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| **REPORT REFERENCE NO.** | **RC/21/9** |
| **MEETING** | **RESOURCES COMMITTEE** |
| **DATE OF MEETING** | **9 SEPTEMBER 2021** |
| **SUBJECT OF REPORT** | **TREASURY MANAGEMENT PERFORMANCE 2021-22 – QUARTER 2** |
| **LEAD OFFICER** | **TREASURER** |
| **RECOMMENDATIONS** | ***That the performance in relation to the treasury management activities of the Authority for 2021-22 (to June 2020) be noted.*** |
| **EXECUTIVE SUMMARY** | The Chartered Institute of Public Finance and Accountancy (CIPFA) issued a Code of Practice for Treasury Management. The Code suggests that members should be informed of Treasury Management activities at least twice a year, but preferably quarterly. This report therefore ensures this Authority is embracing Best Practice in accordance with CIPFA's Code of Practice. |
| **RESOURCE IMPLICATIONS** | As indicated within the report. |
| **EQUALITY IMPACT ASSESSMENT** | An initial assessment has not identified any equality issues emanating from this report. |
| **APPENDICES** | A. Investments held as at 30 June 2021. |
| **LIST OF BACKGROUND PAPERS** | Treasury Management Strategy (including Prudential and Treasury Indicators) as approved at the meeting of the Fire & Rescue Authority held on the 10 February 2021 – Minute DSFRA/69 refers. |

## 1. INTRODUCTION

1.1. The Treasury Management Strategy for Devon and Somerset Fire & Rescue Authority (the Authority) has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Treasury Management in Public Services Code of Practice (the Code) and the CIPFA Prudential Code. The Code recommends that members be updated on treasury management activities regularly (TMSS, annual and midyear reports). This report, therefore, ensures this Authority is implementing best practice in accordance with the Code and includes:

- The creation and maintenance of a Treasury Management Policy Statement, which sets out the policies and objectives of the Authority's treasury management activities;
- The creation and maintenance of Treasury Management Practices, which set out the manner in which the Authority will seek to achieve those policies and objectives;
- The receipt by the full Authority 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;
- The 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.

1.2. Treasury management in this context is defined as:

> "The management of the local authority'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. "

1.3. The preparation of this report demonstrates that the Authority is implementing best practice in accordance with the code.

## 2. ECONOMICS UPDATE

***UK***

2.1. The 24 June Monetary Policy Committee (MPC) meeting voted unanimously to keep Bank Rate unchanged at 0.10%. They voted by a majority of 8-1 to continue unchanged the existing programme of UK government bond purchases of £875bn which is due to end by the end of this year. In the press release, it was noted that:

> *"Since May, developments in global GDP growth have been somewhat stronger than anticipated, particularly in advanced economies. Global price pressures have picked up further, reflecting strong demand for goods, rising commodity prices, supply-side constraints and transportation bottlenecks, and these have started to become apparent in consumer price inflation in some advanced economies. Financial market measures of inflation expectations suggest that the near-term strength in inflation is expected to be transitory".*

2.2. The MPC noted the developing upside risks in the UK to both activity and inflation. It said that the news on activity "had predominately been to the upside" and that Bank staff had "revised up their expectations for 2021 Q2 GDP growth to 5½% from 4¼%". For the first time, the policy statement noted that "there are increasing signs of recruitment difficulties for some businesses" and the minutes said, "it was possible that the near-term upward pressure on prices could prove somewhat larger than expected". Indeed, by saying that inflation "is likely to exceed 3% for a temporary period" the MPC admitted the Governor will have to write to the Chancellor later this year explaining why inflation is more than 1% above the 2% target.

2.3. But the key point is that the MPC still appears willing to ride out the inevitable spike in inflation over the next six months as it thinks it will be short-lived and caused by one-off reopening price rises and supply shortages relative to demand - boosted by consumers having built up huge savings of around £145bn during lockdown. These spikes will drop out of the CPI calculation over the next twelve months. The forward guidance in the policy statement designed to demonstrate the MPC's patience was left intact, and the emphasis remained on "the medium-term prospects for inflation" rather than factors that are "likely to be transient". The minutes said the MPC should "ensure that the recovery was not undermined by a premature tightening in monetary conditions". It also repeated that it will not raise Bank Rate until the 2% inflation target has been attained sustainably i.e. the mere fact that it is forecasting inflation to be over 2% during 2021 and 2022 is not in itself sufficient to justify an increase in Bank Rate in the near future. The MPC indicated in the minutes that some members would prefer to wait for a clearer picture of the underlying pace of the recovery once the furlough scheme expires at the end of September, before making any judgement on medium-term inflationary pressures. This implies that the MPC may be unlikely to be in a position to consider a change in policy until early in 2022 at the earliest.

2.4. In addition, the Bank is undertaking a review of its stated current policy to raise Bank Rate first before unwinding quantitative easing (QE) purchases of gilts. Indeed, it now appears to be likely that the Bank could unwind QE first before raising Bank Rate as it sees QE as a very useful quick acting weapon to use to combat any sudden dysfunction in financial markets, as happened in March 2020. However, it is currently nearly maxed out on the total level of QE. Unwinding QE first would cause short term gilt yields to remain anchored at low levels and medium and long term gilt yields to steepen.

2.5. Money markets are currently expecting Bank Rate to start rising in mid-2022 but they are probably being too heavily influenced by looking across the Atlantic where inflationary pressures are much stronger than in the UK and building up further under a major boost from huge Federal government stimulus packages. Overall, there could be only a minimal increase in Bank Rate in 2023 or possibly no increases before 2024.

***Gross Domestic Product (GDP)***

2.6. The Bank revised up its expectations for the level of UK GDP in 2021 Q2 by around 1½% since the May Report due to the easing of restrictions on economic activity; this now leaves total GDP in June only around 2½% below its pre-Covid 2019 Q4 level. UK GDP grew by 1.5% in the three months to April 2021: this was the first expansion since the three months to December 2020. Forward looking monthly business surveys are running at exceptionally high levels indicating that we are heading into a strong economic recovery. Capital Economics do not think that the UK economy will suffer major scarring from the lockdowns. The one month delay to the final easing of restrictions in July is unlikely to have much effect on the progress of recovery with GDP getting back to pre-Covid levels during August.

***Consumer Price Index (CPI)***

2.7. The annual inflation rate in the United Kingdom rose to 2.1% y/y in May from 1.5% y/y in April: this is the first time that the measure has been above the Bank of England's 2% target since July 2019.

***COVID-19 Vaccines***

2.8. These have been the game changer which have enormously boosted confidence that life in the UK could largely return to normal during the second half of 2021 after a third wave of the virus threatened to overwhelm hospitals in Q1 this year. 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 UK has made fast progress, giving both jabs to nearly half of the total population and one jab to two thirds, (84% of all adults). This programme should be completed in the second half of the year. 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.

***US***

2.9. Since the Democrats won the elections in late 2020 and gained control of both Congress and the Senate, (although power is more limited in the latter), they have passed a $1.9trn (8.8% of GDP) stimulus package in March 2021 on top of the $900bn fiscal stimulus deal passed by Congress in late December. These, together with the vaccine rollout proceeding swiftly to hit the target of giving a first jab to over half of the population within the President's first 100 days, will promote a rapid easing of restrictions and strong economic recovery during 2021. The Democrats are also now negotiating to pass a $1trn fiscal stimulus package aimed at renewing infrastructure over the next decade. Although this package is longer-term, if passed, it would also help economic recovery in the near-term.

2.10. After Chair Jerome Powell unveiled the Fed's adoption of a flexible average inflation target in his Jackson Hole speech in late August 2020, the mid-September meeting of the Fed agreed by a majority to a toned down version of the new inflation target in his speech – that:

> *"it would likely be appropriate to maintain the current target range until labour market conditions were judged to be consistent with the Committee's assessments of maximum employment and inflation had risen to 2% and was on track to moderately exceed 2% for some time."*

2.11. This change was aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary "trap" like Japan. It is to be noted that inflation had actually been under-shooting the 2% target significantly for most of the last decade, so financial markets took note that higher levels of inflation are likely to be in the pipeline; long-term bond yields duly rose after that meeting. There is now some expectation that where the Fed has led in changing its policy towards implementing its inflation and full employment mandate, other major central banks will follow by allowing inflation to run higher for longer, even if they do not call it a policy of average inflation targeting as such.

2.12. In the Fed's June meeting, it stuck to its line that it expects strong economic growth this year to have only a transitory impact on inflation which is being temporarily boosted by base effects, spikes in reopening inflation and supply shortages. The big surprise was the extent of the upward shift in the "dot plot" of interest rate projections: having previously expected no hikes until 2024 at the earliest, most officials now anticipate two in 2023, with 7 out of 18 expecting to raise rates next year. This was a first indication that there was rising concern about the risks around inflationary pressures building up on a more ongoing basis and is somewhat hard to reconcile to the words around inflation pressures being only transitory.

2.13. Treasury yields in the US ought to rise much more strongly than gilt yields in the UK due to the divergence in the levels of inflationary pressures and the levels of surplus capacity currently in both economies, (the US is much nearer full capacity than the UK). Bond investor sentiment could lean in the direction that even if central banks refrain from raising central rates in the short term, all they are doing is setting up sharper increases further down the line. This is likely to cause increases in longer-term bond yields without any actual increases in central rates. There will then be a question as to how strong an influence rising treasury yields will have on gilt yields. Due to the divergence between the US and UK economies, it is expected that the Fed rate will need to increase first before Bank Rate and that there could be a significant delay before the Bank of England follows suit.

### *EU*

2.14. Both the roll out and take up of vaccines was disappointingly slow in the EU in the first few months of 2021 but has since been rapidly catching up. This delay will inevitably put back economic recovery after the economy had staged a rapid rebound from the first lockdowns in Q3 of 2020 but contracted slightly in Q4 to end 2020 only 4.9% below its pre-pandemic level. After contracting by another 0.3% in Q1 of 2021, recovery will now be delayed until Q3 of 2021. At its June meeting, the ECB forecast strong economic recovery with growth of 4.6% and 4.7% in 2021 and 2022 respectively.

2.15. Inflation is likely to rise sharply to around 2.5% during 2021 for a short period, but as this will be transitory, due to one-off factors, it will cause the ECB little concern. It is currently unlikely that it will cut its central rate even further into negative territory from -0.5%, although the ECB has stated that it retains this as a possible tool to use. The ECB's December 2020 meeting added a further €500bn to the PEPP scheme, (purchase of government and other bonds), and extended the duration of the programme to March 2022 and re-investing maturities for an additional year until December 2023. Three additional tranches of TLTRO, (cheap loans to banks), were approved, indicating that support will last beyond the impact of the pandemic, implying indirect yield curve control for government bonds for some time ahead. The total PEPP scheme of €1,850bn of QE, which started in March 2020, is providing protection to the sovereign bond yields of weaker countries like Italy. There is, therefore, unlikely to be a euro crisis while the ECB maintains this level of support. The March ECB meeting also took action to suppress the rise in long bond yields by stepping up its monthly PEPP purchases. Meetings in April and June confirmed these policies so monetary policy will remain highly accommodative with no sign yet of tapering of asset purchases.

### *China*

2.16. After a concerted effort to get on top of the virus outbreak in Q1 of 2020, economic recovery was strong in the rest of 2020; this enabled China to recover all the contraction in Q1 2021. Policy makers have both quashed the virus and implemented a programme of monetary and fiscal support that has been particularly effective at stimulating short-term growth. After making a rapid recovery in 2020/21, growth is likely to be tepid in 2021/22.

### *Japan*

2.17. A third round of fiscal stimulus in December 2020 took total fresh fiscal spending in 2020 in response to the virus close to 12% of pre-virus GDP. That is huge by past standards, and one of the largest national fiscal responses. The resurgence of Covid in Q1 2021, coupled with a slow roll out of vaccines, has pushed back economic recovery. However, quickening of vaccinations in the second half of 2021 will lead to a strong economic recovery to get back to pre-virus levels by the end of 2021 – around the same time as the US and sooner than the Eurozone.

### *World Growth*

2.18. World growth was in recession in 2020 but should recover during 2021. Inflation is unlikely to be a significant problem in most countries for some years due to the creation of excess production capacity and depressed demand during the coronavirus crisis.

### *Interest Rate Forecasts*

2.19. The Authority's treasury advisor, Link Group Ltd, has provided the following forecast (as set out below):

| Link Group Interest Rate View | 10.5.21 | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Jun-21 | Sep-21 | Dec-21 | Mar-22 | Jun-22 | Sep-22 | Dec-22 | Mar-23 | Jun-23 | Sep-23 | Dec-23 | Mar-24 |
| BANK RATE | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.25 | 0.25 | 0.25 |
| 3 month ave earnings | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.30 | 0.30 | 0.30 |
| 6 month ave earnings | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.20 | 0.30 | 0.40 | 0.40 | 0.40 |
| 12 month ave earnings | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.30 | 0.30 | 0.40 | 0.50 | 0.50 | 0.50 |
| 5 yr PWLB | 1.20 | 1.20 | 1.30 | 1.30 | 1.30 | 1.40 | 1.40 | 1.40 | 1.40 | 1.50 | 1.50 | 1.50 |
| 10 yr PWLB | 1.70 | 1.70 | 1.70 | 1.80 | 1.80 | 1.90 | 1.90 | 1.90 | 2.00 | 2.00 | 2.00 | 2.00 |
| 25 yr PWLB | 2.20 | 2.20 | 2.30 | 2.40 | 2.40 | 2.40 | 2.50 | 2.50 | 2.50 | 2.50 | 2.50 | 2.60 |
| 50 yr PWLB | 2.00 | 2.00 | 2.10 | 2.20 | 2.20 | 2.20 | 2.30 | 2.30 | 2.30 | 2.30 | 2.30 | 2.40 |

2.20. 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, although some forecasters had suggested that a cut into negative territory could have happened prior to more recent months when strong recovery started kicking in. However, the minutes of the Monetary Policy Committee in February 2021 made it clear that commercial banks could not implement negative rates within six months; by that time the economy would be expected to be recovering strongly and so there would be no requirement for negative rates. As shown in the forecast table above, one tentative increase in Bank Rate from 0.10% to 0.25% has now been pencilled in for quarter 2 of 2023/24 as an indication that the Bank of England will be moving towards some form of monetary tightening around this time. However, it could well opt for reducing its stock of quantitative easing purchases of gilts as a first measure to use before increasing Bank Rate so it is quite possible that we will not see any increase in Bank Rate in the three-year forecast period shown.

### *Significant risks to the forecasts*

- COVID vaccines do not work to combat new mutations and/or new vaccines take longer than anticipated to be developed for successful implementation;
- The lockdowns cause major long-term scarring of the economy;
- The Government implements an austerity programme that supresses GDP growth;
- The MPC raises tightens monetary policy too early – by raising Bank Rate or unwinding QE;
- The MPC tightens monetary policy too late to ward off building inflationary pressures;

- Major stock markets e.g. 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; and
- Geo-political risks are widespread e.g. German general election in September 2021 produces an unstable 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. TREASURY MANAGEMENT STRATEGY STATEMENT

### *Annual Investment Strategy*

3.1. The Authority’s Annual Investment Strategy, which is incorporated in the Treasury Management Strategy Statement (TMSS) was approved by the Authority on the 10 February 2021. It outlines the Authority’s investment priorities as follows:

- Security of Capital
- Liquidity
- Yield

3.2. The Authority will also aim to achieve the optimum return on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep a significant proportion of investments short term. This will not only cover short term cash flow needs but will also seek out value available in significantly higher rates in periods up to 12 months with highly credit rated financial institutions using the Link suggested creditworthiness matrices, including Credit Default Swap (CDS) overlay information provided by Link.

### *Creditworthiness*

3.3. Although the credit rating agencies changed their outlook on many UK banks from stable to negative outlook during this quarter, due to upcoming risks to banks’ earnings and asset quality during the economic downturn caused by the pandemic, the majority of ratings were affirmed due to the continuing strong credit profiles of UK banks. Although CDS prices, (these are market indicators of credit risk), for UK banks spiked upwards at the end of March due to the liquidity crisis throughout financial markets, those CDS prices have returned to more average levels since then.

3.4. A full list of investments held as at 30 June 2021 are shown in Appendix A.

3.5. The average level of funds available for investment purposes during the quarter was £40.671m (£41.179m at the end of 2020/21). These funds were available on a temporary basis and the level of funds was dependent on the level of reserves, timing of precept payments, receipt of grants and progress on the Capital Programme.

| Benchmark | Benchmark Return | Authority Performance | Investment interest to Quarter 1 |
|---|---|---|---|
| 3 Month LIBID | (0.04%) | 0.15% | £0.023m. |

3.6. As illustrated above, the Authority outperformed the 3 month LIBID benchmark by 0.19bp. It is currently anticipated that the actual investment return for the whole of 2021-22 will under recover the Authority's budgeted investment target of £0.100m by £0.015m. However, there is much economic uncertainty and low interest rates at the moment so this forecast is likely to be revised.

***Borrowing Strategy***

*Prudential Indicators*

3.7. It is a statutory duty for the Authority to determine and keep under review the "Affordable Borrowing Limits". The Authority's' approved Prudential Indicators (affordability limits) are outlined in the approved TMSS.

3.8. A full list of the approved limits (as amended) are included in the Financial Performance Report 2021-22, considered elsewhere on the agenda, which confirms that no breaches of the Prudential Indicators were made in the period to June 2021 and that there are no concerns that they will be breached during the financial year.

*Current external borrowing*

3.9. The Authority has not taken any external loans since June 2012 and has been using cash resources to meet any capital expenditure. The amount of outstanding external borrowing as at 30 June 2021 was £24.851m, forecast to reduce to £24.757m by the end of the financial year as a result of standard loan repayments. All of this debt is at fixed rate with the remaining principal having an average rate of 4.25% and average life of 24.6 years.

*Loan Rescheduling*

3.10. No debt rescheduling was undertaken during the quarter. The Authority will continue to work closely with our treasury advisors to explore any opportunities to repay existing loans, however current Public Works Loan Board early repayment rates mean there is no financial benefit in undertaking premature loan repayment at this time.

*New Borrowing*

3.11. Gilt yields and PWLB rates rose sharply during the first three months of 2021 but have lacked any consistent direction since then over the last three months to 30th June.

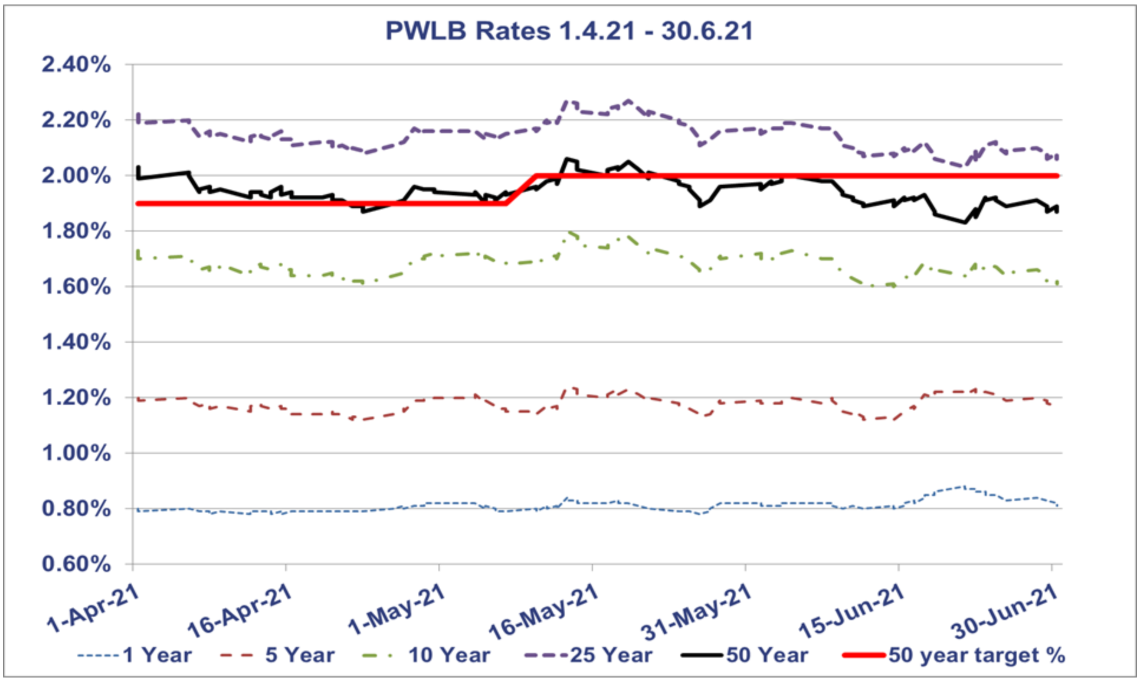
3.12. The 50 year PWLB target certainty rate for new long-term borrowing started at 1.90% in this quarter but then rose to 2.00% in May.

3.13. No new borrowing was undertaken during the quarter and none is planned during 2021-22 as a result of the Authority's adopted financial strategy to utilise revenue funds (revenue budget and reserves) to finance capital investment needs for the medium term.

**PWLB rates quarter ended 30 June 2021**

| | 1 Year | 5 Year | 10 Year | 25 Year | 50 Year |
|---|---|---|---|---|---|
| **Low** | 0.78% | 1.12% | 1.60% | 2.03% | 1.83% |
| **Date** | 08/04/2021 | 22/04/2021 | 11/06/2021 | 21/06/2021 | 21/06/2021 |
| **High** | 0.88% | 1.24% | 1.80% | 2.27% | 2.06% |
| **Date** | 21/06/2021 | 13/05/2021 | 13/05/2021 | 13/05/2021 | 13/05/2021 |
| **Average** | 0.81% | 1.18% | 1.68% | 2.14% | 1.94% |
| **Spread** | 0.10% | 0.12% | 0.20% | 0.24% | 0.23% |

3.14. Borrowing rates for this quarter are shown below.




*Borrowing in Advance of Need*

3.15. The Authority has not borrowed in advance of need during this quarter.

## 4. CONCLUSION

4.1. In compliance with the requirements of the Chartered Institute of Public Finance and Accountancy Code of Practice of Treasury Management, this report provides the Committee with the first quarter report on treasury management activities for 2021-22 to June 2021. As is indicated in this report, none of the Prudential Indicators have been breached, and a prudent approach has been taken in relation to investment decisions taken so far, with priority being given to liquidity and security over yield. Whilst investment returns are recovering as a result of the increase in interest rates, the Authority is still anticipating that investment returns will meet the budgeted target, as rates were forecast to rise when the budget was set.

**SHAYNE SCOTT**
**Director of Finance & Resourcing (Treasurer)**

**APPENDIX A TO REPORT RC/21/9**

| Investments as at 30 June 2021 | | | | | |
|---|---|---|---|---|---|
| Counterparty | Maximum to be invested | Amount Invested | Call or Term | Period invested | Interest rate(s) |
| | £m | £m | | | |
| Lancashire County Council | 7.000 | -5.000 | T | 12 mths | 0.40% |
| Mid & East Antrim Borough Council | 5.000 | -2.000 | T | 12 mths | 0.40% |
| Bank of Scotland | 5.000 | -5.000 | T | 12 mths | 0.20% |
| Redcar & Cleveland Borough Council | 5.000 | -3.000 | T | 12 mths | 0.30% |
| Staffordshire & Moorlands District Council | 5.000 | -1.500 | T | 18 mths | 0.50% |
| Goldman Sachs | 5.000 | -2.000 | T | 6 mths | 0.18% |
| Goldman Sachs | 5.000 | -2.000 | T | 6 mths | 0.21% |
| Goldman Sachs | 5.000 | -3.000 | T | 6 mths | 0.27% |
| Cheshire County Council | | -3.000 | T | 3 mths | 0.06% |
| Standard Chartered | 7.000 | -3.000 | T | 6 mths | 0.12% |
| National Bank of Kuwait (International) PLC | 7.000 | -5.000 | T | 12 mths | 0.21% |
| | | | | | |
| Barclays Bank | | -0.001 | C | Instant Access | Variable |
| Aberdeen Standard | 8.000 | -2.905 | C | Instant Access | Variable |
| Federated Cash Plus | 8.000 | -1.650 | C | Instant Access | Variable |
| **Total Amount Invested** | | **-39.056** | | | |