AGENDA ITEM xx

REPORT TO AUDIT AND GOVERNANCE COMMITTEE

25 NOVEMBER 2024

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

TREASURY MANAGEMENT STRATEGY MID YEAR REPORT 2024/25

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 2024.

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 2024/25 was approved by Council on 21st February 2024. 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 headline consumer price inflation remained around the Bank of England (BoE) target later in the period, falling from an annual rate of 3.2% in March to 2.0% in May and then rebounding marginally to June to 2.2% in July and August, as was expected, due to base effects from energy prices. Core and services price inflation remained higher at 3.6% and 5.6% respectively in August.

The UK economy continued to expand over the period, albeit slowing from the 0.7% gain in the first calendar quarter to 0.5% (downwardly revised from 0.6%) in the second. Of the monthly figures, the economy was estimated to have registered no growth in July.

Labour market data was slightly better from a policymaker perspective, showing an easing in the tightness of the job market, with inactivity rates and vacancies declining. However, a degree of uncertainty remains given ongoing issues around the data collected for the labour force survey by the Office for National Statistics. Figures for the three months to July showed the unemployment rate fell to 4.1% (3mth/year) from 4.4% in the previous three-month period while the employment rate rose to 74.8% from 74.3%.

Over the same period average regular earnings (excluding bonuses) was 5.1%, down from 5.4% in the earlier period, and total earnings (including bonuses) was 4.0% (this figure was impacted by one-off payments made to NHS staff and civil servants in June and July 2023). Adjusting for inflation, real regular pay rose by 2.2% in May to July and total pay by 1.1%.

With headline inflation lower, the BoE cut Bank Rate from 5.25% to 5.00% at the August Monetary Policy Committee (MPC) meeting. The decision was finely balanced, voted by a 5-4 majority with four members preferring to hold at 5.25%. At the September MPC meeting, committee members voted 8-1 for no change at 5.00%, with the lone dissenter preferring Bank Rate to be cut again to 4.75%. The meeting minutes and vote suggested a reasonably hawkish tilt to rates, with sticky inflation remaining a concern among policymakers.

The latest BoE Monetary Policy Report, published in August, showed policymakers expected GDP growth to continue expanding during 2024 before falling back and moderating from 2025 to 2027. Unemployment was forecast to stay around 4.5% while inflation was shown picking up in the latter part of 2024 as the previous years' energy price declines fell out of the figures before slipping below the 2% target in 2025 and remaining there until early 2027.

Arlingclose, the authority's treasury adviser, maintained its central view that Bank Rate would steadily fall from the 5.25% peak, with the first cut in August being followed by a series of further cuts, with November 2024 the likely next one, taking Bank Rate down to around 3% by the end of 2025.

Financial markets: Sentiment in financial markets continued to mostly improve over the period, but the ongoing trend of bond yield volatility remained. The general upward trend in yields in the early part of the period was reversed in the later part, and yields ended the half-year not too far from where they started. However, the volatility in response to economic, financial and geopolitical issues meant it was a bumpy ride for bond investors during that time.

Over the period, the 10-year UK benchmark gilt yield started at 3.94% and ended at 4.00% but hit a high of 4.41% in May and a low of 3.76% in mid-September. While the 20-year gilt started at 4.40% and ended at 4.51% but hit a high of 4.82% in May and a low of 4.27% in mid-September. The Sterling Overnight Rate (SONIA) averaged 5.12% over the period to 30th September.

Credit review: Arlingclose maintained its advised recommended maximum unsecured duration limit on all banks on its counterparty list at 100 days.

Credit default swap prices were generally lower at the end of the period compared to the beginning for the vast majority of the names on UK and non-UK lists. Price volatility over the period was also generally more muted compared to previous periods.

Financial market volatility is expected to remain a feature, at least in the near term and, credit default swap levels will be monitored for signs of ongoing credit stress. As ever, the institutions and durations on the Authority's counterparty list recommended by Arlingclose remain under constant review.

<u>Local Context</u>

On 31st March 2024, the Authority had net borrowing of £86.61m 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

	31.3.24 Actual £m
General Fund CFR	189.99
Less: Other debt liabilities	-5.55
Borrowing CFR	**184.44**
Less: Usable reserves	-103.5
Less: Working capital	5.67
Net Borrowing / (Investments)	**86.61**

The treasury management position at 30th September 2024 and the change over the six month period is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.24 Balance £m	Movement £m	30.9.24 Balance £m
Long-term borrowing	89.75	1.40	91.15
Short-term borrowing	18.64	-8.62	10.02
Total borrowing	**108.39**	**-7.23**	**101.16**
Long-term investments	-13.03	0.05	-12.98
Short-term investments	0.00	0.00	0.00
Cash and cash equivalents	-8.75	-4.58	-13.33
Total investments	**-21.78**	**-4.54**	**-26.32**
Net Borrowing	**86.61**	**-11.76**	**74.85**

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.

After substantial rises in interest rates since 2021 many central banks have now begun to reduce rates, albeit slowly. Gilt yields were volatile over the 6-month period and have reduced slightly between April and September 2024. Much of the downward pressure from lower inflation figures was counteracted by upward pressure from positive economic data. Data from the US continues to impact global bond markets including UK gilt yields.

The PWLB certainty rate for 10-year maturity loans was 4.80% at the beginning of the half year and 4.79% at the end. The lowest available 10-year maturity rate was 4.52% and the highest was 5.18%. Rates for 20-year maturity loans ranged from 5.01% to 5.57% during the half year, and 50-year maturity loans from 4.88% to 5.40%.

Whilst the cost of short-term borrowing from other local authorities spiked to around 7% in late March 2024, primarily due a dearth of LA-LA lending/borrowing activity during the month, as expected shorter-term rates reverted to a more normal range and were generally around 5.00% - 5.25%.

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 has no new plans to borrow to invest primarily for financial return.

At 30th September 2024 the Authority held £101.16m of loans, a decrease of £7.23m since 31st March 2024. This is due to the repayment of a short term loan that has not been replaced and the repayment of principal on long term loans. Outstanding loans on 30th September 2024 are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.24 Balance £m	**Q2 Net Movement £m**	**30.9.24 Balance £m**	**30.9.24 Weighted Average Rate %**	**30.9.24 Weighted Average Maturity (years)**
Public Works Loan Board	55.13	-2.22	52.91	2.92	15.32
Banks (LOBO)	37.00	0.00	37.00	4.79	36.70
Local Authorities	16.26	-5.00	11.26	7.50	3.68
Others (fixed-term)	0.00	0.00	0.00	2.50	2.79
Total borrowing	**108.39**	**-7.23**	**101.16**	**3.81**	**21.84**

LOBO loans: At the 30th September the Authority held £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 but in early November 2024 FMS bank asked if the authority would like to repay £21m of loans held with them at no additional cost. These two loans had an original maturity date of 2077 and to reduce future interest rate risk and cost to the authority these two loans were repaid. The authority has funded these repayments by securing a short term loan in the local to local market.

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.

<u>Treasury Investment Activity</u>

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 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

	31.3.24 Balance £m	**Net Movement £m**	**30.9.24 Balance £m**
Banks & building societies (unsecured)	-0.40	0.32	-0.08
Government (incl. local authorities)	0.00	0.00	0.00
Property Fund	-13.03	0.05	-12.98
Shares / Cash	-0.05	0.00	-0.05
Money Market Funds	-8.30	-4.90	-13.20
Total investments	**-21.78**	**-4.53**	**-26.32**

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 reduced from 5.25% to 5.00% in August 2024 with short term interest rates largely being around these levels. The rates on DMADF deposits ranged between 4.925% and 5.19% and money market rates between 4.8% 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 %**
31.03.2024	4.89	A+	100%	1	5.07%
30.06.2024	4.76	A+	100%	1	5.17%
30.09.2024	4.78	A+	100%	1	5.10%
Similar LAs	4.65	A+	60%	100	5.09%
All LAs	4.6	A+	61%	11	4.90%

*Weighted average maturity

Externally Managed Pooled Funds: £12.98m 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 £0.683m (4.56%) during 2023/24, and has generated £0.342m (4.58%) 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.

The Authority has set up a reserve of £1.7m to mitigate the impact of the statutory override not being extended and unrealised losses on pooled investment funds are required to be recognised.

Non-Treasury Investments

The definition of investments in the Treasury Management Code now 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 £18.213m of such investments in;

- directly owned property £17.970m
- loans to local businesses £0.039m
- other £0.204m

These investments generated £0.902m of investment income for the Council after taking account of direct costs in 2023/24 representing a rate of return of 5.02%.

MRP Regulations

On 10th April 2024 amended legislation and revised statutory guidance were published on Minimum Revenue Provision (MRP). The majority of the changes take effect from the 2025/26 financial year, although there is a requirement that for capital loans given on or after 7th May 2024 sufficient MRP must be charged so that the outstanding CFR in respect of the loan is no higher than the principal outstanding less the Expected Credit Loss (ECL) charge for that loan.

The regulations also require that local authorities cannot exclude any amount of their CFR from their MRP calculation unless by an exception set out in law. Capital receipts cannot be used to directly replace, in whole or part, the prudent charge to revenue for MRP (there are specific exceptions for capital loans and leased assets). The changes to MRP guidance are not expected to have a significant impact on your Authority.

Compliance

The Deputy Chief Executive & Director of Finance, Transformation and Performance 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	30.9.24 Actual £m	2024/25 Operational Boundary £m	2024/25 Authorised Limit £m	Complied? Yes/No
Borrowing	111.67	101.16	204.80	219.80	Yes
PFI and Finance Leases	4.54	4.54	4.54	4.54	Yes
Total debt	**116.21**	**105.70**	**209.34**	**224.34**	

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.

Table 7: Investment Limits

Sector	Counterparty limit	Sector limit	Maximum	30.9.24 Actual	Complied? Yes/No
The UK Government	Unlimited	n/a	£8,200,000	£0	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	£460,000	£80,000	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	£25,000,000	£13,200,000	Yes
Strategic pooled funds	£15,000,000	£25,000,000	£13,030,000	£12,982,000	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

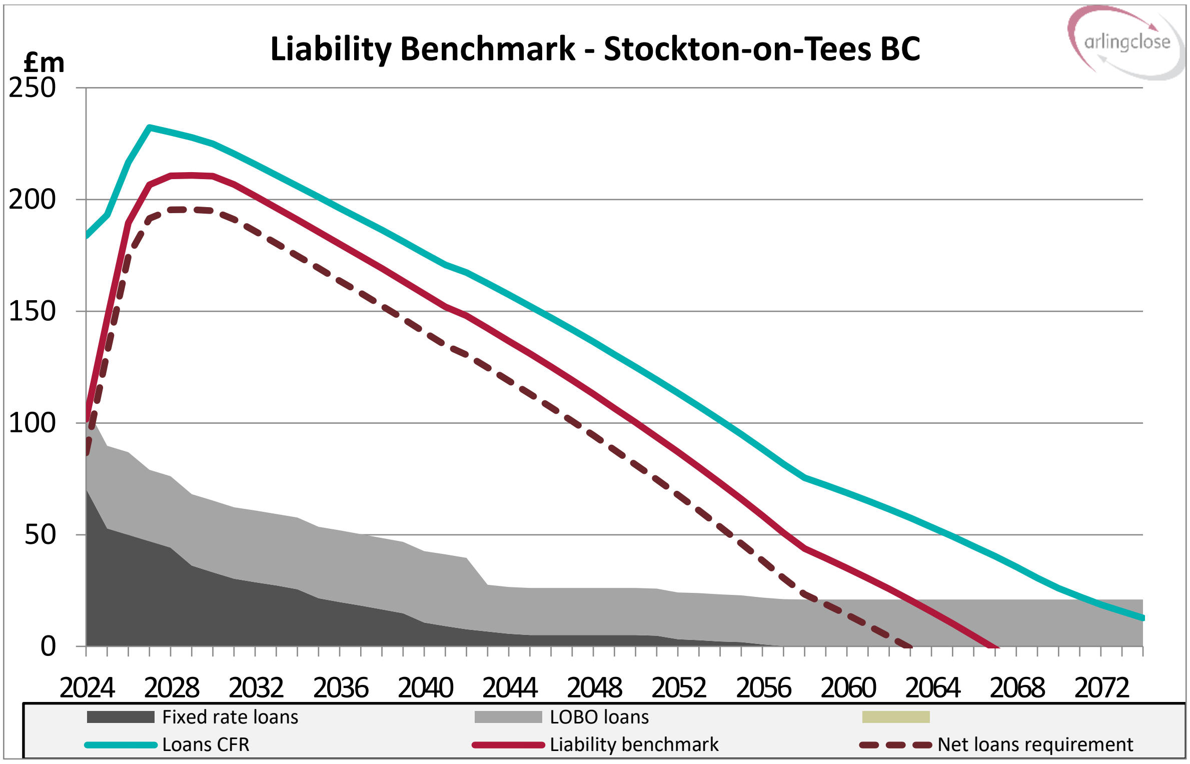
As required by the 2021 CIPFA Treasury Management Code, the Authority monitors and measures the following treasury management prudential indicators.

Liability Benchmark: This 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.

	31.3.24 Actual	31.3.25 Forecast	31.3.26 Forecast	31.3.27 Forecast
Loans CFR	184.4	193.1	216.6	232.2
External Borrowing	-108.4	-90.6	-87.8	-79.9
Internal (over) Borrowing	**76.1**	**102.5**	**128.8**	**152.3**
Less: Balance sheet resources	-97.9	-61.5	-42.1	-40.7
Investments (New Borrowing)	**-21.8**	**41.0**	**86.7**	**111.7**
Treasury Investments	21.8	15.0	15.0	15.0
New Borrowing	**-0.1**	**56.0**	**101.7**	**126.7**

Net Loans Requirement	86.5	131.6	174.5	191.6
Liquidity Allowance	15.0	15.0	15.0	15.0
Liability Benchmark	**101.5**	**146.6**	**189.5**	**206.6**

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:

	30.9.24 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	9.90%	25%	0%	Yes
12 months and within 24 months	4.98%	40%	0%	Yes
24 months and within 5 years	5.14%	60%	0%	Yes
5 years and within 10 years	9.22%	80%	0%	Yes
10 years and above	70.75%	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:

	2023/24	2024/25	2025/26
Actual principal invested beyond year end	£13.03m	£12.98m	£14.00m
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.

	2023/24 actual	2024/25 forecast	2025/26 budget	2026/27 budget
Total net income from service and commercial investments £m	£0.902m	£1.093m	£1.093m	£1.093m
Proportion of net revenue stream	0.49%	0.61%	0.59%	0.58%

The table identifies that the authority is not reliant on commercial and service investment income to maintain its core functions.

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.

	2023/24 actual	2024/25 forecast	2025/26 budget	2026/27 budget
Financing costs (£m)	£5.1m	£6.8m	£9.1m	£10.1m
Proportion of net revenue stream	1.3%	3.8%	4.9%	5.4%

Arlingclose's Economic Outlook for the remainder of 2024/25 (based on 11th November 2024 interest rate forecast)

In line with our forecast, Bank Rate was cut to 4.75% in November.

The MPC will continue to reduce Bank Rate, but more slowly and by less. We see another rate cut in February 2025, followed by a cut alongside every Monetary Policy Report publication, to a low of 3.75%.

Long-term gilt yields have risen to reflect both UK and US economic, monetary and fiscal policy expectations, and increases in bond supply. Volatility will remain elevated as the market digests incoming data for clues around the impact of policy changes.

This uncertainty may also necessitate more frequent changes to our forecast than has been the case recently.

The risks around the forecasts lie to the upside over the next 12 months, but are broadly balanced in the medium term.

Name of Contact Officer: Garry Cummings
Post Title: Deputy Chief Executive & Director of Finance, Transformation and Performance.
Telephone No. 01642 527011
Email Address: garry.cummings@stockton.gov.uk