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Annual Treasury Management Report 2021/22

Report by Gary Fairley, Chief Officer Corporate Solutions

Report for Decision

1 Recommendations

The Audit Committee is invited to consider this report before the final report is presented to Council. Committee should note that the proposed recommendation to Council is that it note the Annual Treasury Management Report 2021/22.

2 Purpose of Report/Executive Summary

The purpose of the report is to inform members of the Audit Committee of the Treasury Management activity undertaken in 2021/22 and the year-end position.

Date: 17 June 2022

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3 Background

The main points arising from treasury activity in 2021/22 were:

- The pooled internal loans fund rate for General Fund and HRA was 2.98% in 2021/22, which is again expected to be one of the lowest when benchmarked against all mainland Authorities in Scotland;

- Were the pooled internal loans fund rate to have equated to the Scottish weighted average of 3.68%, this would have generated loan charges in 2021/22 of £16.3 million. The Council's actual 2021/22 loan charges for General Services and HRA were £14.1 million, representing a cash saving (compared to the Scotland average) of £2.2 million in 2021/22;

- Total new long term borrowing taken in the year amounted to £50.000 million, this being five £10 million maturity loans from PWLB drawn on 16 December 2021 with loan tenors of between 42 and 50 years at interest rates of between 1.26% and 1.36%, drawing down long term loan funding to de-risk the funding of the Council's General Services and HRA capital plan at historically low PWLB rates. The cash saving to the Council in interest costs over the life of these loans, compared to borrowing from PWLB at the time of writing this report (17 June 2022), is £44.921 million;

- During 2021/22, the Council fully funded its borrowing requirement. This meant that the capital borrowing need (the Capital Financing Requirement) was fully funded with loan debt, and the Council was able to secure loans at historically low PLWB rates;

- Total long term borrowing maturing in the year amounted to £1.523 million, comprising the following:-
    - One £0.648 million Maturity Loan with PWLB matured on 3 August 2021 (original tenor 27 years at an interest rate of 8.50%);
    - £0.044 million of PWLB Annuities of various tenors and interest rates;
    - £0.649 million of Annuity and EIP, and £0.183 million of interest free loans.

- The average rate of interest paid on external debt was 3.22% in 2021/22, down from 3.31% in 2020/21 and reflecting the historically low interest rates secured on longer-term PWLB borrowing in 2021/22;

- Three deposits were placed with high credit-worthy banks, which matured on 17 June 2022 and secured an interest rate return on surplus funds during the period of deposit;

- The average rate of return on deposits was 0.79% in 2021/22, exceeding the benchmark of 0.34% for the eighteenth year in succession;

- Cash balances in instant access accounts throughout the year were significantly higher than normal, and reflective of (a) the Scottish Government providing upfront funding to local authorities to support a range of grant schemes, in particular schemes to support local businesses; (b) advanced Revenue Support Grant payments and Early Years Capital Grant payments in 2021/22, (c) developer contribution receipts, (d) PWLB borrowing taken in advance, and (d) the continued impact of Covid on the Council's cashflow due to rephasing of capital expenditure plans. The level of higher cash balances that are being held are fully committed to fund revenue an capital expenditure in the 2022/23 and forthcoming financial years.

- No debt rescheduling was undertaken during 2021/22.

A detailed report "*Annual Treasury Management Review 2021/22*" on the activity during 2021/22 is attached as Appendix 2.

The Treasury Portfolio at the start and end of the financial year is shown in Tables 1 and 2 below.

Table 1: Loan Portfolio at 1 April 2021 and 31 March 2022

Loan Type	**Principal Outstanding 1 Apr 2021 £000's**	**Principal Outstanding 31 Mar 2022 £000's**	**Movement £000's**
PWLB Annuity	597	553	-44
PWLB Maturity	235,424	284,776	+49,352
LOBO	20,000	20,000	0
Forward Starting Loans	18,191	17,542	-648
Temporary Market Loans	0	0	0
Salix Loans	583	400	-183
Total Loans	**274,795**	**323,271**	**+48,476**

Table 2: Deposits at 1 April 2021 and 31 March 2022

Deposit Type	**Principal Outstanding 1 Apr 2021 £000's**	**Principal Outstanding 31 Mar 2022 £000's**	**Movement £000's**
Bank Call Accounts	26,470	31,059	+4,589
Money Market Funds	29,818	30,324	+506
Bank Notice Accounts	14,985	14,985	0
Bank Fixed Term Deposit Accounts	0	35,000	+35,000
Other Local Authorities	60,000	45,000	-15,000
Total Deposits	**131,273**	**156,367**	**+25,095**

Throughout 2021/22, all counterparties that the Council placed deposits with met their obligations in respect of the return of the deposited funds in full and on the required dates.

4. Other Issues

The Code recommends that Treasury reports are presented to and scrutinised by Audit Committee in advance of being considered by Council.

The report is being presented to Audit Committee on 29 June 2022 and subsequently to Council, and will be updated to reflect any comments that the Audit Committee have.

In late December 2021, CIPFA published the new Prudential Code and Treasury Management Code of Practice. Both these documents are an update on the 2017 equivalent documentation, both of which the Council follows fully. In addition, CIPFA published the accompanying Guidance Note to the Treasury Management Code of Practice, which sets out in more detail the requirements of the updated code.

An update on the main changes to the Prudential Code and Treasury Management Code of Practice was outlined in the Treasury Management & Investment Strategy & Prudential Indicators 2022-23 report to Audit Committee on 25 January 2022 and Council on 15 February 2022.

There are no fundamental or material changes to either the Prudential Code or Treasury Management Code that materially impact on the Council's Treasury Management & Annual Investment Strategy 2022/23 nor the Treasury Management Outturn Report. Therefore, the current policy framework as set out in the TMIS 2022/23 remains relevant with no changes, and there is no impact on any day to day treasury operations.

Council officers are currently working with Link, the Council's Treasury advisers, to provide a full and comprehensive update to the Council's Treasury Management Practices. The updated version of these practices will be brought to the next meeting of the Audit Committee on 27 September 2022 for scrutiny.

5 Report Implications (Resource, Digital and Risk)

5.1 Resource

Treasury Management activity during the year, in accordance with the approved strategy, has once again been effective in minimising the cost of borrowing and maximising the return on deposits within the parameters set by the strategy for the year.

Although benefits from Treasury Management activity continue to accrue there are no direct financial implications or other resource issues arising from this report.

The loan charges associated with Capital Expenditure and Treasury Management activity during 2021/22 are reported in the Financial

Monitoring 2021/22 – General Fund Revenue report elsewhere on today's agenda.

5.2 Digital

None.

5.3 Risk

As the Council follows the requirements of the CIPFA Code of Practice and the Prudential Code this minimises the risks involved in Treasury Management activities place. For those risks that do exist there are robust and effective controls in place to further mitigate the level of risks. These include further written Treasury Management Practices, which define the responsibilities of all staff involved, and which are currently being updated to reflect the provisions of the new Prudential and Treasury Management Codes and will be presented to the next meeting of Audit Committee.

5.4 Ensuring Equalities (if required a separate IIA must be completed)

This report does not recommend any change to policy or practice and therefore does not require an Equalities Impact Assessment.

5.5 Additional Report Implications

See Appendix A

Appendices:-

Appendix A: Report Implications
Appendix 1: Loans Fund Rate Comparison with other Scottish Local Authorities
Appendix 2: Annual Treasury Management Review 2021/22
Appendix 3: Deposit Benchmarking Analysis 2021/22

APPENDIX A – Report Implications

A.1 Key Priorities within the Single Midlothian Plan

Not applicable

A.2 Key Drivers for Change

Key drivers addressed in this report:

☐ Holistic Working
☐ Hub and Spoke
☐ Modern
☒ Sustainable
☒ Transformational
☐ Preventative
☐ Asset-based
☒ Continuous Improvement
☐ One size fits one
☐ None of the above

A.3 Key Delivery Streams

Key delivery streams addressed in this report:

☐ One Council Working with you, for you
☒ Preventative and Sustainable
☐ Efficient and Modern
☐ Innovative and Ambitious
☐ None of the above

A.4 Delivering Best Value

The report does not directly impact on Delivering Best Value.

A.5 Involving Communities and Other Stakeholders

Although no external consultation has taken place, cognisance has been taken of professional advice obtained from Link Asset Services, the Council's appointed Treasury Consultants.

A.6 Impact on Performance and Outcomes

The strategies adopted are an integral part of the corporate aim to achieve Best Value as they seek to minimise the cost of borrowing by exercising prudent debt management and placement of deposits. This in turn helps to ensure that the Council's capital expenditure is sustainable in revenue terms.

A.7 Adopting a Preventative Approach

Not applicable.

A.8 Supporting Sustainable Development

Not applicable.

Appendix 1:-

Loans Fund Pooled Rate Comparison 2020/21

Loans Fund Rate	2020/21
All Scottish Councils	Pooled Rate
West Dunbartonshire	2.29%
Aberdeenshire	2.66%
Midlothian	2.98%
North Lanarkshire	3.03%
East Lothian	3.05%
Dumfries & Galloway	3.14%
Perth & Kinross	3.15%
East Dunbartonshire	3.21%
Argyll & Bute	3.41%
Inverclyde	3.42%
East Ayrshire	3.50%
Falkirk	3.52%
Fife	3.53%
Dundee City	3.54%
Aberdeen City	3.58%
Renfrewshire	3.59%
South Ayrshire	3.64%
East Renfrewshire	3.67%
Scottish Borders	3.67%
Glasgow City	3.73%
Highland	3.73%
West Lothian	3.75%
Moray	3.87%
Stirling	3.87%
North Ayrshire	3.92%
Edinburgh City	4.26%
Angus	4.57%
Clackmannanshire	5.06%

The Pooled Loans Fund Rate combines the interest paid by the Council on money borrowed, with the interest earned by the Council on money invested, along with other charges such as internal interest allowed, premiums written off and treasury-related expenses to arrive at a weighted average “loans fund rate” figure for each authority, as noted in the final column above.

Appendix 2

Annual Treasury Management Review 2021/22

Midlothian Council
June 2022

Contents

This Council is required by regulations issued under the Local Government in Scotland Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2021/22. This report meets the requirements of both the updated CIPFA Code of Practice on Treasury Management, (the Code), and the updated CIPFA Prudential Code for Capital Finance in Local Authorities, (the Prudential Code).

During 2021/22 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 23/02/2021);
- a mid-year, (minimum), treasury update report (Council 14/12/2021);
- an annual review following the end of the year describing the activity compared to the strategy, (this report);

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is, therefore, important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Audit Committee before they are reported to the full Council.

1. The Council's Capital Expenditure and Financing 2021/22

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

Table 1: Capital Expenditure + Financing

	2020/21 Actual £000	2021/22 Budget £000	2021/22 Actual £000
General Fund			
Capital Expenditure	25,570	36,346	23,386
Available Funding	15,612	22,068	17,368
Borrowing Required	**9,958**	**14,278**	**6,018**
HRA			
Capital Expenditure	15,632	107,271	39,477
Available Funding	9,241	22,714	32,979
Borrowing Required	**6,391**	**84,557**	**6,498**
General Fund and HRA			
Capital Expenditure	41,202	143,617	62,863
Available Funding	24,853	44,782	50,347
Borrowing Required	**16,349**	**98,835**	**12,516**

2. The Council's Overall Borrowing Need

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and what resources have been used to pay for the capital spend. It represents the 2021/22 unfinanced capital expenditure (see above table), plus prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

Reducing the CFR – the Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Scheduled Debt Amortisation (or loans repayment), to reduce the CFR. This is effectively a repayment of the borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the minimum loan repayment each year through an additional revenue charge.

The Council's CFR for the year is shown below, and represents a key prudential indicator.

Table 2: Council's Underlying Borrowing Requirement

CFR:	31-Mar-21 Actual	2021/22 Budget	31-Mar-22 Actual
	£000	£000	£000
Opening balance	**£ 283,384**	**£ 307,354**	**£ 283,384**
Add Borrowing Required	£ 17,900	£ 98,835	£ 12,516
Less scheduled debt amortisation	£ (8,170)	£ (9,594)	£ (5,670)
Closing balance	**£ 283,384**	**£ 396,595**	**£ 290,230**

Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

Gross borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2020/21) plus the estimates of any additional capital financing requirement for the current (2021/22) and next three financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2021/22. The table below highlights the Council's gross borrowing position against the CFR (excluding PFI schemes). The Council has complied with this prudential indicator.

Table 3: Council's Gross Borrowing Position			
	31-Mar-21	2021/22	31-Mar-22
	Actual	Budget	Actual
	£000	£000	£000
Gross Borrowing	£ 274,795	£ 363,996	£ 323,271
CFR	£ 283,384	£ 396,595	£ 290,230

The authorised limit – this Council has kept within its authorised external borrowing limit as shown by the table below. Once this has been set, the Council does not have the power to borrow above this level.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

Table 4: Gross Borrowing against Authorised Limit / Operational Boundary	
	2021/22
Authorised limit - borrowing	£ 676,508
Operational boundary - borrowing	£ 396,596
Maximum gross borrowing position	£ 323,450
Average gross borrowing position	£ 288,364

3. Treasury Position as at 31 March 2021

The Council's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting detailed in the Purpose section of this report, and through officer activity detailed in the Council's Treasury Management Practices. At the beginning and the end of 2021/22 the Council's treasury (excluding borrowing by PFI and finance leases) position was as follows:

Table 5: Treasury Position

	31 March 2021 Principal	Rate/ Return	Average Life (Yrs)	31 March 2022 Principal	Rate/ Return	Average Life (Yrs)
Debt						
Fixed Rate Debt						
PWLB	£ 236,021	3.30%	31.36	£ 285,328	2.71%	33.13
Market	£ 23,774	2.92%	30.49	£ 22,943	2.95%	29.49
Total Fixed Rate Debt	**£ 259,795**	**3.27%**	**31.28**	**£ 308,271**	**2.73%**	**32.86**
Variable Rate Debt						
PWLB	£ -	n/a	n/a	£ -	n/a	n/a
Market	£ 15,000	4.63%	29.71	£ 15,000	4.63%	28.71
Total Variable Rate Debt	**£ 15,000**	**4.63%**	**29.71**	**£ 15,000**	**4.63%**	**28.71**
Total debt/gross borrowing	**£ 274,795**	**3.34%**	**31.19**	**£ 323,271**	**2.82%**	**32.67**
CFR	**£ 283,384**			**£ 290,230**		
Over/ (under) borrowing	**£ (8,589)**			**£ 33,041**		
Deposits						
Fixed Rate Deposits						
In House	£ 60,000	1.62%	1.41	£ 80,000	1.06%	0.41
With Managers	£ -	n/a	n/a	£ -	n/a	n/a
Total Fixed Rate Deposits	**£ 60,000**	**1.62%**	**1.41**	**£ 80,000**	**1.06%**	**0.41**
Variable Rate Deposits						
In House	£ 71,272	0.13%	0.11	£ 76,367	0.61%	0.10
With Managers	£ -	n/a	n/a	£ -	n/a	n/a
Total Variable Rate Deposits	**£ 71,272**	**0.13%**	**0.11**	**£ 76,367**	**0.61%**	**0.10**
Total Deposits	**£ 131,272**	**0.81%**	**0.70**	**£ 156,367**	**0.84%**	**0.26**

The maturity structure of the debt portfolio was as follows:

Table 6: Maturity Structure of Debt Portfolio							
	31-Mar-21		2021/22			31-Mar-22	
	Actual		Original Limits			Actual	
	£000	%	%			£000	%
Under 12 months	£ 1,471	1%	0%	to	50%	£ 1,465	0%
12 months to 2 years	£ 1,465	1%	0%	to	50%	£ 830	0%
2 years to 5 years	£ 3,624	1%	0%	to	50%	£ 3,553	1%
5 years to 10 years	£ 23,923	9%	0%	to	50%	£ 33,857	10%
10 years to 20 years	£ 53,308	19%	0%	to	50%	£ 43,421	13%
20 years to 30 years	£ 13,421	5%	0%	to	50%	£ 12,563	4%
30 years to 40 years	£ 95,534	35%	0%	to	50%	£ 95,534	30%
40 years to 50 years	£ 77,049	28%	0%	to	50%	£ 127,048	39%
50 years and above	£ 5,000	2%	0%	to	50%	£ 5,000	2%
Total	**£ 274,795**	**100%**				**£ 323,271**	**100%**

The maturity structure of the Council's deposits was as follows:

Table 7: Maturity Structure of Deposit Portfolio		
	31-Mar-21	31-Mar-22
	£000	£000
Deposit		
Under 1 Year	£ 71,272	£ 154,367
Over 1 Year	£ 60,000	£ 2,000
Total	**£ 131,272**	**£ 156,367**

The exposure to fixed and variable interest rates on debt was as follows:-

Table 8: Fixed/Variable Interest Rate Exposure of Debt Portfolio							
	31-Mar-21		2021/22			31-Mar-22	
	Actual		Original Limits			Actual	
	£000	%	%			£000	%
Fixed Interest Rate Exposure	£259,795	95%	0%	to	100%	£ 308,271	95%
Variable Interest Rate Exposure	£ 15,000	5%	0%	to	30%	£ 15,000	5%
Total	**£ 274,795**	**100%**				**£ 323,271**	**100%**

4. The Strategy for 2021/22

During 2021/22, the Council fully funded its borrowing requirement. This meant that the capital borrowing need, (the Capital Financing Requirement), was fully funded with loan debt, and the Council was able to source loans at historically low PWLB rates.

Interest rate forecasts within the Treasury Management & Investment Strategy expected only gradual rises in medium and longer term fixed borrowing rates during 2021/22 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period.

Link Group Interest Rate View	9.11.20													
	Dec-20	Mar-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	0.10	0.10	0.10	0.10	0.10
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
12 month ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
5 yr PWLB	1.80	1.80	1.80	1.80	1.80	1.90	1.90	1.90	1.90	1.90	2.00	2.00	2.00	2.00
10 yr PWLB	2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30	2.30	2.30	2.30	2.30
25 yr PWLB	2.50	2.50	2.60	2.60	2.60	2.60	2.70	2.70	2.70	2.70	2.80	2.80	2.80	2.80
50 yr PWLB	2.30	2.30	2.40	2.40	2.40	2.40	2.50	2.50	2.50	2.50	2.60	2.60	2.60	2.60

Link Group Interest Rate View	7.2.22												
	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
BANK RATE	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
3 month av. earnings	0.80	1.00	1.00	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20
6 month av. earnings	1.00	1.10	1.20	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30
12 month av. earnings	1.40	1.50	1.60	1.70	1.70	1.60	1.60	1.50	1.40	1.40	1.40	1.40	1.40
5 yr PWLB	2.20	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30
10 yr PWLB	2.30	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40
25 yr PWLB	2.40	2.50	2.50	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60
50 yr PWLB	2.20	2.30	2.30	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40

Return on funds placed on deposit which had been low during 2020/21, continued to remain low during much of 2021/22 at near zero or even into negative territory, before rising in line with base rate increases from December 2021.

The expectation for interest rates within the treasury management strategy for 2021/22 was that Bank Rate would continue throughout the year at 0.10%. This forecast was changed when the Bank of England increased base rate in December 2021, raising it to 0.25% at its meeting on 16th December 2021, 0.50% at its meeting of 4th February 2022 and then to 0.75% in March 2022 as a result of emerging inflation pressures in the economy.

5. The Economy and Interest Rates

UK

Over the last two years, 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 until raising it to 0.25% at its meeting on 16th December 2021, 0.50% at its meeting of 4th February 2022 and then to 0.75% in March 2022.

The UK economy has endured several false dawns through 2021/22, but with most of the economy now opened up and nearly back to business-as-usual, the GDP numbers have been robust (9% y/y Q1 2022) and sufficient for the MPC to focus on tackling the second-round effects of inflation, now that the CPI measure has already risen to 6.2% and is likely to exceed 8% in April.

Gilt yields fell towards the back end of 2021, but despite the war in Ukraine gilt yields have shot higher in early 2022. At 1.38%, 2-year yields remain close to their recent 11-year high and 10-year yields of 1.65% are close to their recent six-year high. These rises have been part of a global trend as central banks have suggested they will continue to raise interest rates to contain inflation.

Historically, a further rise in US Treasury yields will probably drag UK gilt yields higher. There is a strong correlation between the two factors. However, the squeeze on real household disposable incomes arising from the 54% leap in April utilities prices as well as rises in council tax, water prices and many phone contract prices, are strong headwinds for any economy to deal with. In addition, from 1st April 2022, employees also pay 1.25% more in National Insurance tax. Consequently, inflation will be a bigger drag on real incomes in 2022 than in any year since records began in 1955.

Average inflation targeting. This was the major change in 2020/21 adopted by the Bank of England in terms of implementing its inflation target of 2%. The key addition to the Bank's forward guidance in August 2020 was a new phrase in the policy statement, namely that "it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably". That mantra now seems very dated. Inflation is the "genie" that has escaped the bottle, and a perfect storm of supply side shortages, labour shortages, commodity price inflation, the impact of Russia's invasion of Ukraine and subsequent Western sanctions all point to inflation being at elevated levels until well into 2023.

USA

The flurry of comments from Fed officials following the mid-March FOMC meeting – including from Chair Jerome Powell himself – hammering home the hawkish message from the mid-March meeting, has had markets pricing in a further 225bps of interest rate increases in 2022 on top of the initial move to an interest rate range of 0.25% - 0.5%.

In addition, the Fed is expected to start to run down its balance sheet. Powell noted that the rundown could come as soon as the next meeting in May.

The upward pressure on inflation from higher oil prices and potential knock-on impacts on supply chains all argue for tighter policy (CPI is estimated at 7.8% across Q1), but the hit to real disposable incomes and the additional uncertainty points in the opposite direction.

More recently, the inversion of the 10y-2y Treasury yield spread at the end of March led to predictable speculation that the Fed's interest rate hikes would quickly push the US economy into recession. Q1 GDP growth is likely to be only between 1.0% and 1.5% annualised (down from 7% in Q4 2021). But, on a positive note, the economy created more than 550,000 jobs per month in Q1, a number unchanged from the post-pandemic 2021 average. Unemployment is only 3.8%.

EU

With euro-zone inflation having jumped to 7.5% in March it seems increasingly likely that the ECB will accelerate its plans to tighten monetary policy. It is likely to end net asset purchases in June – i.e., earlier than the Q3 date which the ECB targeted in March. And the market is now anticipating possibly three 25bp rate hikes later this year followed by more in 2023. Policymakers have also hinted strongly that they would re-start asset purchases if required. In a recent speech, Christine Lagarde said "we can design and deploy new instruments to secure monetary policy transmission as we move along the path of policy normalisation."

While inflation has hit the headlines recently, the risk of recession has also been rising. Among the bigger countries, Germany is most likely to experience a "technical" recession because its GDP contracted in Q4 2021, and its performance has been subdued in Q1 2022. However, overall, Q1 2022 growth for the Eurozone is expected to be 0.3% q/q with the y/y figure posting a healthy 5.2% gain. Finishing on a bright note, unemployment fell to only 6.8% in February.

China

After a concerted effort to get on top of the virus outbreak in Q1 of 2020, economic recovery was strong in the rest of the year; however, 2021 has seen the economy negatively impacted by political policies that have focussed on constraining digital services, restricting individual freedoms, and re-establishing the power of the One-Party state. With the recent outbreak of Covid-19 in large cities, such as Shanghai, near-term economic performance is likely to be subdued. Official GDP numbers suggest growth of c4% y/y, but other data measures suggest this may be an overstatement.

Japan

The Japanese economic performance through 2021/22 is best described as tepid. With a succession of local lockdowns throughout the course of the year, GDP is expected to have risen only 0.5% y/y with Q4 seeing a minor contraction. The policy rate has remained at -0.1%, unemployment is currently only 2.7% and inflation is sub 1%, although cost pressures are mounting.

World growth

World growth is estimated to have expanded 8.9% in 2021/22 following a contraction of 6.6% in 2020/21.

Deglobalisation

Until recent years, world growth has been boosted by increasing globalisation i.e. countries specialising in producing goods and commodities in which they have an economic advantage and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has also depressed inflation. However, the rise of China as an economic superpower over the last 30 years, which now accounts for 18% of total world GDP (the USA accounts for 24%), and Russia's recent invasion of Ukraine, has unbalanced the world economy. In addition, after the pandemic exposed how frail extended supply lines were around the world, both factors are now likely to lead to a sharp retrenchment of economies into two blocs of western democracies v. autocracies. It is, therefore, likely that we are heading into a period where there will be a reversal of world globalisation and a decoupling of western countries from dependence on China (and to a much lesser extent Russia) to supply products and vice versa. This is likely to reduce world growth rates.

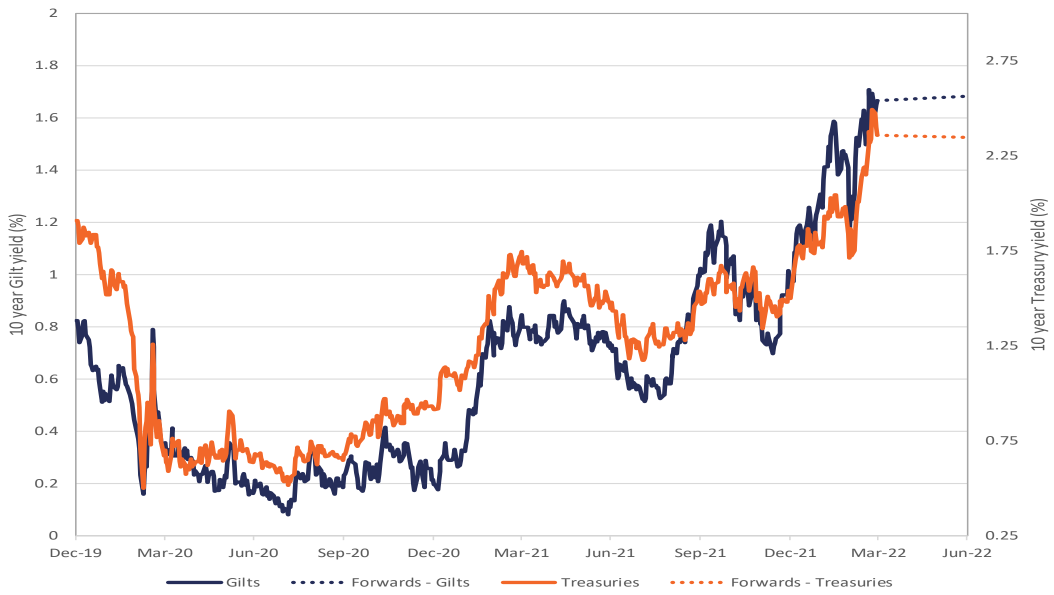
Central banks' monetary policy

During the pandemic, the governments of western countries have provided massive fiscal support to their economies which has resulted in a big increase in total government debt in each country. It is therefore very important that bond yields stay low while debt to GDP ratios slowly subside under the impact of economic growth. This provides governments with a good reason to amend the mandates given to central banks to allow higher average levels of inflation than we have generally seen over the last couple of decades. Both the Fed and Bank of England have already changed their policy towards implementing their existing mandates on inflation, (and full employment), to hitting an average level of inflation. Greater emphasis could also be placed on hitting subsidiary targets e.g. full employment before raising rates. Higher average rates of inflation would also help to erode the real value of government debt more quickly.

6. Borrowing Rates in 2021/22

PWLB rates are based on gilt (UK Government bonds) yields through H.M.Treasury determining a specified margin to add to gilt yields. The main influences on gilt yields are Bank Rate, inflation expectations and movements in US treasury yields. Inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation and the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers: this means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. This has pulled down the overall level of interest rates and bond yields in financial markets over the last 30 years. We have seen, over the last two years, many bond yields up to 10 years in the Eurozone turn negative on expectations that the EU would struggle to get growth rates and inflation up from low levels. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. Recently, yields have risen since the turn of the year on the back of global inflation concerns.

Graph of UK gilt yields v. US treasury yields



Gilt yields fell sharply from the spring of 2021 through to September and then spiked back up before falling again through December. However, by January sentiment had well and truly changed, as markets became focussed on the embedded nature of inflation, spurred on by a broader opening of economies post the pandemic, and rising commodity and food prices resulting from the Russian invasion of Ukraine.

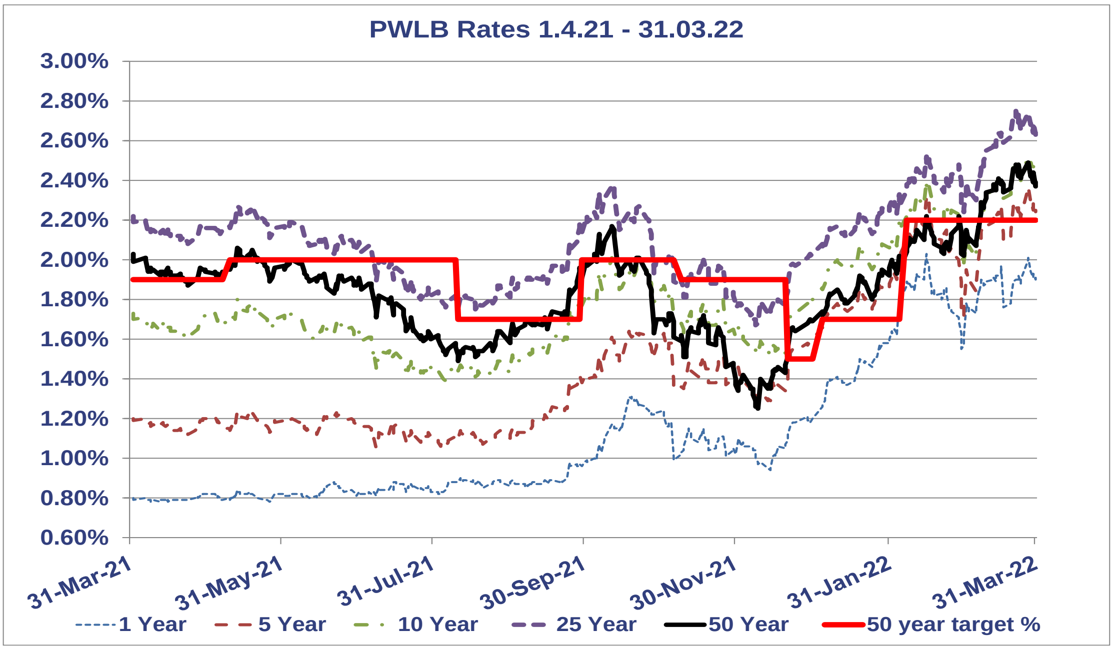
At the close of the day on 31 March 2022, all gilt yields from 1 to 5 years were between 1.11% – 1.45% while the 10-year and 25-year yields were at 1.63% and 1.84%.

Regarding PWLB borrowing rates, the various margins attributed to their pricing are as follows: -

- PWLB Standard Rate is gilt plus 100 basis points (G+100bps)
- PWLB Certainty Rate is gilt plus 80 basis points (G+80bps)
- PWLB HRA Standard Rate is gilt plus 100 basis points (G+100bps)
- PWLB HRA Certainty Rate is gilt plus 80bps (G+80bps)
- Local Infrastructure Rate is gilt plus 60bps (G+60bps)

There is likely to be a further rise in short dated gilt yields and PWLB rates over the next three years. Medium to long dated yields are driven primarily by inflation concerns but the Bank of England is also embarking on a process of Quantitative Tightening whereby the Bank's £895bn stock of gilt and corporate bonds will be sold back into the market over several years. The impact this policy will have on the market pricing of gilts, while issuance is markedly increasing, is an unknown at the time of writing.

HIGH/LOW/AVERAGE PWLB RATES FOR 2021/22



	1 Year	5 Year	10 Year	25 Year	50 Year
01/04/2021	0.80%	1.20%	1.73%	2.22%	2.03%
31/03/2022	1.91%	2.25%	2.43%	2.64%	2.39%
Low	0.78%	1.05%	1.39%	1.67%	1.25%
Low date	08/04/2021	08/07/2021	05/08/2021	08/12/2021	09/12/2021
High	2.03%	2.37%	2.52%	2.75%	2.49%
High date	15/02/2022	28/03/2022	28/03/2022	23/03/2022	28/03/2022
Average	1.13%	1.45%	1.78%	2.10%	1.85%
Spread	1.25%	1.32%	1.13%	1.08%	1.24%

7. Borrowing Outturn for 2021/22

New Treasury Borrowing:-

New loans were drawn to fund the net unfinanced capital expenditure and naturally maturing debt.

The loans drawn were:-

Table 9: New Loans Taken in Financial Year 2021/22						
Lender	**Date Taken**	**Principal £000's**	**Interest Rate**	**Fixed/ Variable**	**Maturity Date**	**Term (Yrs)**
PWLB Maturity	16 Dec 2021	£ 10,000	1.26%	Fixed	16 Dec 2071	50.00
PWLB Maturity	16 Dec 2021	£ 10,000	1.27%	Fixed	16 Dec 2070	49.00
PWLB Maturity	16 Dec 2021	£ 10,000	1.30%	Fixed	16 Dec 2067	46.00
PWLB Maturity	16 Dec 2021	£ 10,000	1.34%	Fixed	16 Dec 2064	43.00
PWLB Maturity	16 Dec 2021	£ 10,000	1.36%	Fixed	16 Dec 2063	42.00
Total		**£ 50,000**				

Maturing Debt:-

The following table gives details of treasury debt maturing during the year:-

Table 10: Maturing Debt in Financial Year 2021/22						
Lender	**Date Repaid**	**Principal £000's**	**Interest Rate**	**Fixed/ Variable**	**Date Originally Taken**	**Original Term (Yrs)**
PWLB	03 Aug 2021	£ 648	8.50%	Fixed	16 Aug 1994	27.00
PWLB Annuities	Various	£ 44	7.75%-9.50%	Fixed	02 Aug 1968 to 15 May 1972	56-60 years
Salix	Various	£ 183	0.00%	Fixed	Various	7-8 years
Deutsche Pfandbriefbank	Various	£ 357	2.63%	Fixed	29 Jun 2017	28.00
Deutsche Pfandbriefbank	Various	£ 291	2.73%	Fixed	15 Nov 2018	25.50
Total		**£ 1,523**				

Rescheduling:-

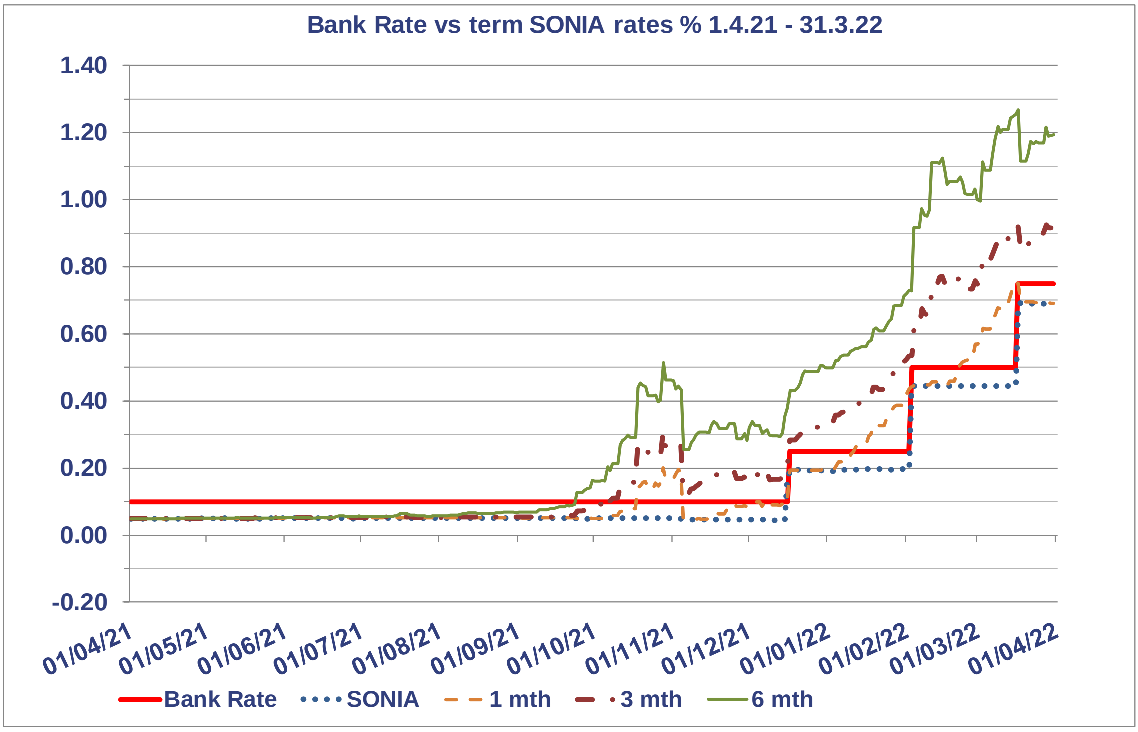
No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

Summary of debt transactions:-

The average interest rate payable on external debt decreased from 3.34% at the start of 2021/22 to 3.22% at the end of 2021/22. The average life of debt within the loan portfolio lengthened from 31.16 years to 32.66 years.

8. Deposit Rates in 2021/22

Money market fund rates started the year at 0.01%, remaining at this level until the bank of England base rate increases in the latter half of the year, before trending upwards to end the year at 0.51%-0.53%.



	Bank Rate	SONIA	1 mth	3 mth	6 mth
High	0.75	0.69	0.75	0.93	1.27
High Date	17/03/2022	18/03/2022	16/03/2022	28/03/2022	17/03/2022
Low	0.10	0.05	0.05	0.05	0.05
Low Date	01/04/2021	15/12/2021	10/11/2021	14/04/2021	09/04/2021
Average	0.19	0.14	0.17	0.24	0.34
Spread	0.65	0.65	0.71	0.88	1.22

9. Funds on Deposit Outturn for 2021/22

Deposit Policy:-

The Council's policy for placing deposits is governed by Scottish Government Investment Regulations, which have been implemented in the annual investment strategy approved by the Council on 23 February 2021. This policy sets out the approach for choosing counterparties, and for financial institutions 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 activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties. The position at 31 March 2022 was as follows:-

Table 11: Breakdown of Deposits by Counterparty at 31 March 2022

Counterparty	Deposit Start Date	Deposit End Date	Principal Outstanding 31 Mar 2022 £000's
Royal Bank of Scotland	Instant Access Call Account		1,143
Bank of Scotland	Instant Access Call Account		29,915
MMF - Aberdeen Liquidity Fund	Instant Access Money Market Fund		7,846
MMF - Federated	Instant Access Money Market Fund		7,623
MMF - Legal & General	Instant Access Money Market Fund		14,855
Santander	180 Day Notice Account		14,985
Wokingham Borough Council	25-Mar-20	24-Mar-23	15,000
London Borough of Croydon Council	03-Apr-20	03-Oct-22	13,000
Stoke on Trent City Council	06-Apr-20	06-Apr-23	2,000
London Borough of Waltham Forest Council	30-Apr-20	29-Apr-22	15,000
Goldman Sachs International Bank	17-Dec-21	17-Jun-21	15,000
Standard Chartered Bank	17-Dec-21	17-Jun-21	15,000
National Bank of Canada	17-Dec-21	17-Jun-21	5,000
Total Deposits			**156,367**

Deposits placed by the Council:-

The Council maintained an average balance of £144.6 million of internally managed funds. The internally managed funds earned an average rate of return of 0.79%. The comparable performance indicator is the average 6-month SONIA un-compounded rate, which was 0.34%.

10. Performance Measurement

One of the key requirements in the Code is the formal introduction of performance measurement relating to investments, debt and capital financing activities.

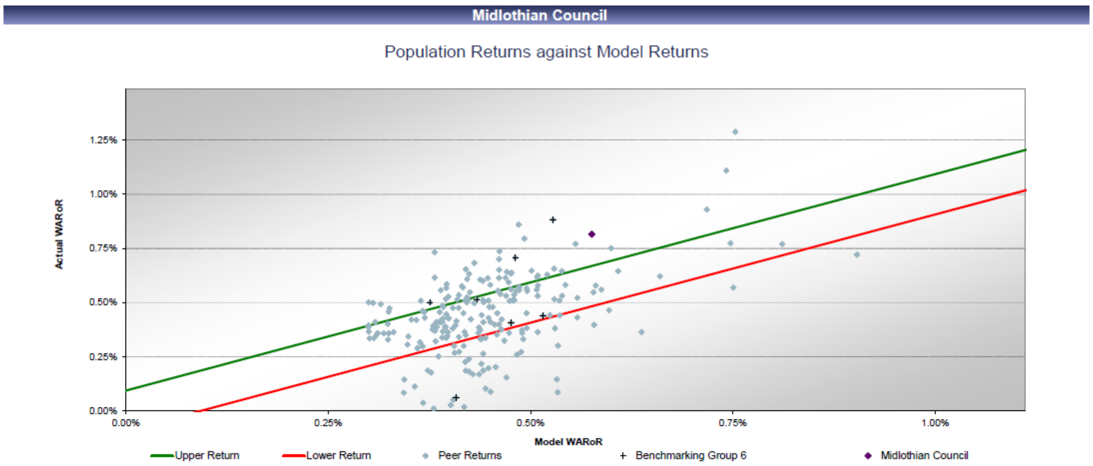
Loans Fund Rate

Combining the interest paid (earned) on external debt (deposits) with charges for premiums written off and internal interest allowed into an average Loans Fund Rate, Midlothian's result of 2.98% for 2020/21 was the third lowest Loans Fund Rate amongst all mainland authorities in Scotland (see Appendix 1).

The comparative Loans Fund Rate for 2021/22, of 2.98%, is once again expected to be one of the lowest when benchmarked against all mainland authorities in Scotland (note that at present, these benchmark figures are not yet available).

Deposit Benchmarking

The Council participates in the Scottish Investment Benchmarking Group set up by its Treasury Management Consultants, Link. This service provided by Link provides benchmarking data to authorities for reporting and monitoring purposes, by measuring the security, liquidity and yield within an individual authority portfolio. Based on the Council's funds on deposit as at 31 March 2022, the Weighted Average Rate of Return (WARoR) on deposits of 0.82% against other authorities is shown in the graph below:-



	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
Midlothian Council	0.82%	0.58%	0.24%	0.48%	0.67%	Above

** Models for 30 June 2021, 30 September 2021 and 31 December 2021 are attached as Appendix 3.*

As can be seen from the above graph, Midlothian is performing above the Link model benchmarks (red to green lines), and is achieving one of the highest Weighted Average Rates of Return (WARoR) for the Weighted Average Credit

Risk held, not only amongst peer Councils within the Benchmarking Group but also amongst the population of authorities across the UK.

Debt Performance

Whilst deposit performance criteria have been well developed and universally accepted, debt performance indicators continue to be a more problematic area with the traditional average portfolio rate of interest acting as the main guide. In this respect, the relevant figures for Midlothian are incorporated in the table in Section 3.

11. Conclusion

The Council's overall cost of borrowing continues to benefit significantly from the approved strategy and the proactive Treasury Management activity undertaken.

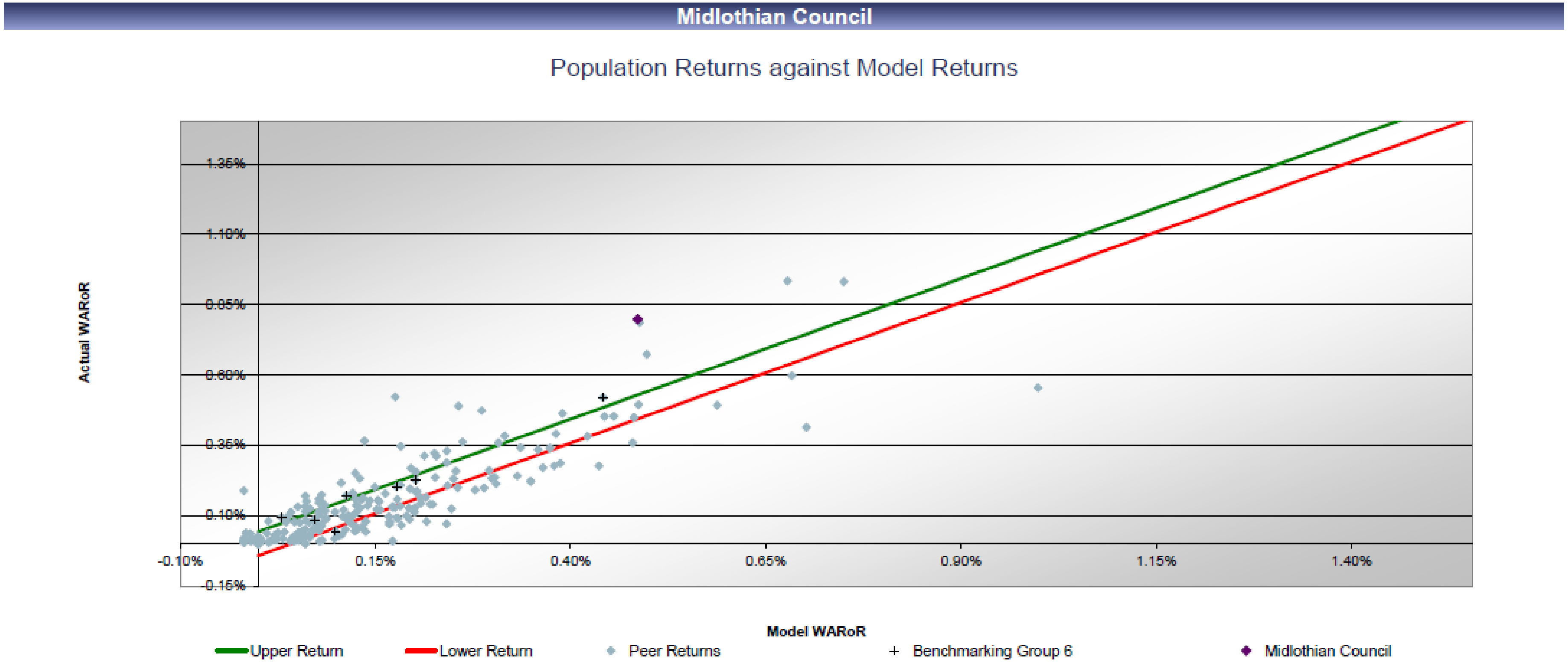
The cost of long term borrowing has been maintained by taking up opportunities to borrow from the PWLB at historically low interest rates.

A better than average return on deposits has been achieved for the eighteenth consecutive year and Midlothian continues to perform above the Link model benchmarks and is achieving one of the highest Weighted Average Rates of Return (WARoR) for the Weighted Average Credit Risk held, not only amongst peer Councils within the Benchmarking Group but also amongst the population of authorities across the UK.

Overall Midlothian's Loans Fund Rate of 2.98% for the year is expected to be one of the lowest when benchmarked against all mainland Authorities in Scotland.

Appendix 3

Midlothian Council Deposit Portfolio return as at 30 June 2021



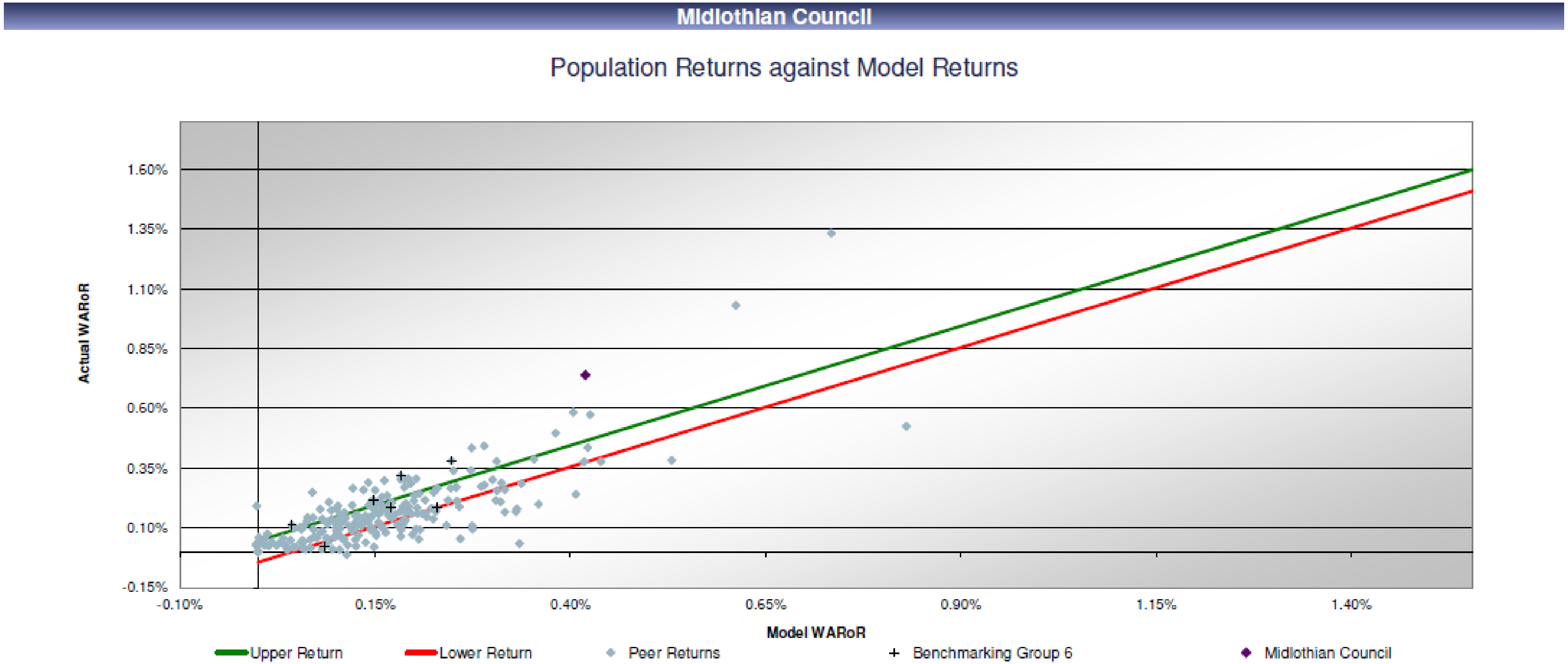
	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
Midlothian Council	0.80%	0.49%	0.31%	0.44%	0.53%	Above

Midlothian Council Deposit Portfolio return as at 30 September 2021

Midlothian Council

	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
Midlothian Council	0.77%	0.46%	0.31%	0.42%	0.50%	Above

Midlothian Council Deposit Portfolio return as at 31 December 2021



	Actual WARoR	Model WARoR	Difference	Lower Bound	Upper Bound	Performance
Midlothian Council	0.74%	0.42%	0.32%	0.37%	0.46%	Above