ANNEX I

2021/22 TREASURY MANAGEMENT Q1 (APR-JUN) UPDATE

1. Purpose

1.1. Local authorities are under legal obligation by the Local Government Act 2003 to have regard to the treasury risk management framework of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Treasury Management in the Public Services: Code of Practice 2017 Edition (the Code). The Council is also required to have regard to Ministry of Housing, Communities and Local Government (MHCLG) guidance in relation to Investments and Minimum Revenue Provision (MRP).

1.2. The Code requires, as a minimum, the Council to report:

a) an annual treasury strategy in advance of the year; this was presented to Council on 24/02/2021;
b) a mid-year (minimum) treasury update report:
c) an annual report following the end of the year describing the activity undertaken compared to the strategy.

1.3. In line with best practice principles, the Council will also present quarterly update reports for Q1 (this report) and Q3.

1.4. The CIPFA Prudential Code for Capital Finance in Local Authorities (2017 Edition) includes a requirement for local authorities to produce a Capital Strategy, a summary document to be approved by Council covering capital expenditure and financing, treasury management and non-treasury investments. The Council's Capital Strategy was also approved by Council on 24/02/2021.

2. External Context

UK Economic background:

2.1. The coronavirus outbreak has resulted in huge economic damage to the UK and to economies around the world. After the Bank of England (BoE) 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 to negative bank rate could have happened prior to more recent months when strong recovery started kicking in. However, the minutes of the MPC meeting in February 2021 made it clear that commercial banks could not implement negative bank rate 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.

2.2. In its latest meeting on 24th June, the BoE Monetary Policy Committee (MPC) 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. The MPC noted the developing upside risks in the UK to both activity and inflation, conceding the distinct likelihood that inflation will exceed 3% for a temporary period.

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.

2.4. 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 MPC will aim to ensure that economic recovery is not undermined by a premature tightening in monetary conditions. The MPC also repeated that it will not raise Bank Rate until the 2% inflation target has been attained <u>sustainably</u>, which is conceivably unlikely to be until early in 2022 at the earliest.

2.5. In addition, the BoE 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 QE could unwind first before raising Bank Rate, as QE is seen as a very useful quick acting weapon to use to combat any sudden dysfunction in financial markets (as happened in March 2020). Unwinding QE first would cause short term gilt yields to remain anchored at low levels and medium- and long-term gilt yields to steepen. Money markets are currently expecting Bank Rate to start rising in mid-2022 but they are probably being too heavily influenced by the US where inflationary pressures are much stronger than in the UK and building up further under government stimulus packages. Overall, there could be only a minimal increase in Bank Rate in 2023 or possibly no increases before 2024.

2.6. The BoE revised up its expectations for the level of UK gross domestic product (GDP – a measure of the size and health of a country's economy over a period of time) in 2021 Q2 by around 1.5% since its previous May report due to the easing of restrictions on economic activity; this now leaves total GDP in June only around 2.5% below pre-Covid-19 2019 Q4 levels. 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.

2.7. Forward-looking monthly business surveys which provide a snapshot gauge to sentiment are running at exceptionally high levels, indicating that participants believe we are heading into a strong economic recovery. 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-19 levels during August.

2.8. The UK annual inflation rate rose to 2.1% year-on-year (y/y) in May from 1.5% y/y in April: this is the first time that the measure has been above the BoE 2% target since July 2019.

2.9. Covid-19 vaccines have enormously boosted confidence that life in the UK could largely return to normal during the second half of 2021. 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. A key risk remains 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 implemented to contain their spread.

Gilt Yields & Borrowing Rates:

2.10. Since the start of 2021 gilt yields and PWLB rates have risen sharply. What has unsettled financial markets has been a $1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a Covid-19 recovery package, in addition to the $900bn support package passed in December. Financial markets have been concerned that the two packages, on top of stimulus in cutting the Bank Rate to near zero and unleashing massive QE, could cause an excess of demand in the economy which gives rise to strong inflationary pressures; these could then force action much earlier to start increasing the Bank Rate despite their stated policy being to target average inflation and saying that increases were unlikely in the next few years.

3. <u>Borrowing</u>

3.1. The Council's primary objective when borrowing is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should long-term plans change is a secondary objective.

3.2. Tables 1 below sets out the profile of the Council's borrowing portfolio by source:

Table 1: Borrowing profile at 30th June 2021 by loan source

Tenor Bucket	Market		PWLB		Total	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
Liquid	£0.00	0.0%	£0.00	0.0%	£0.00	0.0%
< 1 Year	£5,000,000.00	33.3%	£9,732,747.02	2.2%	£14,732,747.02	3.2%
1 - 2 Years	£0.00	0.0%	£13,096,560.34	3.0%	£13,096,560.34	2.9%
2 - 5 Years	£0.00	0.0%	£40,516,823.75	9.1%	£40,516,823.75	8.8%
5 - 10 Years	£0.00	0.0%	£59,910,517.91	13.5%	£59,910,517.91	13.1%
10 - 20 Years	£0.00	0.0%	£149,754,921.58	33.8%	£149,754,921.58	32.6%
20 - 30 Years	£0.00	0.0%	£20,000,000.00	4.5%	£20,000,000.00	4.4%
30 - 40 Years	£0.00	0.0%	£133,000,000.00	30.0%	£133,000,000.00	29.0%
40 - 50 Years	£10,000,000.00	66.7%	£17,360,000.00	3.9%	£27,360,000.00	6.0%
> 50 Years	£0.00	0.0%	£0.00	0.0%	£0.00	0.0%
Total	**£15,000,000.00**	**100.0%**	**£443,371,570.60**	**100.0%**	**£458,371,570.60**	**100.0%**

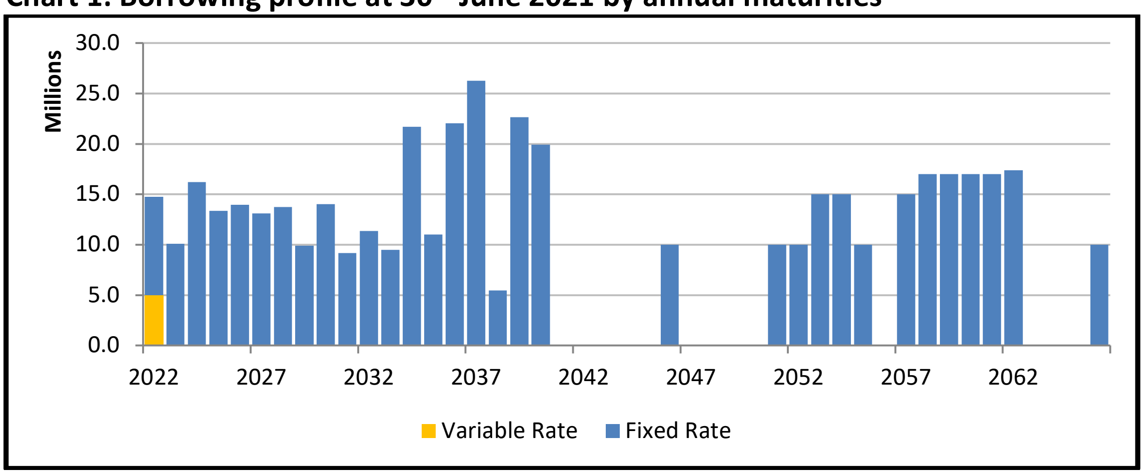
3.3. Tables 2 below sets out the profile of the Council's borrowing portfolio by interest rate structure/exposure:

Table 2: Borrowing profile at 30th June 2021 by interest rate structure

Tenor Bucket	Fixed Rate Loans	% of Total	Variable Rate Loans	% of Total	Total	% of Total
Liquid	£0.00	0.0%	£0.00	0.0%	£0.00	0.0%
< 1 Year	£9,732,747.02	2.1%	£5,000,000.00	100.0%	£14,732,747.02	3.2%
1 - 2 Years	£13,096,560.34	2.9%	£0.00	0.0%	£13,096,560.34	2.9%
2 - 5 Years	£40,516,823.75	8.9%	£0.00	0.0%	£40,516,823.75	8.8%
5 - 10 Years	£59,910,517.91	13.2%	£0.00	0.0%	£59,910,517.91	13.1%
10 - 20 Years	£149,754,921.58	33.2%	£0.00	0.0%	£149,754,921.58	32.6%
20 - 30 Years	£20,000,000.00	4.4%	£0.00	0.0%	£20,000,000.00	4.4%
30 - 40 Years	£133,000,000.00	29.3%	£0.00	0.0%	£133,000,000.00	29.0%
40 - 50 Years	£27,360,000.00	6.0%	£0.00	0.0%	£27,360,000.00	6.0%
> 50 Years	£0.00	0.0%	£0.00	0.0%	£0.00	0.0%
Total	**£453,371,570.60**	**100.0%**	**£5,000,000.00**	**100.0%**	**£458,371,570.60**	**100.0%**

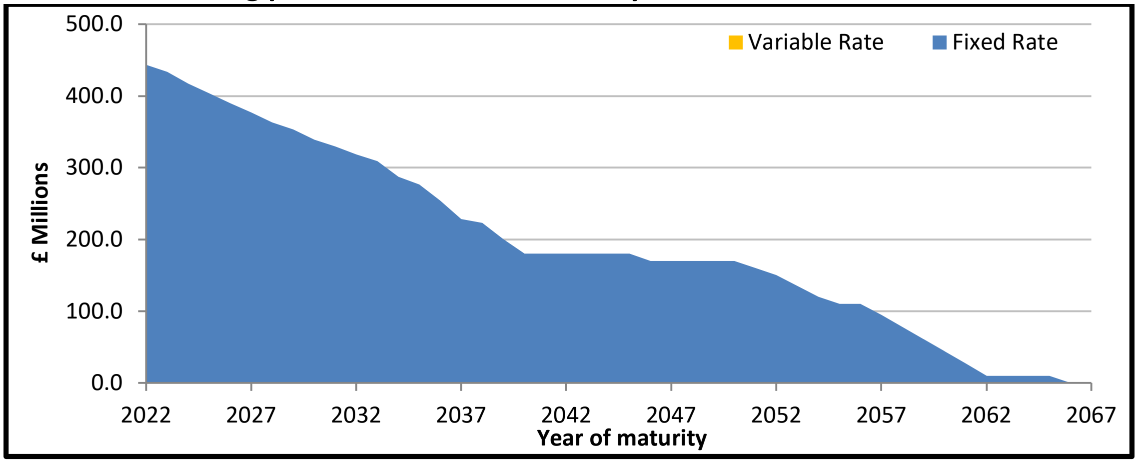
3.4. Chart 1 below shows the annual maturity profile of the Council's borrowing portfolio:

Chart 1: Borrowing profile at 30th June 2021 by annual maturities



3.5. Chart 2 below shows the fallout structure of the Council's borrowing portfolio:

Chart 2: Borrowing profile at 30th June 2021 by cumulative annual maturities



3.6. No new borrowing was undertaken during Q1. No principal repayments were due during the quarter, so the weighted average rate across the Council's borrowing portfolio at 30th June 2021 remained as it was carried forward from 2020/21 Q4, at 4.34%.

3.7. The Council continues to hold a £5m Lender's Option Borrower's Option (LOBO) loan where the lender has the option every 6 months to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. Treasury management practice is to present such loans at their next potential maturity date (in this case a rolling 6-month exposure) rather than their backstop maturity date (in this case November 2041). Given underlying market conditions the lender did not exercise their option during the quarter and is not expected to do so soon, so officers are considering this loan to be long term funding.

4. Housing Revenue Account (HRA) Debt Pooling Arrangements

4.1. Up until 2020/21, the Council adopted a single pool approach whereby we managed debt as a single consolidated portfolio and apportioned costs to the General Fund (GF) and HRA respectively.

4.2. From 2021/22 onwards, the Council has adopted a two-pool approach to managing its debt. The portfolio of external loans at 1st April 2021 has been separated into General Fund and HRA pools in an equitable manner. As mentioned in paragraph 3.6 above, no new loans have been raised or principal amounts repaid during the quarter and since the separation into two loan pools, and so for now borrowing information continues to be shown in this report on an aggregate basis, but future treasury update reports will show the borrowing position for each pool.

4.3. The Council is developing ambitious plans to invest in large-scale housing capital schemes and the majority of these will apply borrowing powers to facilitate delivery. The September 2021 refresh of the Medium-Term Financial Plan (MTFP) includes a strategic approach to both external and internal borrowing – that is raising new loans to meet capital spending commitments or, using available cash-backed reserves and working capital in lieu to suppress external borrowing.

5. Debt Restructuring

5.1. No debt rescheduling was undertaken during the quarter. Debt rescheduling opportunities have been limited due to the current economic climate and consequent structure of interest rates. Officers and the Councils treasury advisors continue to monitor this position.

6. Annual Investment Strategy

6.1. The Treasury Management Strategy Statement (TMSS) for 2021/22, which includes the Annual Investment Strategy, was approved by the Council on 24th February 2021. It sets out the Council's fundamental investment priorities as being (in order):

1. **S**ecurity of Capital;
2. **L**iquidity; and then
3. **Y**ield

6.2. The Council's investment activity during the quarter conformed to the approved strategy and the Council had no difficulties meeting its liquidity requirements.

6.3. The Council's investment portfolio represents the holding of positive short-term cashflows at any given time plus prudent medium and long-term provisions, balances and reserves. During the quarter, the Council's investment balances ranged from a low of £328.7m to a high of £375.3m, in part due the receipt and distribution of coronavirus related funding as well as normal cashflow timing differences between income and expenditure. The average balance held was £351.9m. Table 3 below shows the Council's investment maturity position at 30th June 2021:

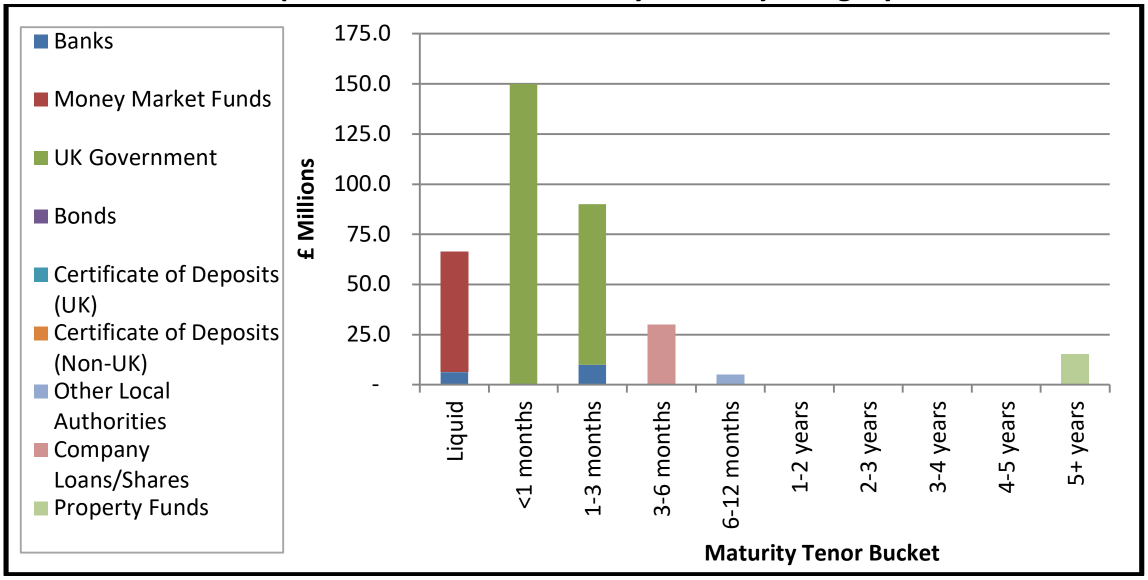
Table 3: Investment Maturity Position at 30th June 2021

Counterparty	Start Date	Maturity Date	Interest Rate	Interest Rate Structure	Principal O/S (£)
Same-day access: Banks					
Barclays Bank plc	n/a	n/a	0.0000%	Variable	14,336.19
National Westminster Bank plc	n/a	n/a	0.0100%	Variable	6,190,101.71
Handelsbanken plc	n/a	n/a	0.0000%	Variable	6,675.06
					6,211,112.96
35-day access: Banks					

Counterparty	Start Date	Maturity Date	Interest Rate	Interest Rate Structure	Principal O/S (£)
Handelsbanken plc	n/a	n/a	0.1200%	Variable	10,000,000.00
					10,000,000.00
Same-day access: Money Market Funds					
Federated	n/a	n/a	0.0101%	Variable	15,000,000.00
Aberdeen	n/a	n/a	0.0100%	Variable	15,000,000.00
Deutsche	n/a	n/a	0.0100%	Variable	15,000,000.00
Morgan Stanley	n/a	n/a	0.0100%	Variable	15,000,000.00
					60,000,000.00
UK Government:					
Debt Management Office	04/01/21	02/07/21	0.0100%	Fixed	50,000,000.00
Debt Management Office	04/06/21	09/07/21	0.0100%	Fixed	50,000,000.00
Debt Management Office	25/06/21	26/07/21	0.0100%	Fixed	50,000,000.00
Debt Management Office	07/04/21	09/08/21	0.0100%	Fixed	50,000,000.00
Debt Management Office	14/06/21	14/09/21	0.0100%	Fixed	30,000,000.00
					230,000,000.00
Other Local Authorities:					
Cheshire West and Chester Council	31/03/20	31/03/22	1.8000%	Fixed	5,000,000.00
					5,000,000.00
Company Loans/Shares:					
Milton Keynes Development Partnership LLP	11/11/20	11/11/21	2.6300%	Fixed	30,000,000.00
					30,000,000.00
Property Funds (variable net asset value [VNAV]):					
CCLA Local Authorities Property Fund	30/03/15		4.4455%	Variable	10,393,222.35
CCLA Local Authorities Property Fund	26/02/16		4.4455%	Variable	4,886,876.23
					15,280,098.58
					356,491,211.54

6.4. Chart 3 below shows the investment portfolio maturity profile by tenor buckets per category type at 30th June 2021:

Chart 3: Investment profile at 30th June 2021 by maturity category & tenor buckets



Credit background:

6.5. There have not been any further significant downgrades to short and long-term credit ratings since March 2020. In the main, where they did change, alterations were limited to negative rating 'outlooks', which indicate potential downgrading could occur soon. However, with economies now reopening, a number of these negative 'outlooks' have now been reversed, implying ratings are not likely to change soon.

6.6. Although credit default swaps (CDS) prices - the live traded market of insurance policies taken by lenders to protect against borrower defaults and that we use as an indicator to measure real-time credit risk - spiked for banks at the outset of the pandemic in 2020, they have subsequently returned to near pre-pandemic levels. However, sentiment can easily shift, and so we continue to monitor market movements closely.

6.7. Financial stimulus injected into the economy in response to the pandemic by the Government and BoE has provided a rich and cheap flow of liquidity to the banking sector which has distorted financial markets. With plentiful supply, then demand and therefore interest rates for local authority deposits remains extremely low. In some cases, highly rated institutions have raised minimum trade dealing amounts to £50m or more per transaction. This has seen several market operators, including the Debt Management Office, offer zero or negative returns for short-term maturities.

6.8. There is in essence very little return for taking substantially more risk, albeit from a very low starting point. In the short-term the Council's deposits held with the UK Government's Debt Management Office (no upper counterparty limit) will remain significant.

6.9. The Council also utilises AAA-rated Money Market Funds for short-term liquid cash investments. These pooled funds represent well-diversified, same-day access options with assets under management usually in the tens of billion pounds at any given time from many business sectors, including local authorities. Each fund with assets of more than one billion pounds under management is considered by the Council to be as comparatively secure as its peers, yet the Council limits investments to a maximum of £15m per fund.

6.10. In a negative interest rate environment, adopting a principle that an investment must always be worth more at the end than deposited at the start would mean taking greater risk to achieve that goal. That could be in the form of more liquidity risk by investing for longer, more credit risk by selecting less creditworthy counterparts, or even both. And in taking those risks to generate a return, even if it were at an interest rate of 0.01%, it would represent placing yield ahead of security and/or liquidity risk. The Council will continue to manage its investment to the principles defined in Treasury Management Strategy endorsed by Council, which depending on prevailing market conditions, may include receiving back slightly less than invested for liquid or short-term investments where prudent to safeguard public funds.

Externally managed strategic funds:

6.11. The Council invested a cash sum of £15.0m into an externally managed strategic pooled property fund with the CCLA; £10.0m in March 2015 and a further £5.0m in February 2016. Short-term security and liquidity are lesser considerations for this type of investment with the primary objectives instead being regular revenue income and long-term price stability.

6.12. At 30th June 2021, the Council's holdings stood at £15.280m against £14.774m at 31st March 2021, representing an increase in fair value of £0.506m and an overall unrealised gain of £0.280m. The Council has no plans to liquidate this investment. Despite challenging market conditions, this investment has yielded a 4.21% average gross return this quarter.

Investments for policy reasons outside of normal treasury management operations:

6.13. Although not classed as treasury management activities per se, the 2017 CIPFA Code now requires the Council to report on investments for policy reasons outside of normal treasury management operations. This includes service investments for operational and/or regeneration as well as commercial investments made primarily for financial income reasons. These investments typically earn a higher rate of return compared to normal treasury management investments, which reflects the additional risks that the Council is exposed to.

6.14. The Council has advanced a £30.0m 1-year loan to its wholly owned subsidiary company Milton Keynes Development Partnership (MKDP) LLP, used to finance the acquisition of assets from the Homes and Communities Agency (HCA) in 2012/13. The commercial loan rate of 2.63% was set with reference to State Aid regulations and prevailing market rates and is due to mature in November 2021.

6.15. The Council holds a £5.0m principal investment (match-funded by external investment) in a National Homelessness Property Fund, the assets of which are for use as housing temporary accommodation in Milton Keynes. Accepting that this investment constitutes a greater risk than traditional treasury management investments, the Council has earned a return of c. 1.90% so far this year. This investment is not shown within the tables and charts above as it was funded through the capital programme and reported through the capital monitoring process.

Investment income performance:

6.16. Investment income performance against the 3-month London Interbank Bid Rate (LIBID), which is the bidding rate at which banks are willing to borrow from each other, is shown in Table 4 below:

Table 4: Investment income performance against 3-month LIBID benchmark

Period	MKC Performance	Benchmark Performance	Difference
Q1 (Apr-Jun)	0.44%	-0.04%	+0.48%

6.17. The budget for investment income was prudently set with expectation of challenging market conditions and has been reduced considerably in recent years with income return projections for the financial year reported through the Budget Monitoring process. The Council's remaining medium and long-term General Fund investments continue to provide some protection against the immediate impact of low interest rates, which is reflected in our continued ability to outperforming the benchmark returns.

7. <u>Compliance with Treasury and Prudential Limits</u>

7.1. It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. The Council's approved Treasury and Prudential Indicators are set as part of the Treasury Strategy and Capital Strategy.

7.2. During the quarter the Council has operated within its treasury limits and Prudential Indicators, shown in Table 5 below.

Table 5: Prudential and Treasury Indicators

Prudential Indicator	2021/22 Indicator	Q1 2021/22
Authorised limit for external debt	----- £855.000m -----	
Operational boundary for external debt	----- £825.000m -----	
Gross borrowing	£448.639m	£458.372m
Capital Financing Requirement (CFR)	£743.969m	£715.901m
Ratio of financing costs to net revenue streams: GF	7.37%	7.37%
HRA	42.69%	42.69%
Principal sums invested > 365 days	£75.000m	£15.280m
Maturity structure of borrowing limits:-		
Under 12 months	Max. 15% Min. 0%	3.2%
12 months to 2 years	Max. 15% Min. 0%	2.9%
2 years to 5 years	Max. 50% Min. 0%	8.8%
5 years to 10 years	Max. 50% Min. 0%	13.1%
10 years and above	Max. 100% Min. 50%	72.0%