Agenda item:10

Warwickshire Joint Audit and Standards Committee Report Summary

Meeting Date:	**18th January 2023**
Subject:	**Treasury Management outturn report 2021/22**
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Purpose of the Report:

To inform Members of the Committee of the 2021/22 outturn position on the treasury management activities of Warwickshire Police in accordance with the CIPFA Code of Treasury Management.

The report outlines the impact of the economic outlook and its implications on the treasury management portfolio and activity in 2021/22. The in-house Treasury team, with the assistance of our Treasury Management advisors - Arlingclose, will continue to monitor and manage the debt and investment portfolio for Warwickshire and future update reports will be brought to the Joint Audit and Standards Committee for consideration and comment.

Recommendation:

The Committee is asked to consider and comment on the Treasury Management Outturn Report for 2021/22 before its final consideration by the Warwickshire Police and Crime Commissioner.

Background:

Warwickshire Police adopts the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports.

The Authority's treasury management strategy for 2021/22 was approved by the Police & Crime Commissioner following scrutiny at a Joint Audit Standards Committee (JASC) meeting, in March 2021, via a formal decision notice, published on the OPCC website. The PCC through the delegations to the force has borrowed and invested moderate sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk remains central to the PCC's treasury management strategy.

Treasury risk management by the PCC is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the PCC's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

The 2017 Prudential Code includes a requirement for PCC's and local authorities to provide a Capital Strategy, a summary document approved by The Police & Crime Commissioner covering capital expenditure and financing, treasury management and non-treasury investments. The PCC's Capital Strategy, complying with CIPFA's requirement, was also approved by the Commissioner in March 2021, and is also published on the OPCC website.

Executive summary:

This report has been compiled by the force finance team, with assistance from our expert treasury management advisors, Arlingclose. This report also covers a technical overview on the external context which includes commentary on the economic background, financial markets and credit backgrounds/worthiness for 2021/22. This is a high-level overview but should be considered in the light of the outturn for 2021/22 for Warwickshire.

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.

Bank Rate was 0.1% at the beginning of the reporting period. April and May saw the economy gathering momentum as the shackles of the pandemic restrictions were eased. Despite the improving outlook, market expectations were that the Bank of England would delay rate rises until 2022. Rising, persistent inflation changed that.

UK CPI was 0.7% in March 2021 but thereafter began to steadily increase. Initially driven by energy price effects and by inflation in sectors such as retail and hospitality which were re-opening after the pandemic lockdowns, inflation then was believed to be temporary. Thereafter price rises slowly became more widespread, as a combination of rising global costs and strong demand was exacerbated by supply shortages and transport dislocations. The surge in wholesale gas and electricity prices led to elevated inflation expectations. CPI for February 2022 registered 6.2% year on year, up from 5.5% in the previous month and the highest reading in the National Statistic series. Core inflation, which excludes the more volatile components, rose to 5.2% y/y from 4.4%.

The government's jobs furlough scheme insulated the labour market from the worst effects of the pandemic. The labour market began to tighten and demand for workers grew strongly as employers found it increasingly difficult to find workers to fill vacant jobs. Having peaked at 5.2% in December 2020, unemployment continued to fall and the most recent labour market data for the three months to January 2022 showed the unemployment rate at 3.9% while the employment rate rose to 75.6%. Headline 3-month average annual growth rate for wages were 4.8% for total pay and 3.8% for regular pay. In real terms, after adjusting for inflation, total pay growth was up 0.1% while regular pay fell by 1.0%.

With the fading of lockdown – and, briefly, the 'pingdemic' – restraints, activity in consumer-facing sectors improved substantially as did sectors such as oil and mining with the reopening of oil rigs but materials shortages and the reduction in the real spending power of households and businesses dampened some of the growth momentum. Gross domestic product (GDP) grew by an upwardly revised 1.3% in the fourth calendar quarter of 2021 according to the final estimate (initial estimate 1.0%) and took UK GDP to just 0.1% below where it was before the pandemic. The annual growth rate was revised down slightly to 7.4% (from 7.5%) following a revised 9.3% fall in 2020.

Having increased Bank Rate from 0.10% to 0.25% in December, 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.

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.

GDP growth in the euro zone increased by 0.3% in calendar Q4 2021 following a gain of 2.3% in the third quarter and 2.2% in the second. Headline inflation remains high, with CPI registering a record 7.5% year-on-year in March, the ninth successive month of rising inflation. Core CPI inflation was 3.0% y/y in March, was well above the European Central Bank's target of 'below, but close to 2%', putting further pressure on its long-term stance of holding its main interest rate of 0%.

The US economy expanded at a downwardly revised annualised rate of 6.9% in Q4 2021, a sharp in increase from a gain of 2.3% in the previous quarter. In its March 2022 interest rate announcement, the Federal Reserve raised the Fed Funds rate to between 0.25% and 0.50% and outlined further increases should be expected in the coming months. The Fed also repeated it plan to reduce its asset purchase programme which could start by May 2022.

Financial markets: The conflict in Ukraine added further volatility to the already uncertain inflation and interest rate outlook over the period. The Dow Jones started to decline in January but remained above its pre-pandemic level by the end of the period while the FTSE 250 and FTSE 100 also fell and ended the quarter below their pre-March 2020 levels.

Bond yields were similarly volatile as the tension between higher inflation and flight to quality from the war pushed and pulled yields, but with a general upward trend from higher interest rates dominating as yields generally climbed.

The 5-year UK benchmark gilt yield began the quarter at 0.82% before rising to 1.41%. Over the same period the 10-year gilt yield rose from 0.97% to 1.61% and the 20-year yield from 1.20% to 1.82%.

The Sterling Overnight Rate (SONIA) averaged 0.39% over the quarter.

Credit review: In the first half of FY 2021-22 credit default swap (CDS) spreads were flat over most of period and are broadly in line with their pre-pandemic levels. In September spreads rose by a few basis points due to concerns around Chinese property developer Evergrande defaulting but then fell back. Fitch and Moody's revised upward the outlook on a number of UK banks and building societies on the Authority's counterparty to 'stable', recognising their improved capital positions compared to 2020 and better economic growth prospects in the UK.

Fitch also revised the outlook for Nordea, Svenska Handelsbanken and Handelsbanken plc to stable. The agency considered the improved economic prospects in the Nordic region to have reduced the baseline downside risks it previously assigned to the lenders.

The successful vaccine rollout programme was credit positive for the financial services sector in general and the improved economic outlook meant some institutions were able to reduce provisions for bad loans. However, in 2022, the uncertainty engendered by Russia's invasion of Ukraine pushed CDS prices modestly higher over the first calendar quarter, but only to levels slightly above their 2021 averages, illustrating the general resilience of the banking sector.

Having completed its full review of its credit advice on unsecured deposits, in September Arlingclose extended the maximum duration limit for UK bank entities on its recommended lending list from 35 days to 100 days; a similar extension was advised in December for the non-UK banks on this list. As ever, the institutions and durations on the Authority's counterparty list recommended by Arlingclose remains under constant review.

2 The Police and Crime Commissioner Treasury Position

The Police and Crime Commissioner raises long-term borrowing to fund capital expenditure, i.e., expenditure on land, buildings and equipment. The Police and Crime Commissioner took out a new PWLB EIP loan in March 2022 for £10m @ 2.10% for funding of the capital programme. As at 31st March 2022, the Commissioner has a total of £20.156m of long-term borrowing and £3.0m short-term borrowing.

Alongside any borrowing for capital purposes, the Commissioner also has an investment portfolio. This consists of the Commissioner's reserves and short-term cash flows. This cash was invested in-house in 2021/22.

As at 31 March 2021, the Police and Crime Commissioner for Warwickshire had £1.0m of cash investments and this increased to £5.3m by 31 March 2022, due to taking out the new PWLB loan in March 2022. Table 1.1 shows the Commissioner's debt and investment position at the beginning and the end of the year, as follows:

Table 1: Summary of Treasury Position for Warwickshire at 31 March 2022

	Principal at 31.03.21	Rate/ Return For 20/21	Principal at 31.03.22	Rate/ Return for 21/22
A: Fixed Rate Funding	£m	%	£m	%
Public Works Loans Board Debt	12.135	5.02	20.156	4.66
Temporary Borrowing from LAs	4.000	0.14	3.000	0.08
B: Investments				
In House	1.000	0.10	5.300	0.07

3 Treasury Management Strategy for 2021/22

The Police and Crime Commissioner approved the Treasury Management Strategy for 2021/22 in March 2021 based on information from his financial advisors and the expert advice of Arlingclose. The Joint Audit and Standards Committee reviewed the proposals and the approved strategy is available on the PCC website for information.

4 Borrowing Outturn for 2021/22

Due to the high level of capital expenditure during 2021/22 (£16m), mainly related to the Evolve programme, the Police and Crime Commissioner took a £10m loan from the PWLB borrowing in March 2022. The £16m of capital spend was also funded from capital receipts of £5.2m, capital grants £0.2m and revenue reserves £0.8m, with the balance of £9.8m funded from borrowing. Borrowing costs for Warwickshire were £0.517m compared to a budget of £0.600m, due to the new borrowing being taken out late in the year.

5 Compliance with Treasury Limits and Prudential Indicators

During the financial year the Commissioner operated broadly within the treasury limits and Prudential Indicators set out in the Police and Crime Commissioner's Treasury Policy Statement and Treasury Management Strategy.

The only breaches were in amounts of cash held within our main bank account (Lloyds), which were previously set at £5m, but raised to £10m in March 2020, in case we needed access to more cash due to potential police and staff overtime payments, and to support other local government suppliers to maintain their cashflow at this difficult time, by paying invoices as soon as possible rather than waiting until they were due for payment.

There were brief periods where our cash holding exceeded £10m, despite best efforts to make Short Term investments with other local authorities. Many public sector organisations were temporarily ‘cash rich’ due to various Government grants issued to pay for additional costs due to Coronavirus. Also, at this time the Bank of England interest rates were extremely low and it was not cost effective to make overnight or short term investments with UKDMO for the amount of interest we would receive. The Lloyd’s limit was subsequently reduced back to £5m for the 2022/23 financial year.

Full details of the Prudential indicators set for 2021/22 and the results for the year are shown in **Appendix A.**

6 Investment Rates 2021/22

The Bank of England Base Rate (Bank Rate) remained at an historic low of 0.1% from 19th March 2020 until 16th December 2021 when it was increased to 0.25%. This was increased further in February 2022 (to 0.5%) and March 2022 (to 0.75%). At the time of writing this report (Jan 2023), the Bank Rate has seen a serious of increases by the Bank of England in an effort to tackle high inflation levels and now stands at 3.5%.

7 Investment Outturn for 2021/22

The Police and Crime Commissioner’s investment policy was governed by MHCLG guidance, which was implemented in the annual investment strategy approved by the Police and Crime Commissioner in March 21. 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 Commissioner manages short-term cash balances in-house and investments with the institutions listed in the Commissioner’s approved lending list. In 2021/22 the Commissioner has invested for a range of different periods from overnight to six months, dependent on cash flow, the interest rate view, and the interest rates on offer. Table 3 summarises the investment performance for 2021/22.

Table 3: Investment Outturn 2021/22

	Average balance of Investments £m	Rate of Return %	Benchmark Return %
Internally Managed - Warwickshire	8.4	0.07	0.19

Warwickshire achieved investment income of £16k in 2021/22 compared to a budget of £20k. Whilst almost on budget, the interest earned was much less due to our decision to hold more cash, the lower interest rates and difficulty in placing funds in investments with other local authorities.

No institutions in which investments were made had any difficulty in repaying investments and interest in full during the year.

8 Debt Rescheduling for 2021/22

No debt rescheduling was undertaken in 2021/22.

9 Approved Limits

Approved Limits for Warwickshire

During 2021/22 there were some brief mid-month instances of breaching the cash holding limits for the Lloyd's current account set within the Treasury Management strategy due to difficulty in being able to invest funds short term, and the decision to hold on to more cash. Covid19 continued during most of the year and our capital programme gave rise to volatile trends in supplier payments, emphasising the need to hold on to more cash.

11 Treasury Management Indicators

The Commissioner had arrangements in place during 2021/22 to measure and manage exposure to treasury management risks by the use of Treasury Management indicators governing upper limits for fixed and variable rate exposure.

Security - The Commissioner measures exposure to credit risk by monitoring the value weighted average credit rating/credit score of the investment portfolios. These rating levels are shown in the table below.

	Target
Portfolio average credit rating for Warwickshire	A+

	Achieved
Portfolio average credit rating for Warwickshire	AA

Liquidity - The Commissioner measured and managed exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period without additional borrowing. This was achieved, based on the target below:

	Target
Total Cash Available for 3 months for Warwickshire	£5m

Principal Sums Invested for Periods Longer than 364 days

The purpose of this indicator was to control the Commissioner's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were as below and were achieved:

	Target
Limit on principal invested beyond the year end for Warwickshire	£3m

12 Conclusion

Against a backdrop of uncertainty on the national and international stage, due to the continuing Coronavirus pandemic, Warwickshire has achieved acceptable returns from its treasury management activity and has operated within the terms its approved Treasury Management strategy for 2021/22.

Appendix A – Prudential Indicators

1. AFFORDABILITY PRUDENTIAL INDICATORS	2021/22 Estimate	2021/22 Actual	Achieved
	£’000	**£’000**	
Capital Expenditure	15,483	16,030	
In Year borrowing requirement	12,554	9,790	Yes
In year Capital Financing Requirement	12,554	7,369	Yes
Capital Financing Requirement 31 March 2022	46,603	40,284	Yes
Ratio of financing costs to net revenue stream	3.11%	2.53%	Yes
Incremental Impact of Capital Investment Decisions:			
Increase per council tax payer	£3.68	£3.04	Yes
2. TREASURY MANAGEMENT PRUDENTIAL INDICATORS	**2021/22 Estimate**	**2021/22 Actual**	**Achieved**
Authorised limit for external debt	**£’000**	**£’000**	
- Borrowing	60,000	23,156	Yes
Operational boundary for external debt	**£’000**	**£’000**	
- Borrowing	50,000	23,156	Yes
Upper limit for fixed rate interest exposure			
- net principal re fixed rate borrowing / investments	50,000	23,156	Yes
Upper limit for variable rate exposure			
- net principal re variable rate borrowing / investments	15,000	0	Yes