AGENDA ITEM

REPORT TO AUDIT AND GOVERNANCE COMMITTEE

27 NOVEMBER 2023

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

TREASURY MANAGEMENT STRATEGY MID YEAR REPORT 2023/24

SUMMARY

This report informs Members of the performance against the treasury management and prudential indicators set in the Treasury Management Strategy approved by Council in February 20232.

Introduction

The Authority has adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports.

The Authority's Treasury Management Strategy for 2023/24 was approved by Council on 22nd February 2023. The Authority 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 Authority's treasury management strategy.

External Context

Arlingclose Stockton's Treasury Management advisors have provided us with the following commentary on the external environment.

Economic background: UK inflation remained stubbornly high over much the period compared to the US and euro zone, keeping expectations elevated of how much further the Bank of England (BoE) would hike rates compared to the regions. However, inflation data published in the latter part of the period undershot expectations, causing financial markets to reassess the peak in BoE Bank Rate. This was followed very soon after by the BoE deciding to keep Bank Rate on hold at 5.25% in September, against expectation for another 0.25% rise.

Economic growth in the UK remained relatively weak over the period. In calendar Q2 2023, the economy expanded by 0.4%, beating expectations of a 0.2% increase. However, monthly GDP data showed a 0.5% contraction in July, the largest fall to date in 2023 and worse than the 0.2% decline predicted which could be an indication the monetary tightening cycle is starting to cause recessionary or at the very least stagnating economic conditions.

Inflation continued to fall from its peak as annual headline CPI declined to 6.7% in July 2023 from 6.8% in the previous month against expectations for a tick back up to 7.0%. The largest downward contribution came from food prices. The core rate also surprised on the downside, falling to 6.2% from 6.9% compared to predictions for it to only edge down to 6.8%.

The Bank of England's Monetary Policy Committee continued tightening monetary policy over most of the period, taking Bank Rate to 5.25% in August. Against expectations of a further hike in September, the Committee voted 5-4 to maintain Bank Rate at 5.25%. Each of the four dissenters were in favour of another 0.25% increase.

Financial market Bank Rate expectations moderated over the period as falling inflation and weakening data gave some indication that higher interest rates were working. Expectations fell from predicting a peak of over 6% in June to 5.5% just ahead of the September MPC meeting, and to then expecting 5.25% to be the peak by the end of the period.

Following the September MPC meeting, Arlingclose, the authority's treasury adviser, modestly revised its interest forecast to reflect the central view that 5.25% will now be the peak in Bank Rate. In the short term the risks are to the upside if inflation increases again, but over the remaining part of the time horizon the risks are to the downside from economic activity weakening more than expected.

Financial markets: Financial market sentiment and bond yields remained volatile, with the latter generally trending downwards as there were signs inflation, while still high, was moderating and interest rates were at a peak.

Gilt yields fell towards the end of the period. The 5-year UK benchmark gilt yield rose from 3.30% to peak at 4.91% in July before trending downwards to 4.29%, the 10-year gilt yield rose from 3.43% to 4.75% in August before declining to 4.45%, and the 20-year yield from 3.75% to 4.97% in August and then fell back to 4.84%. The Sterling Overnight Rate (SONIA) averaged 4.73% over the period.

Credit review: Having completed a review of its credit advice on unsecured deposits at UK and non-UK banks following concerns of a wider financial crisis after the collapse of Silicon Valley Bank purchase of Credit Suisse by UBS, as well as other well-publicised banking sector issues, in March Arlingclose reduced the advised maximum duration limit for all banks on its recommended counterparty list to 35 days. This stance continued to be maintained at the end of the period.

Following the issue of a Section 114 notice, in September Arlingclose advised against undertaking new lending to Birmingham City Council, and later in the month cut its recommended duration on Warrington Borough Council to a maximum of 100 days.

Heightened 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.

<u>Local Context</u>

On 31st March 2023, the Authority 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

	31.3.23 Actual £m
General Fund CFR	184.16
Less: Other debt liabilities	-6.79
Borrowing CFR	**177.37**
Less: Usable reserves	-115.71
Less: Working capital	3.72
Net Borrowing / (Investments)	**65.38**

The treasury management position at 30th September 2023 and the change over the six months is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.23 Balance £m	**Movement £m**	**30.9.23 Balance £m**
Long-term borrowing	77.43	0.67	78.10
Short-term borrowing	16.81	-6.81	10.00
Total borrowing	**94.24**	**-6.14**	**88.10**
Long-term investments	-13.56	-0.03	-13.59
Short-term investments	0.00	0.00	0.00
Cash and cash equivalents	-15.30	-19.64	-34.94
Total investments	**-28.86**	**-19.67**	**-48.53**
Net Borrowing	**65.38**	**-25.82**	**39.56**

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 intends to avoid this activity in order to retain its access to PWLB loans. The Authority has reviewed its capital programme in light of the Prudential Code 2021 requirements and PWLB lending arrangements to ensure that borrowing to invest primarily for commercial return is no longer undertaken.

Borrowing Strategy and Activity

As outlined in the treasury strategy, the Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low 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.

There was a substantial rise in the cost of both short- and long-term borrowing over the last 18 months. Bank Rate rose by 1% from 4.25% at the beginning of April to 5.25% at the end of September. Bank Rate was 2% higher than at the end of September 2022.

UK gilt yields were volatile, mainly facing upward pressure since early April following signs that UK growth had been more resilient, inflation stickier than expected, and that the Bank of England saw persistently higher rates through 2023/24 as key to dampening domestic demand. Gilt yields, and consequently PWLB borrowing rates, rose and broadly remained at elevated levels. On 30th September, the PWLB certainty rates for maturity loans were 5.26% for 10-year loans, 5.64% for 20-year loans and 5.43% for 50-year loans. Their equivalents on 31st March 2023 were 4.33%, 4.70% and 4.41% respectively.

The Authority has an increasing CFR due to the capital programme and an estimated borrowing requirement as determined by the Liability Benchmark which also takes into account usable reserves and working capital. Having considered the appropriate duration and structure of the Authority's borrowing need based on realistic projections and in keeping with these objectives, existing loans were allowed to mature without replacement. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

At 30th September 2023 the Authority held £88.1m of loans, a decrease of £6.14m since 31st March 2023. This is due to the repayment of a short term loan that has not been replaced and other long term loans that have matured and again not replaced. Outstanding loans on 30th September 2023 are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.23 Balance £m	**Q2 Net Movement £m**	**30.9.23 Balance £m**	**30.9.23 Weighted Average Rate %**	**30.9.23 Weighted Average Maturity (years)**
Public Works Loan Board	41.11	-1.15	39.96	2.17	20.01
Banks (LOBO)	37.00	0.00	37.00	4.79	36.70
Local Authorities	16.13	-5.00	11.13	7.75	3.44
Others (fixed-term)	0.00	0.00	0.00	0.00	0.00
Total borrowing	**94.24**	**-6.14**	**88.10**	**3.63**	**24.93**

LOBO loans: The Authority continues to hold £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 Authority 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 first six months of the year.

Over the medium term it is estimated the authority, based on the current capital programme and the fact the authority has internally borrowed over the previous years will be required to undertake significant borrowing. In the higher rate environment that we are currently operating in this will mean higher costs of borrowing. Future borrowing requirements and financial requirements are currently being analysed and information will be provided as part of future MTFP and Treasury reports.

Treasury Investment Activity

CIPFA revised TM Code defines treasury management investments as those which arise from the Authority's cash flows or treasury risk management activity that ultimately represents balances which need to be invested until the cash is required for use in the course of business.

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances fluctuated due to timing differences between income and expenditure. The investment position at the end of September is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.23 Balance £m	Net Movement £m	30.9.23 Balance £m
Banks & building societies (unsecured)	-0.24	0.16	-0.08
Government (incl. local authorities)	0.00	-4.80	-4.80
Property Fund	-13.56	-0.03	-13.59
Shares / Cash	-0.06	0.00	-0.06
Money Market Funds	-15.00	-15.00	-30.00
Total investments	**-28.86**	**-19.67**	**-48.53**

Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Authority'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.

The Authority expects to be a long-term borrower and new treasury investments are therefore primarily made to manage day-to-day cash flows using short-term low risk instruments. The existing portfolio of strategic pooled funds will be maintained to diversify risk into different asset classes and boost investment income.

Bank Rate increased by 1%, from 4.25% at the beginning of April to 5.25% by the end of September. Short-dated cash rates rose commensurately, with 3-month rates rising to around 5.25% and 12-month rates to nearly 6%. The rates on DMADF deposits also rose, ranging between 4.8% and 5.4% by the end of June and Money Market Rates between 4.9% and 5.3%.

The progression of risk and return metrics 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 %
31.03.2023	4.92	A+	100%	1	3.85%
30.06.2023	4.68	A+	79%	4	4.40%
30.09.2023	4.32	AA-	65%	2	4.84%
Similar LAs	4.57	A+	59%	42	4.71%
All LAs	4.47	AA-	55%	13	4.79%

*Weighted average maturity

£13.59m of the Authority'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. The fund generated a return of £0.586m (3.91%) during 2022/23, and has generated £0.339m (4.23%) in dividend payments for the first six months of the year. This income is being used to support the medium term financial plan.

Because the Authority's externally managed 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 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.

Statutory override: In April 2023 the Department for Levelling Up, Housing and Communities published the full outcome of the consultation on the extension of the statutory override on accounting for gains and losses on pooled investment funds. The override has been extended for two years until 31st March 2025 but no other changes have been made; whether the override will be extended beyond the new date is unknown but commentary to the consultation outcome suggests not. The Authority will discuss with Arlingclose the implications for the investment strategy and what action may need to be taken.

Non-Treasury Investments

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) and Welsh Government also includes within the definition of investments 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 first half of the year complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy.

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

Table 6: Debt Limits

	Maximum in Year £m	**30.9.23 Actual £m**	**2023/24 Operational Boundary £m**	**2023/24 Authorised Limit £m**	**Complied? Yes/No**
Borrowing	93.76	88.10	212.90	222.90	Yes
PFI and Finance Leases	6.50	6.50	6.50	6.50	Yes
Total debt	**100.26**	**94.60**	**219.40**	**229.40**	

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

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Table 7: Investment Limits

Sector	Counterparty limit	Sector limit	Maximum	30.9.23 Actual	Complied ? Yes/No
The UK Government	Unlimited	n/a	£29,800,000	£4,800,000	Yes
Local authorities & other government entities	£5,000,000	Unlimited	£0	£0	Yes
Secured investments	£5,000,000	Unlimited	£0	£0	Yes
Banks (unsecured)	£2,500,000	Unlimited	£499,000	£79,000	Yes
Building societies (unsecured)	£2,500,000	£5,000,000	£0	£0	Yes
Registered providers (unsecured)	£2,500,000	£12,500,000	£0	£0	Yes
Money market funds	£5,000,000	Unlimited	£30,000,000	£30,000,000	Yes
Strategic pooled funds	£15,000,000	£25,000,000	£13,591,000	£13,591,000	Yes
Real estate investment trusts	£5,000,000	£12,500,000	£0	£0	Yes
Other investments	£2,500,000	£5,000,000	£0	£0	Yes

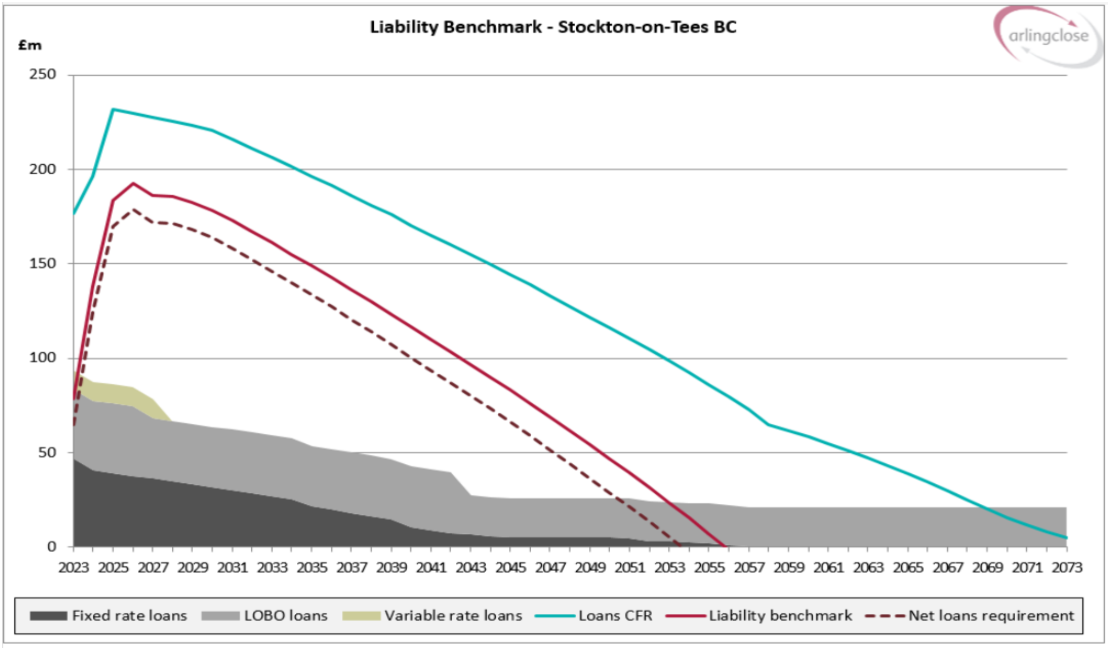
Treasury Management Prudential Indicators

As required by the 2021 CIPFA Treasury Management Code, the Authority monitors and measures the following treasury management prudential indicators.

Liability Benchmark: This new indicator compares the Authority's actual existing borrowing against a liability benchmark that has been calculated to show the lowest risk level of borrowing. The liability benchmark is an important tool to help establish whether the Council is likely to be a long-term borrower or long-term investor in the future, and so shape its strategic focus and decision making. It represents an estimate of the cumulative amount of external borrowing the Council must hold to fund its current capital and revenue plans while keeping treasury investments at a level required to manage day-to-day cash flow.

	31.3.23 Actual	31.3.24 Forecast	31.3.25 Forecast	31.3.26 Forecast
Loans CFR	176.8	196.3	231.9	229.9
External Borrowing	-93.8	-87.4	-86.1	-84.7
Internal (over) Borrowing	**83.0**	**108.9**	**145.8**	**145.2**
Less: Balance sheet resources	-111.8	-72.1	-62.1	-51.2
Investments (New Borrowing)	**-28.8**	**36.8**	**83.7**	**94.0**
Treasury Investments	28.8	13.7	13.8	14.0
New Borrowing	**0.0**	**50.5**	**97.5**	**108.0**
Net Loans Requirement	65.0	124.2	169.8	178.7
Liquidity Allowance	13.6	13.7	13.8	14.0
Liability Benchmark	**78.6**	**137.9**	**183.6**	**192.7**

Following on from the medium-term forecast above, the long-term liability benchmark assumes capital expenditure funded by borrowing based on the current capital programme, minimum revenue provision on new capital expenditure based on a 50 year asset life and income, expenditure and reserves all increasing by inflation. This is shown in the chart below together with the maturity profile of the Authority's existing borrowing.



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

	30.9.23 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	11.35%	25%	0%	Yes
12 months and within 24 months	0.02%	40%	0%	Yes
24 months and within 5 years	5.94%	60%	0%	Yes
5 years and within 10 years	0.01%	80%	0%	Yes
10 years and above	82.67%	100%	0%	Yes

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Long-term Treasury Management Investments: The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The prudential limits on the long-term treasury management limits are:

	2022/23	2023/24	2024/25
Actual principal invested beyond year end	£13.56m	£13.59m	£15m
Limit on principal invested beyond year end	£60m	£40m	£20m
Complied?	Yes	Yes	Yes

Long-term investments with no fixed maturity date include strategic pooled funds, real estate investment trusts and directly held equity but exclude money market funds and bank accounts with no fixed maturity date as these are considered short-term

Net Income from Commercial and Service Investments to Net Revenue Stream: The Authority's income from commercial and service investments as a proportion of its net revenue stream has been and is expected to be as indicated below.

	2022/23 actual	2023/24 forecast	2024/25 budget	2025/26 budget
Total net income from service and commercial investments (£m)	0.968	1.035	1.035	1.035
Proportion of net revenue stream	0.58%	0.65%	0.62%	0.60%

Proportion of Financing Costs to Net Revenue Stream: Although capital expenditure is not charged directly to the revenue budget, interest payable on loans and MRP are charged to revenue.

The net annual charge is known as financing costs; this is compared to the net revenue stream i.e. the amount funded from Council Tax, business rates and general government grants.

	2022/23 actual	2023/24 forecast	2024/25 budget *	2025/26 budget
Financing costs (£m)	4.5	5.6	7.8	8.3
Proportion of net revenue stream	2.69%	3.40%	4.50%	4.60%

Arlingclose's Economic Outlook for the remainder of 2023/24 (based on 7th September 2023 interest rate forecast)

The MPC held Bank Rate at 5.25% in November. Arlingclose believe this is the peak for Bank Rate.

The MPC will cut rates in the medium term to stimulate the UK economy but will be reluctant to do so until it is sure there will be no lingering second-round effects. We see rate cuts from Q3 2024 to a low of around 3% by early-mid 2026.

The immediate risks around Bank Rate remain on the upside, but these diminish over the next few quarters and shift to the downside before balancing out, due to the weakening UK economy and dampening effects on inflation.

Arlingclose expects long-term gilt yields to eventually fall from current levels (amid continued volatility) reflecting the lower medium-term path for Bank Rate. However, yields will remain relatively higher than in the past, due to quantitative tightening and significant bond supply.

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