AGENDA ITEM.

REPORT TO AUDIT & GOVERNANCE COMMITTEE

25 SEPTEMBER 2023

REPORT OF DIRECTOR OF FINANCE, TRANSFORMATION & PERFORMANCE AND DEPUTY CHIEF EXECUTIVE

TREASURY MANAGEMENT STRATEGY – ANNUAL REPORT 2022/23

SUMMARY

This report informs Members of the committee about the treasury management and prudential indicators set in the Treasury Management Strategy approved by Council in February 2022.

REASONS FOR PRODUCING THIS REPORT

The Council operates under the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code) which requires the Council to approve a treasury management annual report after the end of each financial year.

This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

Introduction

The Council's Treasury Management Strategy for 2022/23 was approved at Council on the 23rd February 2022. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk remains central to the Council's Treasury Management Strategy.

The 2021 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, was also approved by full Council on 23rd February 2022.

External Context

The Councils treasury management advisors Arlingclose have provided the following commentary on the external context.

Economic background: The war in Ukraine continued to keep global inflation above central bank targets and the UK economic outlook remained relatively weak with the chance of a mild recession. The economic backdrop during the January to March period continued to be characterised by high energy and commodity prices, high inflation, and the associated impact on household budgets and spending.

Central Bank rhetoric and actions remained consistent with combatting inflation. The Bank of England, US Federal Reserve, and European Central Bank all increased interest rates over the period, even in the face of potential economic slowdowns in those regions.

Starting the financial year at 5.5%, the annual CPI measure of UK inflation rose strongly to hit 10.1% in July and then 11.1% in October. Inflation remained high in subsequent months but appeared to be past the peak, before unexpectedly rising again in February. Annual headline CPI registered 10.4% in February, up from 10.1% in January, with the largest upward contributions coming from food and housing. RPI followed a similar pattern during the year, hitting 14.2% in October. In February RPI measured 13.8%, up from 13.4% in the previous month.

The Bank of England increased the official Bank Rate to 4.25% during the financial year. From 0.75% in March 2022, the Monetary Policy Committee (MPC) pushed through rises at every subsequent meeting over the period, with recent hikes of 50bps in December and February and then 25bps in March, taking Bank Rate to 4.25%.

Financial markets: Uncertainty continued to be a key driver of financial market sentiment and bond yields remained relatively volatile due to concerns over elevated inflation and higher interest rates, as well as the likelihood of the UK entering a recession and for how long the Bank of England would continue to tighten monetary policy. Towards the end of the period, fears around the health of the banking system following the collapse of Silicon Valley Bank in the US and purchase of Credit Suisse by UBS caused further volatility.

Over the period the 5-year UK benchmark gilt yield rose from 1.41% to peak at 4.70% in September before ending the financial year at 3.36%. Over the same timeframe the 10-year gilt yield rose from 1.61% to peak at 4.51% before falling back to 3.49%, while the 20-year yield rose from 1.82% to 4.96% and then declined to 3.82%. The Sterling Overnight Rate (SONIA) averaged 2.24% over the period.

Credit review: In the period there were some credit changes of organisations reflecting changes in circumstances. Arlingclose update on these changes, which inform our Treasury Management approach.

As market volatility is expected to remain a feature, at least in the near term and, as ever, the institutions and durations on the Authority's counterparty list recommended by Arlingclose remains under constant review.

Local authorities remain under financial pressure, but Arlingclose continues to take a positive view of the sector, considering its credit strength to be high. Section 114 notices have been issued by a handful of authorities with specific issues. While Arlingclose's advice for local authorities on its counterparty list remains unchanged, a degree of caution is merited with certain authorities.

Local Context

On 31st March 2023, the Council had net borrowing of £65.38m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31.3.22 Actual £m	2022/23 Movement £m	31.3.23 Actual £m
General Fund CFR	185.30	(1.14)	184.16
Less: Other debt liabilities	(8.06)	1.27	(6.79)
Borrowing CFR	**177.24**	**0.13**	**177.37**
Less: Usable reserves	(137.28)	21.57	(115.71)
Less: Working capital	(2.86)	6.58	3.72
Net Borrowing / (Investments)	**37.10**	**28.28**	**65.38**

The Authority pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

The treasury management position at 31st March 2023 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.22 Balance £m	2022/23 Movement £m	31.3.23 Balance £m	31.3.23 Rate %
Long-term borrowing	78.53	(1.10)	77.43	
Short-term borrowing	5.93	10.88	16.81	
Total borrowing	**84.46**	**9.78**	**94.24**	**4.50%**
Long-term investments	16.61	(3.05)	13.56	
Short-term investments	0.00	0.00	0.00	
Cash and cash equivalents	30.75	(15.45)	15.30	
Total investments	**47.36**	**(18.50)**	**28.86**	
Net Borrowing / (Investments)	**37.10**	**28.28**	**65.38**	

During the year long term loans reduced by £1.1m as the principal element of these were repaid, as per the terms of the loans. No additional long term loans were entered into.

Short term loans increased by £11m during the year. After short term loans matured during the year there was a requirement for cash flow purposes to enter into further loans during the last two months of the financial year. Three £5 million loans with other Local Authorities were arranged.

Overall total borrowing increased from £84.46m as at 31st March 2022 to £94.24m as at 31st March 2023.

Total investments decreased during the year reducing £18.5m from £47.36m at the end of 2021-22 to £28.86m at the end of 2022-23. This was due to the authority internally borrowing to fund the capital programme, repayment of government grants following funding reconciliations and planned use of reserves.

Borrowing Update

CIPFA's 2021 Prudential Code is clear that local authorities must not borrow to invest primarily for financial return and that it is not prudent for local authorities to make any investment or spending decision that will increase the capital financing requirement, and so may lead to new borrowing, unless directly and primarily related to the functions of the Authority. PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield unless these loans are for refinancing purposes.

The Authority did not borrow to invest primarily for commercial return during 2022/23 and has no plans to do so in the current capital MTFP.

The Authority currently holds £16.558m in commercial investments that were purchased prior to the change in the CIPFA Prudential Code. The Authority as part of the updated code in the future will need review the options for exiting these investments if there is an economical case to do so.

Borrowing Strategy during the year

As outlined in the treasury strategy, the Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing lower interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective. The Authority's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio and, where practicable, to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

The cost of both long and short-term borrowing rose dramatically over the year, with rates at the end of March around 2% - 4% higher than those at the beginning of April. Rate rises have been driven primarily by inflation and the need for central banks to control this by raising interest rates.

The PWLB 10 year maturity certainty rate stood at 4.33% at 31st March 2023, 20 years at 4.70% and 30 years at 4.66%.

At 31st March 2023 the Council held £94.24m of loans, an increase of £9.78m from the previous year. The year-end borrowing position and the year-on-year change is shown in Table 3 below.

Table 3: Borrowing Position

	31.3.22 Balance £m	2022/23 Movement £m	31.3.23 Balance £m	Average Rate %	31.3.23 WAM* years
Public Works Loan Board	42.56	(1.45)	41.11	4.78%	7.6
Banks (LOBO)	37.00	0.00	37.00	4.83%	36.9
Local Authorities	0.90	15.23	16.13	3.90%	0.0
Banks (fixed-term)	4.00	(4.00)	0.00	0.00%	0.0
Total borrowing	**84.46**	**9.78**	**94.24**	**4.50%**	**18.0**

**Weighted average maturity*

The Council continues to holds £37m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the year.

Treasury Investment Activity

CIPFA published a revised Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes on 20th December 2021. These define treasury management investments as investments that arise from the organisation's cash flows or treasury risk management activity that ultimately represents balances that need to be invested until the cash is required for use in the course of business.

The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Council's investment balances fluctuated due to timing differences between income and expenditure.

The year-end investment position is shown in Table 4 below.

Table 4: Treasury Investment Position

	31.3.22 Balance	Net Movement	31.3.23 Balance	31.3.23 Income Return
	£m	£m	£m	%
Banks & building societies	0.68	-0.44	0.24	0.90
Government (incl. LA's)	0.00	0.00	0.00	0.00
Money Market Funds	30.00	-15.00	15.00	3.90
Pooled Property funds	16.23	-2.68	13.56	4.26
Total investments	**46.91**	**-18.12**	**28.80**	

Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

Bank Rate has increased from 0.75% at the beginning of the year to 4.25% at the end of March 2023. Short-dated cash rates, which had ranged between 0.7% - 1.5% at the beginning of April, rose by around 3.5% for overnight/7-day maturities and 3.3% for 6-12 month maturities.

By end March 2023, the rates on DMADF deposits ranged between 4.05% and 4.15%. The return on the Council's sterling Low Volatility Net Asset Value (LVNAV) Money Market Funds ranged between 0.9% - 1.1% p.a. in early April and between 3.8% and 3.9% at the end of March.

The progression of credit risk and return metrics for the Council's investments managed in-house are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	WAM* (days)	Rate of Return

31.03.2022	4.8	A+	100%	1	1.68%
30.06.2022	4.72	A+	92%	2	1.98%
30.09.2022	4.8	A+	92%	1	2.45%
31.12.2022	4.85	A+	100%	1	3.39%
31.03.2023	4.92	A+	100%	1	3.85%
Similar LA's (31.03.23)	4.84	A+	60%	64	3.77%
All LAs (31.03.23)	4.71	A+	59%	12	3.66%

*Weighted average maturity

Externally Managed Pooled Funds: £13.56m (based on 31.3.23 valuation) of the Council's investments are held in an externally managed strategic pooled property fund where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds generated a dividend return of £0.587m (4.26%) (£0.536m 2021-22) which is used to support services in year.

The negative correlation between bonds and equities, which had featured for some years, turned positive in 2022 as both bonds and equities sold off simultaneously against an outlook of sticky inflation and high interest rates. Simultaneously, tighter financial conditions, higher bond yields and challenges in some segments of commercial real estate (e.g. offices post-COVID, high street shops and shopping centres) saw commercial property values fall during 2022, with a large fall in the final calendar quarter.

The change in the Authority's funds' capital values and income earned over the 12-month period is shown in Table 4.

Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's medium- to long-term investment objectives are regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three- to five-year period total returns will exceed cash interest rates.

Overall investment income during 2022-23 was £1.399m (£0.600m 2021-22).

The DLUHC published a consultation on the IFRS 9 pooled investment fund statutory override for English authorities for fair value gains and losses on pooled investment funds which was due to expire with effect from 2023/24. The options under evaluation were to allow the override to lapse, to extend it, or to make it permanent. The override will be extended for two years and therefore remain in place for the 2023/24 and 2024/25 financial years. Under the Regulations, gains and losses resulting from unrealised fair value movements relating to treasury pooled investment funds, that otherwise must be recognised in profit or loss under IFRS 9, are not charges to the revenue account, and must be taken into an unusable reserve account.

<u>Non-Treasury Investments</u>

The definition of investments in CIPFA's revised 2021 Treasury Management Code covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. Investments that do not meet the definition of treasury management investments (i.e. management of surplus cash) are categorised as either for service purposes (made explicitly to further service objectives) and or for commercial purposes (made primarily for financial return).

Investment Guidance issued by the Department for Levelling Up Housing and Communities (DLUHC) also broadens the definition of investments to include all such assets held partially or wholly for financial return.

The Council also held £17.287m of such investments in;

- directly owned property £16.559m
- loans to local businesses £0.048m
- loans to subsidiaries £0.476m
- other £0.204m

These investments generated £1.172m of investment income for the Council after taking account of direct costs in 2022/23 representing a rate of return of 6.78%.

Compliance

The Director of Finance, Transformation and Performance and Deputy Chief Executive reports that all treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in Table 6 below.

Table 6: Debt Limits

	2022/23 Maximum	31.3.23 Actual	2022/23 Operational Boundary £m	2022/23 Authorised Limit £m	Complied
Borrowing	94.24	94.24	195.40	218.40	✓
PFI & finance leases	6.79	6.79	6.50	6.50	✓
Total debt	**101.03**	**101.03**	**201.90**	**224.90**	✓

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure. Total debt was above the operational boundary for 0 days during 2022/23.

Compliance with specific investment limits is demonstrated in Table 7 below.

Table 7: Investment Limits

	2022/23	31.3.23	2022/23	2022/23	Complied
	Maximum	Actual	Counterparty Limit	Financial Limit	
The UK Government	£22m	0	Unlimited	N/A	✓
Local authorities & other government entities	£0m	£0m	£5m	Unlimited	✓

Secured investments	£0m	£0m	£5m	Unlimited	✓
Banks (unsecured)	£0.72m	£0.24m	£2.5m	Unlimited	✓
Building societies (unsecured)	£0m	£0m	£2.5m	£5m	✓
Registered providers (unsecured)	£0m	£0m	£2.5m	£12.5m	✓
Money market funds	£30m	£15m	£5m	Unlimited	✓
Strategic pooled funds	£16.2m	£13.58m	£15m	£25m	✓
Real estate investment trusts	£0m	£0m	£5m	£12.5m	✓
Other investments	£0m	£0m	£2.5m	£5m	✓

** see table 4 above for actual values with individual counterparties as at 31st March 2023.*

Treasury Management Indicators

The Council measures and manages its exposures to treasury management risks using the following indicators.

Maturity Structure of Borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	31.3.23 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	18%	25%	0%	✓
12 months and within 24 months	1%	40%	0%	✓
24 months and within 5 years	5%	60%	0%	✓
5 years and within 10 years	13%	80%	0%	✓
10 years and above	63%	100%	0%	✓

Principal Sums Invested for Periods Longer than 365 days: The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2022/23	2023/24	2024/25
Actual principal invested beyond year end	£15m	£15m	£15m
Limit on principal invested beyond year end	£60m	£50m	£40m
Complied	✓	✓	✓

Prudential Indicators 2022/23

Introduction: The Local Government Act 2003 requires the Council to have regard to the Chartered Institute of Public Finance and Accountancy's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

This report compares the approved indicators with the outturn position for 2022/23. Actual figures have been taken from or prepared on a basis consistent with, the Council's Statement of Accounts.

Capital Expenditure: The Council's capital expenditure and financing is summarised as follows.

Capital Expenditure and Financing	**2022/23 Estimate £m**	**2022/23 Actual £m**	**Difference £m**
Total Expenditure	**79.18**	**47.8**	**(31.38)**
Capital Receipts	3.57	1.0	(2.57)
Grants & Contributions	48.5	43.4	(5.10)
Revenue	8.7	1.4	(7.29)
Borrowing	18.4	2.0	(16.42)
Total Financing	**79.18**	**47.8**	**(31.38)**

Capital Financing Requirement: The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose.

Capital Financing Requirement	**31.03.23 Estimate £m**	**31.03.23 Actual £m**	**Difference £m**
General Fund	198.9	184.2	**(14.74)**
Total CFR	**198.9**	**184.2**	**(14.74)**

There was a difference of (£14.74m) on the CFR from the original estimate due to a variance against the approved spend profile within the capital programme in year.

Actual Debt: The Council's actual debt at 31st March 2023 was as follows:

Debt	**31.03.23 Estimate £m**	**31.03.23 Actual £m**	**Difference £m**
Borrowing	138.47	94.24	**(44.23)**
Finance leases	2.21	3.49	**1.28**
PFI liabilities	2.98	3.30	**0.32**
Total Debt	**143.66**	**101.03**	**(42.63)**

There was a significant reduction in the planned borrowing requirements during 2022/23 due to grant payments received by the authority and slippage on the capital programme.

Gross Debt and the Capital Financing Requirement: In order to ensure that over the medium term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence. The table below shows the position as at 31st March 2023;

Debt and CFR	**31.03.23 Estimate £m**	**31.03.23 Actual £m**	**Difference £m**
Total debt	143.66	101.03	**(42.63)**
Capital financing requirement	198.90	184.16	**(14.74)**
Headroom / (Under Borrowed)	**(55.24)**	**(83.13)**	**(27.89)**

Total debt during the year remained below the CFR. At the 31st March the Council was under borrowed by £83.13m.

Operational Boundary for External Debt: The operational boundary is based on the Council's estimate of most likely (i.e. prudent but not worst case) scenario for external debt. It links directly to the Council's estimates of capital expenditure, the capital financing requirement and cash flow requirements, and is a key management tool for in-year monitoring. Other long-term liabilities comprise finance lease, Private Finance Initiative and other liabilities that are not borrowing but form part of the Council's debt.

Operational Boundary and Total Debt	**31.03.23 Boundary £m**	**31.03.23 Actual Debt £m**	**Complied**
Borrowing	195.40	94.24	✓
Other long-term liabilities	6.50	6.79	✓
Total Debt	**201.90**	**101.03**	✓

Authorised Limit for External Debt: The authorised limit is the affordable borrowing limit determined in compliance with the *Local Government Act 2003.* It's the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit and Total Debt	**31.03.23 Limit £m**	**31.03.23 Actual Debt £m**	**Complied**
Borrowing	218.40	94.24	✓
Other long-term liabilities	6.50	6.79	✓
Total Debt	**224.90**	**101.03**	✓

Ratio of Financing Costs to Net Revenue Stream: This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income. The table below shows the position as at 31st March 2023.

Ratio of Financing Costs to Net Revenue Stream	**31.03.23 Estimate %**	**31.03.23 Actual %**	**Difference %**
General Fund	3.0%	1.8%	-1.2%

Name of Contact Officer: Andy Bryson
Post Title: Chief Accountant
Telephone No.: 01642 528850
Email Address: andy.bryson@stockton.gov.uk