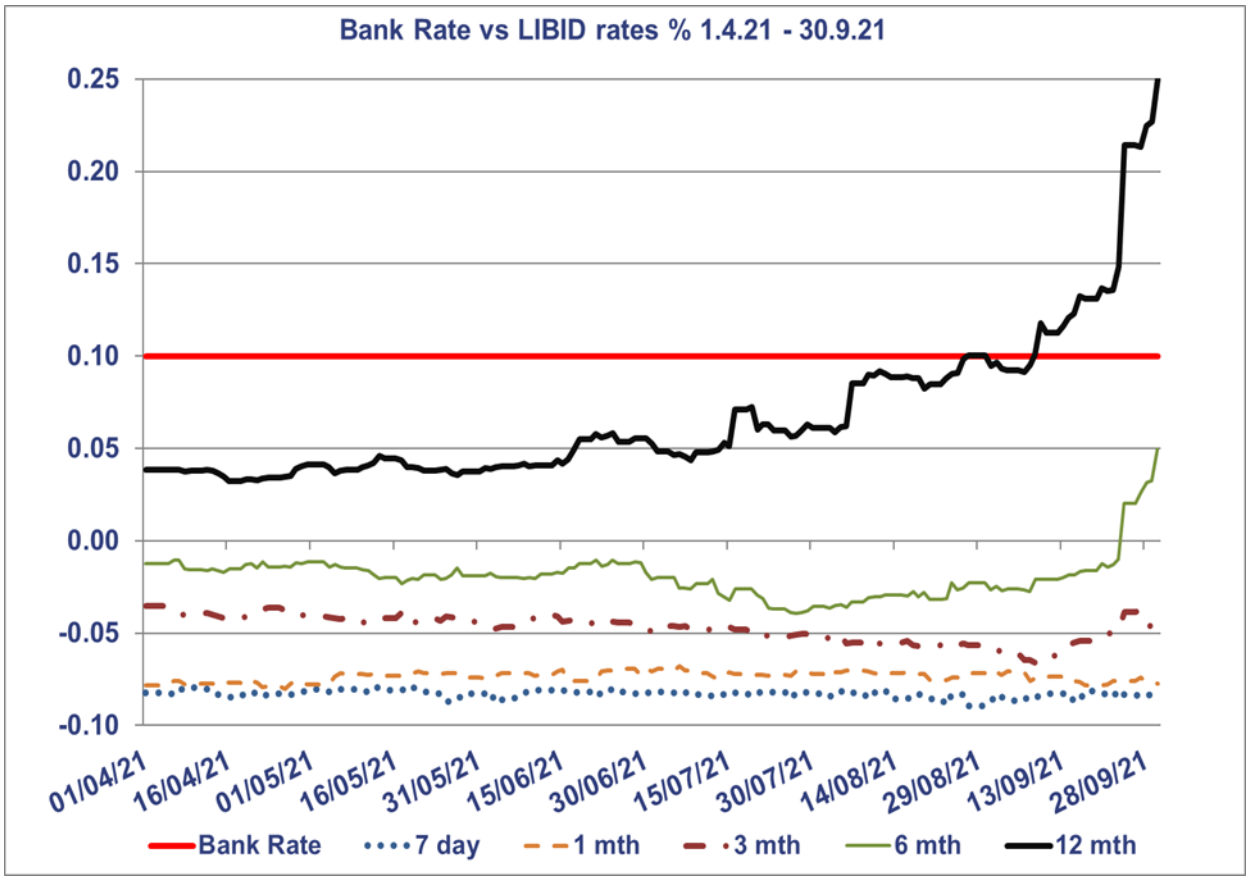
CDS prices

9.6 Although CDS prices (these are market indicators of credit risk) for banks (including those from the UK) spiked at the outset of the pandemic in 2020, they have subsequently returned to near pre-pandemic levels. However, sentiment can easily shift, so it remains important to undertake continual monitoring of all aspects of risk and return in the current circumstances.

Investment balances

9.7 The average level of funds available for investment purposes during the first 6 months was **£505.1m**. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the capital programme.

Investment rates during half year ended 30 September 2021



	Bank Rate	7 day	1 mth	3 mth	6 mth	12 mth
High	0.10	-0.08	-0.07	-0.04	0.05	0.25
High Date	01/04/2021	09/04/2021	06/07/2021	01/04/2021	30/09/2021	30/09/2021
Low	0.10	-0.09	-0.08	-0.07	-0.04	0.03
Low Date	01/04/2021	27/08/2021	26/04/2021	08/09/2021	27/07/2021	16/04/2021
Average	0.10	-0.08	-0.07	-0.05	-0.02	0.07
Spread	0.00	0.01	0.01	0.03	0.09	0.22

Investment performance year to date as at 30 September 2021

Period	LIBID benchmark return	Authority performance
7 day	-0.08%	0.02%

9.8 As illustrated, the Authority outperformed the benchmark by **10 bps**.

Approved limits

9.9 The Treasurer agreed to breach the limits as the Authority experienced high levels of cash deposits during the first six months of the year. Officers are identifying alternatives with a view to bring the investment levels for individual counterparties back to the limits agreed in the Treasury Management Strategy. A full list of investments held as at 30 September 2021 is in Appendix 2.

10. CONCLUSION

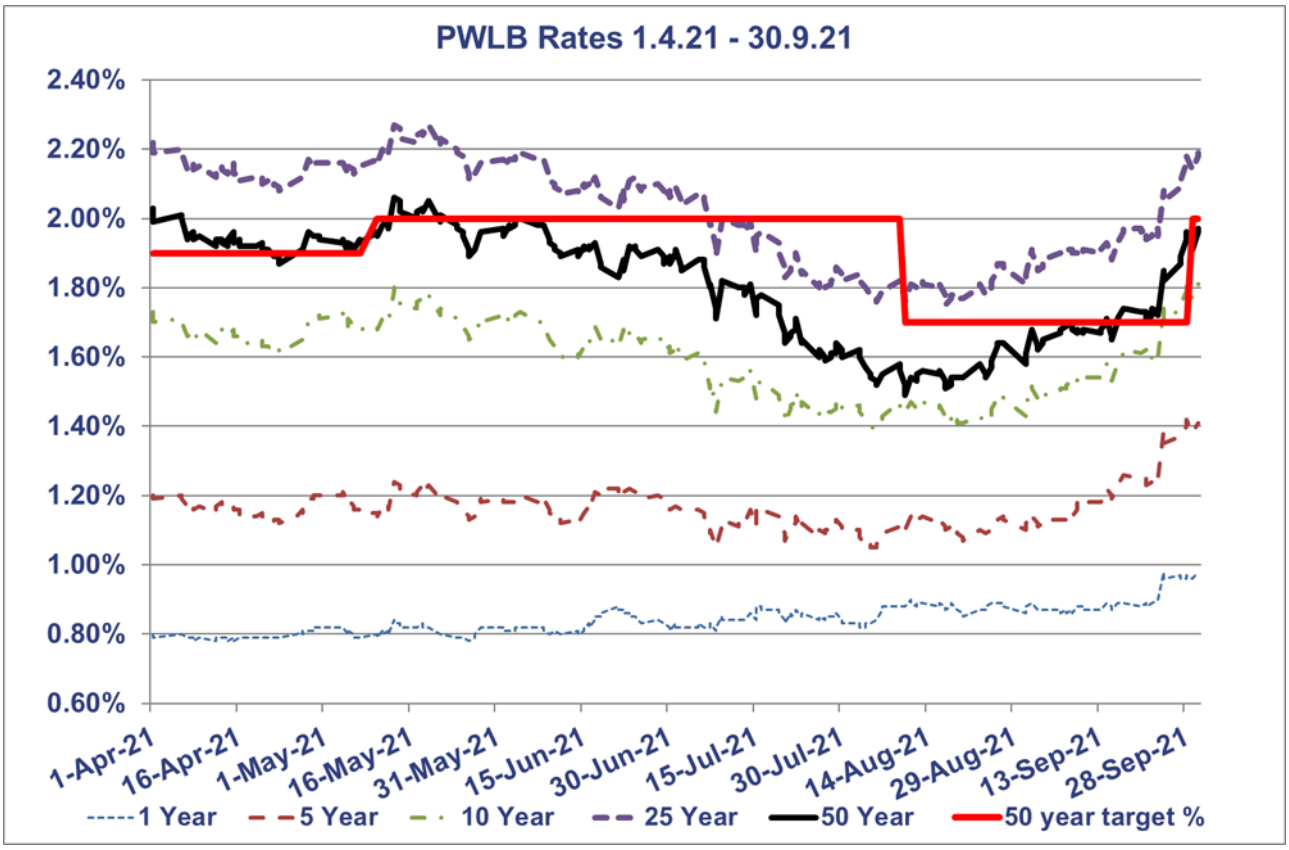
10.1 There has been no requirement for temporary borrowing in 2021/22. Cash resources increased at the start of the financial year and have remained relatively high throughout the first half of the year with a forecast for a continuing strong cash position in the short term.

10.2 A review is underway of all investment options, to determine if a greater rate of return could be attracted without compromising the Authority's strong risk management position and to determine the most appropriate timescales for pursing planned external borrowing to meet the capital financing requirement.

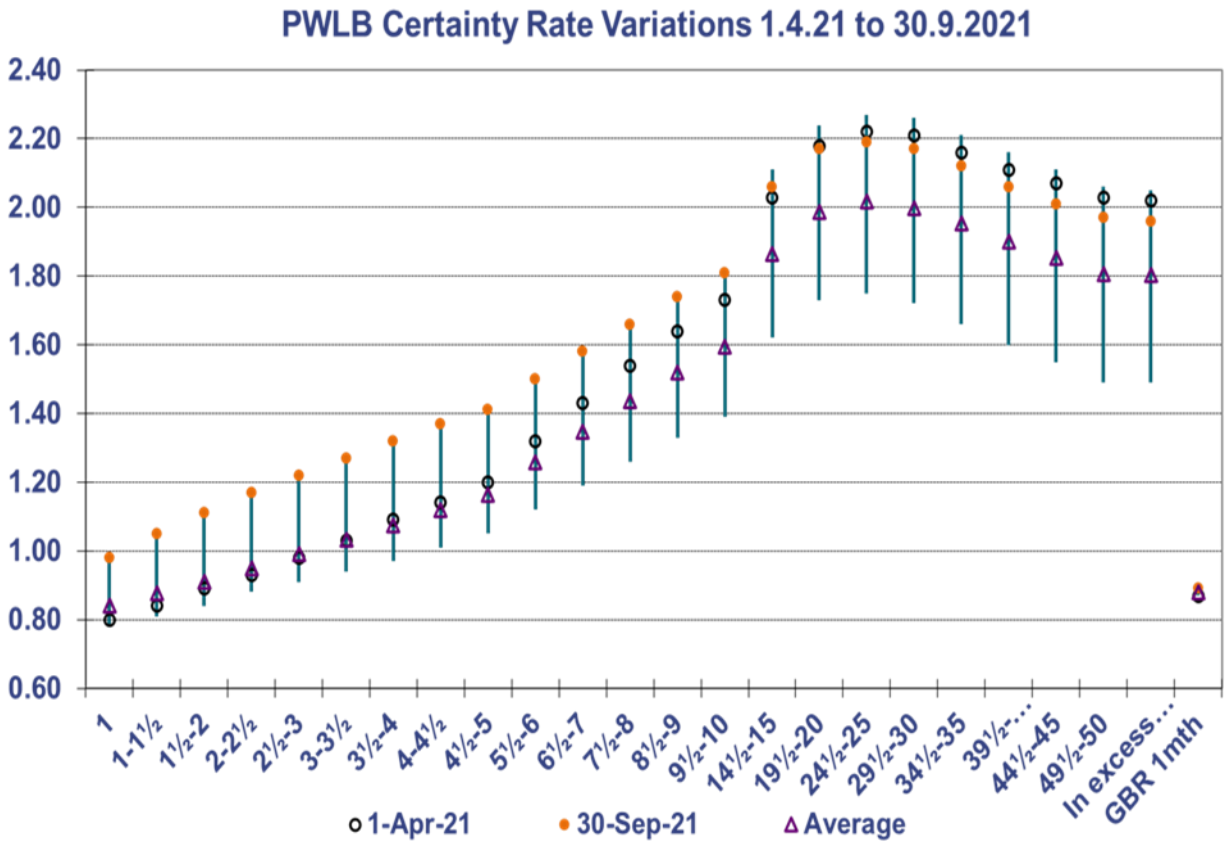
10.3 Officers will continue to monitor the market, and engage with market participants including banks, investment firms, brokers and advisors to review the investment and debt opportunities available to the Authority.

APPENDIX 1: Borrowing rates

The following graph and tables are optional for clients to use if they wish.



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.78%	1.05%	1.39%	1.75%	1.49%
Date	08/04/2021	08/07/2021	05/08/2021	17/08/2021	10/08/2021
High	0.98%	1.42%	1.81%	2.27%	2.06%
Date	24/09/2021	28/09/2021	28/09/2021	13/05/2021	13/05/2021
Average	0.84%	1.16%	1.60%	2.02%	1.81%
Spread	0.20%	0.37%	0.42%	0.52%	0.57%



PWLB RATES

There was much speculation during the **second half of 2019** that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was heightened expectations that the US could have been heading for a recession in 2020. In addition, there were growing expectations of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued. Combined, these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation expectations, 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. The consequence of this has been **the gradual lowering of the overall level of interest rates and bond yields in financial markets.** Over the year prior to the coronavirus crisis, this resulted in many bond yields up to 10 years turning negative in the Eurozone. In addition, there was, at times, an inversion of bond yields in the US whereby 10 year yields fell below shorter-term yields. In the past, this has been a precursor of a recession.

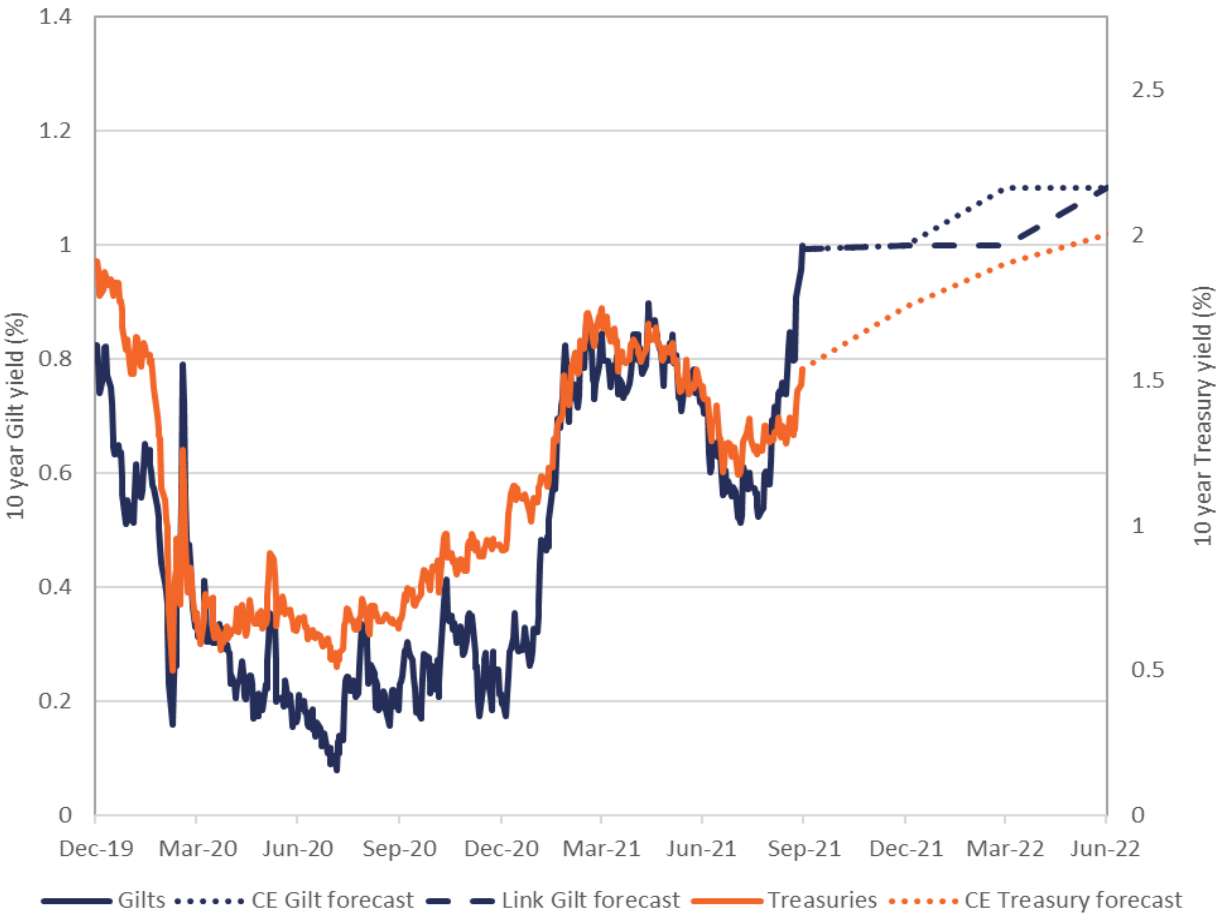
Gilt yields had, therefore, already been on a generally falling trend up until the coronavirus crisis hit western economies during March 2020 which caused gilt yields to spike up. However, yields then fell sharply in response to major western central banks taking rapid policy action to deal with excessive stress in financial markets during March and starting massive quantitative easing driven purchases of government bonds: these actions also acted to put downward pressure on government bond yields at a time when there was a huge and quick expansion of government expenditure financed by issuing government bonds. Such unprecedented levels of issuance in “normal” times would have caused bond yields to rise sharply.

At the start of January 2021, all gilt yields from 1 to 8 years were negative: however, since then all gilt yields have become positive and rose sharply during the spring, especially in medium and longer-term periods, until starting a significant decline since May which was then sharply reversed in August / September. Repeated assurances by the Fed in the US, and by other major world central banks, that inflation would spike up after Covid restrictions were abolished, but would only be transitory, allayed investor fears until August / September when high inflation was again seen as a growing danger and both central banks in the US and UK gave indications that monetary policy tightening was now on the horizon. **There is considerable concern that the US Fed is**

taking a too laid-back view that inflation pressures in the US are purely transitory and that they will subside without the need for the Fed to take significant action to tighten monetary policy. Lack of spare economic capacity and rising inflationary pressures are viewed as being much greater dangers in the US than in the UK. This could mean that rates will end up rising faster and further in the US than in the UK if inflationary pressures were to escalate; the consequent increases in treasury yields could well spill over to cause (lesser) increases in gilt yields.

Correlation between 10 year US treasury yield and 10 year gilt yield

The Link Group forecasts have included a risk of a 75% correlation between movements in US treasury yields and gilt yields over 10 years since 2011. As US treasury yields are expected to rise faster and further than UK gilt yields, there is an upside risk to forecasts for gilt yields due to this correlation. The graph below shows actual movements in both 10 year yields and forecasts by Link (gilt only) and Capital Economics.



- Yields on 10 year Gilts and Treasuries initially both fell during the first quarter of 2020, as signs emerged that the COVID-19 virus would become a global pandemic which would lead to a sharp downturn in economic growth.
- The correlation between 10 year yields in the UK and the US lessened during the second half of 2020 when US yields displayed an increasing tendency to rise, whilst UK yields remained more range bound. This divergence was consistent with the relatively better economic performance registered by the US during the pandemic, which was aided by historically low US business inventory levels needing to be rebuilt.
- During late 2020 gilt yields rose significantly, reflecting optimism that the fast vaccine roll-out in the UK would support a strong economic recovery during 2021.
- During September 2021, treasury yields rose sharply in response to growing investor concerns around high inflation and indications from the Fed that tapering of quantitative easing purchases of treasuries are likely to occur in the near future. Gilts also rose sharply, as did investor concerns around a sharp increase in inflation in the UK which is now likely to go over 4%. In addition, the MPC meeting on 23rd September flagged up major concerns around the strength of inflation which may require Bank Rate to go up much faster than had previously been expected.

APPENDIX 2: Investment Portfolio

The investment portfolio held as of 30 September 2021 was as follows:

Counterparty	Amount
Barclays Bank Call A/C	5,365,790.50
Bank of Scotland Call A/c	10,009,148.53
Aberdeen MMF	25,000,000.00
Aviva MMF	25,000,000.00
BlackRock Heritage MMF	15,500,000.00
CCLA MMF	25,000,000.00
Federated MMF	25,000,000.00
Bradford MDC	5,500,000.00
Central Bedfordshire Council	15,000,000.00
Cornwall Council	20,000,000.00
DMO	339,400,000.00
Dudley MBC	6,000,000.00
Eastleigh BC	20,000,000.00
Lancashire CC	20,000,000.00
LB Barking & Dagenham	20,000,000.00
LB Waltham Forest	5,000,000.00
Stockport MBC	7,500,000.00
South Somerset DC	16,000,000.00
West Dunbartonshire Council	10,000,000.00
Wirral MBC	5,000,000.00
Total	**620,274,939.03**

UK Banks 5 Year Senior Debt Credit Default Swap (CDS) Spreads