Joint Audit and Standards Committee

21st June 2022

West Mercia
Police and Crime Commissioner

Treasury Management Outturn Report 2021/2022

Recommendation

The Committee is asked to consider and comment on the Treasury Management Outturn Report for 2021/2022 before its consideration by the West Mercia Police and Crime Commissioner.

1. Introduction

1.1 West Mercia Police and Crime Commissioner fully complies with the requirements of The Chartered Institute of Public Finance and Accountancy's (CIPFA's) Code of Practice (COP) on Treasury Management 2011. The primary requirements of the Code are the:

- creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Police and Crime Commissioner's treasury management activities and is informed by the Medium Term Capital Programme.

- creation and maintenance of Treasury Management Practices which set out the manner in which the Police and Crime Commissioner will seek to achieve those policies and objectives;

- receipt by the Police and Crime Commissioner of an annual treasury management strategy report for the year ahead, a midyear review report (as a minimum) and an annual review report of the previous year;

- delegation by the Police and Crime Commissioner of responsibilities for implementing and monitoring treasury management policies and practices, and for the execution and administration of treasury management decisions.

- delegation by the Police and Crime Commissioner of the role of scrutiny of treasury management strategy and policies to a specific named body. In this respect the Police and Crime Commissioner has chosen to delegate this responsibility to the Joint Audit Committee

1.2 Therefore, under the CIPFA Code, the Police and Crime Commissioner is required to receive a report on the outturn of the annual treasury management activity.

1.3 Treasury management in the context of this report is defined as:

"The management of the Police and Crime Commissioner'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." *(CIPFA Code of Practice)*.

1.4 The Police and Crime Commissioner is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with a low risk appetite, providing security of capital and sufficient liquidity initially before considering investment return.

1.5 The second main function of the treasury management service is the funding of the Police and Crime Commissioner's capital plans. These capital plans provide a guide to the borrowing need of the Police and Crime Commissioner, essentially the longer term cash flow planning to ensure that the Police and Crime Commissioner can meet their capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasions, debt previously drawn may be restructured to meet the Police and Crime Commissioner's risk or cost objectives.

1.6 The Police and Crime Commissioner approved a Treasury Management Strategy for 2021/22.

2 External Context

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.

Revised CIPFA Codes, Updated PWLB Lending Facility Guidance

In August 2021 HM Treasury significantly revised guidance for the PWLB lending facility with more detail and 12 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.

CIPFA published its revised Prudential Code for Capital Finance and Treasury Management Code on 20th 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.

The principles of the Prudential Code took immediate effect although local authorities could defer introducing the revised reporting requirements until the 2023/24 financial year if they wish.

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.

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.

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. The Authority will follow the same process as the Prudential Code, i.e. delaying changes in reporting requirements to the 2023/24 financial year.

3 Current Treasury Position

3.1 The Police and Crime Commissioner raises long-term borrowing to fund capital expenditure, i.e., expenditure on land, buildings and equipment. Due to more favourable cash flow position than expected (as a result of capital slippage and an underspend on revenue expenditure), The Police and Crime Commissioner did not need to take any new PWLB borrowing in 2021/2022. PWLB maturities that were repaid and not replaced amounted to £1.5m. In addition £10m of short-term borrowing that was taken in 2020/21 was repaid in July 2021 and replaced with short-term borrowing of £5m from December 2021, maturing July 2022 (both from Local Authorities). There was £39.2m of borrowing as at 31st March 2022.

3.2 At the same time as borrowing for capital purposes, the Police and Crime Commissioner also has an investment portfolio. This consists of the Police and Crime Commissioner's reserves and short-term cash flows. This cash was invested in-house.

3.3 As at 31 March 2021, the Police and Crime Commissioner for West Mercia had £9.9m of cash investments and this had reduced to £3.5m by 31 March 2022, mainly due to funding capital expenditure from surplus cash ("internal borrowing"). Table 1 shows the Police and Crime Commissioner's debt and investment position at the beginning and the end of the year was as follows:

Table 1: Summary of Treasury Position 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	35.8	2.22	34.2	2.28
Local Authority Borrowing	**10.0**	**0.30**	**5.0**	**0.11**
Total Debt	**45.8**	**1.79**	**39.2**	**1.97**
B: Investments				
In House	9.9	0.085	3.5	0.55
Total Investments	**9.9**	**0.085**	**3.5**	**0.55**

4 Treasury Management Strategy for 2021/2022

4.1 The Police and Crime Commissioner approved the Treasury Strategy for 2021/2022 in February 2021.

5 Borrowing Outturn for 2021/22

5.1 During 2021/22, the Police and Crime Commissioner took out temporary short-term borrowing from Local Authorities in the first quarter to cover temporary cash flow deficits and then £5m in December 2021 as a short-term loan, repayable in July 2022 to replace the short-term loan from September 2020 of £10m that had matured in July 2021. No long-term borrowing with the Public Works Loans Board (PWLB) was required due to slippage on the capital programme and a healthier cash flow position than expected due to the underspend on revenue expenditure.

The £10.8m of capital spend during the year was funded from revenue contributions to capital of £3.6m, various grants and reserves funding of £1.4m, and the balance from "internal" borrowing of £5.8m. Borrowing costs for West Mercia were £0.792m compared to a budget of £1.230m, with the underspend due to no new PWLB borrowing being taken out, as explained above. The outturn is explained further in the revenue and capital outturn report.

6 Compliance with Treasury Limits and Prudential Indicators

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

6.2 Full details of the Prudential indicators set for 2021/2022 and the results for the year are shown in **Appendix A.**

7 Investment Rates 2021/22

7.1 The Bank of England Bank Rate started the year at its historic lowest level of 0.10% but by March 2022 had risen to 0.75%, as explained in section 2, with further rises expected imminently.

8 Investment Outturn for 2021/2022

8.1 The Police and Crime Commissioner's investment policy was governed by CLG guidance, which was been implemented in the annual investment strategy approved by the Police and Crime Commissioner in 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).

8.2 The Police and Crime Commissioner manages their short-term cash balances in-house and invest with the institutions listed in the Police and Crime Commissioner's approved lending list. In 2021/22 the Police and Crime Commissioners have invested for a range of periods from overnight to 6 months, dependent on the Police and Crime Commissioner's cash flows, its interest rate view and the interest rates on offer. Table 3 summarises the investment performance for 2021/22.

Table 2: Investment Outturn 2021/22

	Average balance of Investments £m	Rate of Return %	Benchmark Return %
Internally Managed - West Mercia	4.9	0.076	0.05

8.3 Investment income for West Mercia was £10k compared to a budget of £3k. Due to the low Bank rate throughout most of the year, investment returns were low for the first 9 months of the year, with surplus cash being invested at 0% on some occasions. As Bank Rate has increased in the final quarter of the year, so have investment returns, resulting in more interest being received than budgeted.

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

9 Debt Rescheduling for 2021/22

9.1 No debt rescheduling was undertaken in 2021/22.

10.0 Approved Limits

<u>Approved Limits for West Mercia</u>

During 2021/22 there was one breach of the limits set within the Treasury Management strategy, all being with HSBC. This was due to a combination of being unable to invest surplus funds in other institutions due to negative interest rates (UK government), periods of investment only being short-term (one or two weeks), and lack of offers from Local Authorities. The short-term limit for HSBC was £10m for the whole of 2021/22.

The amount of the breach was £2.8m for 4 days over a weekend in November when short-term UK DMO rates were negative. We now have an account with Santander in place to deposit funds should the situation arise in the future. UK DMO rates are also currently positive across all maturity periods due to the higher Bank Rate now in place.

Approved Counterparty Limits for West Mercia

During 2021/2022 there were no other breaches of the approved counterparty list or limits set within the Treasury Management strategy, except as mentioned above in respect of HSBC.

11.0 Investment Limits

The investment limits for individual organisations or groups of organisations that applied in the year are shown below.

	West Mercia Cash Limit
Any single organisation, except the UK Central Government	£2m
UK Central Government	Unlimited
Any group of organisations under the same ownership	£2m per group
Registered Providers (Housing Associations)	£5m
Unsecured Investments with Building Societies	£5m
Money Market Funds	£5m
Force Banking Provider HSBC	£10m

12.0 Treasury Management Indicators

The Commissioner measures and manages his exposure to treasury management risks using Treasury Management indicators governing upper limits for fixed and variable rate exposure

Security

The Commissioner measures their exposure to credit risk by monitoring the value weighted average credit rating/credit score of their investment portfolios. Shown in the table below.

	Target
Portfolio average credit rating for West Mercia	A-

	Achieved
Portfolio average credit rating for West Mercia	AA-

Liquidity

The Commissioner will continue to adopt a voluntary measure of his exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling one month period without additional borrowing.

	Target
Total cash available within a rolling one month period for West Mercia	£20m

	Achieved
Average actual total cash available within a rolling one month period for West Mercia	£10.0m

Principal Sums Invested for Periods Longer than 364 days

The purpose of this indicator was to control the Commissioners' 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:-

	Target
Limit on principal invested beyond the year end for West Mercia	£5m

	Achieved
Actual principal invested beyond the year end for West Mercia	£0m

Paul Benfield
Treasurer

Appendix A

PRUDENTIAL INDICATORS – WEST MERCIA

1. AFFORDABILITY PRUDENTIAL INDICATORS	2021/22 Estimate	2021/22 Actual	Achieved
	£'000	**£'000**	
Capital Expenditure	23,582	10,860	
	%	**%**	
Ratio of financing costs to net revenue stream	2.13	1.77	Yes
	£'000	**£'000**	
In Year borrowing requirement			
- in year borrowing requirement	18,086	5,826	Yes
	£'000	**£'000**	
In year Capital Financing Requirement	14,106	2,249	Yes
	£'000	**£'000**	
Capital Financing Requirement 31 March 2022	79,025	60,114	Yes
	£	**£**	
Affordable Borrowing Limit			
Increase per council tax payer	£1.94	£1.27	Yes
2. TREASURY MANAGEMENT PRUDENTIAL INDICATORS	**2021/22 Estimate**	**2021/22 Actual**	**Achieved**
Authorised limit for external debt	**£'000**	**£'000**	
- Borrowing	90,000	39,243	Yes
Operational boundary for external debt	**£'000**	**£'000**	
- Borrowing	80,000	39,243	Yes
Upper limit for fixed rate interest exposure			
- net principal re fixed rate borrowing / investments	£75m	£39.2m	Yes
Upper limit for variable rate exposure			
- net principal re variable rate borrowing / investments	£5m	£0m	Yes