Appendix 1 - Treasury Management Mid-Year Report 2022/23

1. Introduction

1.1. The Council 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.

1.2. The Council's treasury management strategy for 2022/23 was approved at a full Council meeting on 1 March 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.

1.3. CIPFA published its revised Treasury Management Code of Practice [the TM Code] and Prudential Code for Capital Finance in December 2021. The key changes in the two codes are around the permitted reasons to borrow, knowledge and skills, and the management of non-treasury investments. The principles within the two Codes took immediate effect although local authorities could defer introducing the revised reporting requirements within the revised Codes until the 2023/24 financial year if they wish, which the Council has elected to do.

1.4. Treasury risk management at the Council is conducted within the framework of the TM Code.

2. External Context (provided by the Council's treasury management advisor, Arlingclose)

Economic background

2.1. The ongoing conflict in Ukraine has continued to put pressure on global inflation and the economic outlook for the UK and world growth remains weak. The UK political situation towards the end of the period following the 'fiscal event' increased uncertainty further.

2.2. The economic backdrop during the April to September period continued to be characterised by high commodity prices (including oil and gas prices) which were key factors in sustaining high inflation levels. This was a result of supply chain issues which were caused by the ongoing conflict between Russia and Ukraine, as well as China's zero-Covid policy. All these issues had a meaningful impact on consumers' cost of living.

2.3. Over the period, all the major Central Banks (Bank of England, Federal Reserve, European Central Banks) increase their base interest rates as they committed to tackling the sustained high inflation levels.

2.4. UK inflation remained exceedingly high. In July, annual headline CPI was reported at 10.1%, this was the highest rate for 40 years. In August, inflation fell modestly to 9.9% before increasing to 10.1% again in September.

2.5. The energy regulator, Ofgem, increased the energy price cap by 54% in April, while a further increase in the cap from October, which would have seen household energy bills average over £3,500 per annum, was dampened by the UK government stepping in to provide around £150 billion of support to limit bills to £2,500 annually until at least April 2023.

2.6. The labour market continued to show signs of tightness as employers struggled to fill vacancies with workers who have the relevant skill sets matching their requirements. The unemployment rate for April fell to 3.8% and is now back below pre-pandemic levels, although inactivity rather than demand for labour has been the key driver behind this. Pay growth in July was 5.5% for total pay (including bonuses) and 5.2% for regular pay. However, once adjusted for inflation, growth in total pay was -2.6%, whilst regular pay fell -2.8%.

2.7. With disposable income squeezed and higher energy bills still to come, consumer confidence fell to a record low.

2.8. Over the reporting period, the Bank of England increased the official Bank Rate to 2.25%. From 0.75% in March, the Monetary Policy Committee (MPC) pushed through rises of 0.25% in each of the following two MPC meetings, before hiking by 0.50% in August and again in September. The MPC has noted that domestic inflationary pressures are expected to remain strong and so given ongoing strong rhetoric around tackling inflation further Bank Rate rises should be expected.

2.9. On 23rd September the UK government, following a change of leadership, announced a raft of measures in a 'mini budget', loosening fiscal policy with a view to boosting the UK's trend growth rate to 2.5%. With little detail on how government borrowing would be returned to a sustainable path, financial markets reacted negatively. Gilt yields rose dramatically by between 0.7% - 1% for all maturities with the rise most pronounced for shorter dated gilts.

2.10. The swift rise in gilt yields left pension funds vulnerable, as it led to margin calls on their interest rate swaps and risked triggering large scale redemptions of assets across their portfolios to meet these demands. It became necessary for the Bank of England to intervene to preserve market stability through the purchase of long-dated gilts, albeit as a temporary measure, which had the desired effect with 50-year gilt yields falling over 100bps in a single day as a direct result of the intervention.

2.11. After hitting 9.1% in June 2022, annual US inflation eased in July and August to 8.5% and 8.3% respectively. The Federal Reserve also stepped up its fight against inflation with a 0.5% hike in rates in May followed by a further increase of 0.75% in June, July, and September taking policy rates to a range between 3% - 3.25%.

2.12. CPI Inflation in the Eurozone reached 9.1% year over year in August, with energy prices the main contributor but also strong upward pressure from food prices. In July the European Central Bank increased interest rates for the first time since 2011, pushing its deposit rate from –0.5% to 0% and its main refinancing rate from 0.0% to 0.5%. This was followed in September by further hikes of 0.75% to both policy rates, taking the deposit rate to 0.75% and refinancing rate to 1.25%.

Financial markets

2.13. Uncertainty remained a key factor of financial market sentiment and bond yields remained volatile, continuing their general upward trend as concern over higher inflation and higher interest rates continued to dominate. Towards the end of September, volatility in financial markets was significantly exacerbated by the UK government's fiscal plans, leading to an acceleration in the rate of the rise in gilt yields and decline in the value of sterling.

2.14. Over the first half of the financial year, the 5-year UK benchmark gilt yield rose from 1.41% to 4.40%, the 10-year gilt yield rose from 1.61% to 4.15% and the 20-year yield from 1.82% to 4.13%. The Sterling Overnight Rate (SONIA) averaged 1.22% over the period.

Credit review

2.15. Having completed its full review of its credit advice on unsecured deposits at UK and non-UK banks, in May Arlingclose extended the maximum duration limit for five UK banks, four Canadian banks and four German banks to six months. The maximum duration for unsecured deposits with other UK and non-UK banks on Arlingclose's recommended list is 100 days. These recommendations were unchanged at the end of the period.

2.16. Arlingclose continues to monitor and assess credit default swap levels for signs of credit stress, but no changes have been made to the counterparty list or recommended durations. Nevertheless, increased market volatility is expected to remain a feature, at least in the near term and, as ever, the institutions and durations on the Council's counterparty list recommended by Arlingclose remains under constant review.

3. Local Context

3.1. On 31st March 2022, the Council had net borrowing of £700.4m 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

Type of Liability	**31.03.22 Actual** £m**
General Fund CFR	598.1
HRA CFR	404.6
Total CFR **	**1,002.7**
Less: *Other debt liabilities	(28.2)
Borrowing CFR – comprised of:	**974.5**
- External borrowing	700.4
- Internal borrowing	274.1

* finance leases, PFI liabilities and transferred debt that form part of the Authority's total debt
** subject to audit

3.2. The treasury management position on 30 September 2022 and the change over the year is shown in Table 2 on the next page.

Table 2: Treasury Management Summary

	31.03.22		30.09.22	30.09.22

Type of Borrowing / Investment	Balance (£m)	Movement (£m)	Balance (£m)	Rate (%)
Long-term borrowing	600.4	63.5	663.9	2.98
Short-term borrowing	100.0	(30.0)	70.0	2.07
Total borrowing	**700.4**	**33.5**	**733.9**	**2.89**
Short-term investments	5.0	(5.0)	0.0	0.00
Cash and cash equivalents	66.2	(5.2)	61.0	1.95%
Total investments	**71.2**	**(10.2)**	**61.0**	**1.95%**
Net borrowing	**629.2**	**43.7**	**672.9**	

4. Borrowing Update

4.1. 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 Council.

4.2. PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield. The Council does not plan to borrow to invest primarily for commercial return and is therefore unaffected by these changes and retains its ability to continue to fully access PWLB loans.

Borrowing strategy during the period

4.3. On 30 September 2022 the Council held £733.9m of loans, an increase of £33.5m (compared to 31 March 2022), as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30 September are summarised in Table 3 below.

Table 3: Borrowing Position

	31.03.22 Balance £m	Net Movement £m	30.09.22 Balance £m	30.09.22 Weighted Average Rate %	30.09.22 Weighted Average Maturity (years)
Public Works Loan Board	475.4	63.5	538.9	2.57	29
Banks (LOBO)	125	0.0	125.0	4.72	38
Local authorities (short-term)	100.0	(30.0)	70.0	2.07	0
Total borrowing	**700.4**	**33.5**	**733.9**	**2.89**	**28**

4.4. As outlined in the treasury strategy, the Council'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 Council's strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio.

4.5. Over the April – September 2022 period, short-term rates rose significantly, especially in late September after the then Chancellor's announced a 'mini-budget', which included unfunded tax cuts by the Government and additional borrowing to fund consumer energy price subsidies.

4.6. Exceptional volatility in the financial markets threatened financial stability, requiring the Bank of England to intervene in the gilt market. Over a 24-hour period some PWLB rates increased to over 6%, before the intervention had the desired effect, brining rates back down by over 1% for certain maturities. A truly unprecedented period in fixed markets, with a direct impact on the cost of borrowing.

4.7. Interest rates rose by over 2% during the period in both the long and short term rates. As an indication, the 5-year maturity certainity rate rose from 2.30% on 1st April to 5.09% on 30th September; over the same period the 30-year maturity certainty rate rose from 2.63% to 4.68%.

4.8. In keeping with the Council's Treasury Management Strategy, £70m of new long term borrowing was undertaken during the period. This was reduced by £6.5m of repayments on existing loans which were allowed to mature without immediate replacement.

4.9. The Council has a significant capital programme which extends into the foreseeable future. A large proportion of this will be financed by borrowing, which the Council will have to undertake during the current and upcoming years. The Council's treasury advisor, Arlingclose undertakes a weekly 'cost of carry' analysis which informs the Council on when it is financially beneficial to undertake borrowing.

4.10. The Council's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short and long-term borrowing is maintained.

LOBO Loans

4.11. The Authority continues to hold £125m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at 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 year.

5. Treasury Investment Activity

5.1. CIPFA's revised Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes defines treasury management investments as those which arise from the Council'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.

5.2. 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 ranged between £71.2m and £38.0 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

Investments	**31.03.22**	**Net**	**30.09.22**	**30.09.22**	**30.09.22**

	Balance £m	Movement £m	Balance £m	Rate of Return %	Weighted Average Maturity (Days)
Money Market Funds	0.0	20.0	20.0	2.04%	1
UK Government:					
- Local Authorities	5.0	(5.0)	0.0	0.00%	0
- Debt Management Office	66.2	(25.2)	41.0	1.90%	1
Total investments	**71.2**	**(10.2)**	**61.0**	**1.95%**	**1**

5.3. 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 treasury investments before seeking the optimum 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.

5.4. The increases in Bank Rate over the period under review, and with the prospect of more increases to come, short-dated cash rates, which ranged between 0.7% - 1.5% at the end of March, rose by around 1.5% for overnight maturities and by nearly 3.5% for 9-12 month maturities.

5.5. At the end of September, the rates on Debt Management Account Deposit Facility (DMADF) deposits ranged between 1.85% and 3.50%. The return on sterling low volatility net asset value (LVNAV) Money Market Funds ranged between 1.80% and 2.05% at the end of September.

5.6. 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	Weighted Average Maturity (Days)	Rate of Return
31.03.2022	**4.46**	**AA-**	**44%**	**110**	**0.06%**
30.09.2022	**3.40**	**AA**	**33%**	**1**	**1.95%**
Similar Local Authorities	**4.32**	**AA-**	**63%**	**36**	**1.31%**
All Local Authorities	**4.29**	**AA-**	**55%**	**18**	**1.47%**

Scoring:
AAA = highest credit quality = 1; D = lowest credit quality = 26
Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

Non-Treasury Investments

5.7. The definition of investments in CIPFA's revised 2021 Treasury Management Code covers all the financial assets of the Council as well as other non-financial assets which the Council 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).

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

Treasury Performance

5.9. Treasury investments generated an average rate of return of 1.04% in the first half of the financial year. The Council's treasury investment income for the year is likely to be above the budget forecast due to the increase in interest rates during the first half of 2022.

5.10. Borrowing costs for 2022/23 are forecast in line with budget at Q2 at £26.2m (£14.9m HRA, £11.3m General Fund).

6. <u>Compliance</u>

6.1. The Chief Finance Officer reports that all treasury management activities undertaken during the first half of the year complied fully with the principles in the Treasury Management Code and the Council's approved Treasury Management Strategy.

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

Table 6: Debt Limits

	30.09.22 Actual £m	2022/23 Operational Boundary £m	2022/23 Authorised Limit £m	Complied?
Borrowing	733.9	1,236.0	1,286.0	Yes
PFI and Finance Leases	28.2	23.4	25.7	Yes
Total debt	**762.1**	**1,259.4**	**1,311.7**	**Yes**

6.3. 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, however, the Council's debt remained well below this limit at all points in the financial year.

Treasury Management Indicators

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

Security

6.5. The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	30.09.22 Actual	2022/23 Target	Complied?
Portfolio average credit score	3.40 (AA)	7.0 (A-)	Yes

Liquidity

6.6. The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing.

	30.09.22 Actual	2022/23 Target	Complied?
Total cash available within 3 months	61.0	10.0	Yes

Interest Rate Exposures

6.7. This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interests was:

Interest rate risk indicator	30.09.22 Actual	2022/23 Target	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	£0.10m	£1m	Yes
Upper limit on one-year revenue impact of a 1% fall in interest rates	£0.10m	£1m	Yes

6.8. The impact of a change in interest rates is calculated on the assumption that maturing loans and investment will be replaced at current rates.

Maturity Structure of Borrowing

6.9. 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:

	30.09.22 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	11.5%	50%	0%	Yes
12 months and within 24 months	3.8%	40%	0%	Yes
24 months and within 5 years	4.9%	40%	0%	Yes
5 years and within 10 years	7.5%	40%	0%	Yes
10 years and within 20 years	13.5%	40%	0%	Yes
20 years and within 30 years	5.8%	40%	0%	Yes
30 years and with 40 years	19.6%	50%	0%	Yes
40 years and within 50 years	33.4%	50%	0%	Yes
50 years and above	0.0%	40%	0%	Yes

6.10. 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.

6.11. The Council has used short term borrowing (under 1 year in duration) from other local authorities extensively in previous years, as an alternative to longer term borrowing from PWLB, due to lower interest rates at the time, and corresponding revenue savings.

6.12. However, short term borrowing exposes the Council to refinancing risk: the risk that rates rise quickly over a short period of time and are at significantly higher rates when loans mature, and new borrowing has to be raised. With this in mind, the Council has set a limit on the total amount of short-term local authority borrowing, as a proportion of all borrowing.

Short term borrowing	Limit	30.09.22	Complied?
Upper limit on short-term borrowing from other local authorities as a percentage of total borrowing	30%	9.54%	Yes

Principal Sums Invested for Periods Longer than a year

6.13. 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	Nil	Nil	Nil
Limit on principal invested beyond year end	£10m	£10m	£10m
Complied?	Yes	Yes	Yes

7. Economic Outlook (provided by the Council's treasury management advisor, Arlingclose on 26 September 2022)

	Current	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25
Official Bank Rate													
Upside risk	0.00	0.50	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	**2.25**	**4.25**	**5.00**	**5.00**	**5.00**	**5.00**	**5.00**	**5.00**	**5.00**	**4.75**	**4.25**	**3.75**	**3.25**
Downside risk	0.00	-1.00	-1.00	-0.75	-0.50	-0.50	-0.50	-0.75	-1.25	-1.50	-1.75	-1.75	-1.75

7.1. Arlingclose expects the Bank Rate to rise further during 2022/23 to reach 5% by the end of the year.

7.2. The MPC is particularly concerned about the demand implications of fiscal loosening, the tight labour market, sterling weakness and the willingness of firms to raise prices and wages.

7.3. The MPC may therefore raise the Bank Rate more quickly and to a higher level to dampen aggregate demand and reduce the risk of sustained higher inflation. Arlingclose now expects Bank Rate to peak at 5.0%, with 200bps of increases this calendar year.

7.4. This action by the MPC will slow the economy, necessitating cuts in Bank Rate later in 2024.

7.5. Gilt yields will face further upward pressure in the short term due to lower confidence in UK fiscal policy, higher inflation expectations and asset sales by the BoE. Given the recent sharp rises in gilt yields, the risks are now broadly balanced to either side. Over the longer term, gilt yields are forecast to fall slightly over the forecast period.